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

18 October 2012

Our Ref: JC

Dear Sir/Madam

Post-implementation review of certain aspects of the consolidation tax cost setting process

We welcome the opportunity to provide comments on the Board of Taxation's discussion paper that covers the second stage of its post-implementation review of certain aspects of the consolidation regime. Please find our comments on the paper in the attachment.

We are broadly supportive of the majority of the Board's proposals:

- While we agree with the Board's view that there may be currently duplication of deductible liabilities, we would also suggest that there are situations where double taxation may arise and have concerns with the Board's preferred approach to introduce an 'assumption of liability' rule, particularly from a compliance perspective
- We agree with the proposal to remove deferred tax liabilities (**DTLs**) from the entry and exit allocable cost amount (**ACA**) calculations
- We agree that subsection 705-70(1A) should be removed if DTLs are removed from the entry and exit ACA calculations
- We agree that section 705-80 should be removed in full acquisition scenarios (involving the acquisition of all of the membership interests in a joining entity whether or not the joining entity was previously a member of another consolidated group)
- We do not agree that the tax cost of all assets should be capped.

We have also highlighted in section 7 of this submission other issues with liabilities that the Board may wish to consider as part of its review.

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We also understand that Aldrin De Zilva has discussed with Keith James his interest in and appointment to the expert review panel in the review process going forward.

Yours sincerely

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1 Liabilities held by a joining entity

Question 2.1(a)

Do stakeholders agree with the Board's analysis in this chapter? Why, or why not?

We agree with the Board's view that there is duplication of liabilities. However, we query whether any amendments are necessary. In relation to the Board's preferred solution, which is to deem deductible liabilities to be assumed by the head company, at their accounting value, at the joining time, we note that an equivalent rule has already been introduced for taxpayers in respect of some liabilities under the taxation of financial arrangement (**TOFA**) rules.

Section 715-375, which was amended by Tax Laws Amendment (2012 Measures No. 2) Bill 2012, deems liabilities of a joining entity to have been assumed by the head company of the acquiring consolidated group (that is subject to the TOFA rules) for receiving a payment equal to either the amount of the liability determined in accordance with the joining entity's 'accounting principles for tax cost setting' or its 'Division 230 starting value'. The joining entity's 'accounting principles for tax cost setting' are defined as 'the accounting principles that the entity would use if it were to prepare its financial statements just before the joining time'. The Division 230 starting value of a liability depends on which elective method applies to the financial arrangement, and is the liability according to the relevant standards for the particular elective method.

In this regard, we note that the ATO's statistics indicate that all large business & international (**LB&I**) taxpayers are subject to the TOFA rules[1]. These taxpayers, whom would predominantly operate through tax consolidated groups, are, therefore, already required to apply an 'assumption of liability' rule that is equivalent to the Board's preferred solution. We note that section 715-375 only applies to liabilities that are, or form part of, financial arrangements under the TOFA rules. In this regard, we note that the Board has made specific reference to deductible provisions, derivatives and foreign currency loans as examples of the types of liabilities that can result in duplication. Foreign currency loans would be financial arrangements under the TOFA rules as would most derivatives.

While provisions would typically not constitute financial arrangements, we query whether it is appropriate to introduce the Board's preferred solution for provisions given that the requirement to track those provisions after the joining time would impose an onerous compliance burden upon taxpayers. A similar compliance burden arose under CGT event L7, which was one of the reasons for its repeal by the Tax Laws Amendment (2010 Measures No. 1) Bill 2010. The explanatory memorandum to the bill made specific reference to the 'unreasonable compliance cost burden' imposed on groups having to track individual liabilities that are typically recognised on a pooled basis.[2]

We understand that many small to medium sized enterprises (**SMEs**) may not be subject to the TOFA rules with the result that any 'assumption of liability' rule is likely to have more significant ramifications for such taxpayers. We note that the ATO defines SMEs as businesses with an annual turnover of between $2 million and $100 million. Accordingly, we query whether the potential loss to the revenue justifies the compliance costs that would be faced by such taxpayers having to track deductible liabilities following an acquisition. For those SME taxpayers that are not subject to the TOFA rules, they would be required to track all forms of deductible liabilities whether they be provisions or otherwise.

In summary, we understand the Board's concerns but have significant reservations in relation to the Board's preferred solution. We also note that the focus of Chapter 2 of the report appears to be duplication of losses on liabilities. The Board's references to 'deductible liabilities' and consolidated groups having an 'unintended advantage' over other taxpayers who are unable to, or choose not to form a consolidated group,

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[1] 'TOFA – three years in'. Ross Brookes (ATO), James Beeston (ATO) and Julian Cheng (Deloitte), NSW 5th Annual Tax Forum, 17 May 2012

[2] Paragraph 5.285

fails to recognise that consolidated groups may be disadvantaged under the current rules vis-à-vis taxpayers that fall outside of the consolidation rules. That is, there is currently duplication of gains which, to some extent, offsets the duplication of losses identified by the Board.

1.1 Duplication of gains

The following example illustrates the duplication of gains that currently exists:

Example 1.1

The facts are:

- Company A is a subsidiary of Vendor Co and a member of the Vendor Co consolidated group
- Company A was incorporated within that consolidated group with issued share capital of $100
- Company A subsequently borrowed the equivalent of A$100 in a foreign currency which it used to purchase land. This liability would not be taken into account in any entry ACA calculation as it arose after the joining time
- Vendor Co sells its shares in Company A to Purchaser Co
- Neither Vendor Co nor Purchaser Co are subject to the TOFA rules
- At the time of the sale, there is an unrealised foreign exchange gain equivalent to A$20 on the foreign currency borrowing such that the borrowing is recognised at A$80 in the accounts. A DTL of $6 is recorded in recognition of the temporary timing difference
- The consideration for the sale is $114, which is the net asset position of Company A (and its market value) as per its balance sheet at the time of the sale:

Assets	$	Liabilities and equity	$
Cash at bank	100	Foreign currency loan	80
Land	100	DTL	6
		Retained earnings	14
		Share capital	100
	200		200

- Company A repays the loan immediately after its acquisition by Purchaser Co.

Vendor Co's disposal of Company A

Vendor Co's exit allocable cost amount (**ACA**) for its shares in Company A will be worked out under Division 711 as follows:

Step	Description	$	Provision
1	Terminating value of assets	200	
4	Accounting liabilities	(86)	711-45(1)
4	Adjustment for unrealised gains and losses	(20)	711-45(5)
5	Exit ACA	94	

Accordingly, Vendor Co's cost base for its shares in Company A is $94. As Vendor Co receives $114 for those shares, it makes a capital gain of $20 (assuming the shares in Company A are not held on revenue account). Effectively, the unrealised foreign exchange gain on the borrowing has been converted to a capital gain. Vendor Co's pre-tax economic gain is $20 being the proceeds of $120 less the investment in Company A of $100 (the share capital subscribed for).

Purchaser Co's acquisition of Company A

Purchaser Co's entry ACA for its shares in Company A will be worked out under Division 705 as follows:

Step	Description	$	Provision
1	Cost of membership interests	114	
2	Accounting liabilities	86	705-70
2	Adjustment for unrealised gains and losses	-	705-80
8	Entry ACA	200	

As Company A has no losses (having been disposed of by another consolidated group), there should be no adjustment under section 705-80 because if the unrealised foreign exchange gain on the loan were taken into account at the same time as under the accounting standards, there would have been taxable income of $20 that would have given rise to a provision for income tax of $6. This would effectively replace the deferred tax liability of $6 taken into account at step 2. The entry ACA under the notional ACA calculation would also be $200.

The final ACA of $200 would be allocated to cash at bank ($100) and land ($100).

When the loan is repaid, Purchaser Co would currently make a gain of $20 under Division 775 (forex realisation event 4). If Company A were then liquidated, Purchaser Co would receive cash of $114. Accordingly, Purchaser Co would make no economic gain or loss since it provided consideration of $114 to acquire Company A.

It can be seen from Example 1.1 that the foreign exchange gain on the loan of $20 is included in assessable income twice. The vendor's capital gain of $20 effectively represents the unrealised foreign exchange gain while the purchaser includes the gain of $20 in its assessable income when it repays the loan. However, only the vendor recognises an economic gain on the disposal of its shares.

The next example illustrates the outcomes under Example 1.1 where the Board's preferred option – the 'assumption of liability' rule – is adopted.

Example 1.2

Assume the same facts as in Example 1.1 but that Purchaser Co is taken to assume the foreign currency loan of Company A for its accounting value of $80 under a specific 'assumption of liability' rule. Purchaser Co would not, therefore, be assessable on the foreign exchange gain of $20 on repayment of the loan. Accordingly, the purchase price would be increased from $114 to $120 (assuming the DTL is no longer taken into account, it would not reduce the consideration).

Vendor Co's disposal of Company A

Vendor Co's exit ACA for its shares in Company A is still $94. Accordingly, Vendor Co's cost base for its

shares in Company A is $94 (unchanged from Example 1.1). As Vendor Co receives $120 for those shares, it makes a capital gain of $26 (assuming the shares in Company A are not held on revenue account). Effectively, the unrealised foreign exchange gain on the borrowing has been converted to a capital gain. However, as the DTL is still recognised at step 4, the capital gain is $26 instead of $20.

Vendor Co's economic gain is $20 being the proceeds of $120 less the investment in Company A of $100 (the share capital subscribed for).

Purchaser Co's acquisition of Company A

Purchaser Co's entry ACA for its shares in Company A will be worked out under Division 705 as follows:

Step	Description	$	Provision
1	Cost of membership interests	120	
2	Accounting liabilities	86	705-70
2	Adjustment for liability valued differently for joined group	(6)	705-70(1A)
2	Adjustment for unrealised gains and losses	6	705-80
8	Entry ACA	206	

Although there is a DTL of $6 within Company A, this will not be recognised by Purchaser Co because it will be taken to have assumed the foreign currency loan for its accounting value of $80 (instead of inheriting the loan at its historical tax value of $100 as is currently the case). Accordingly, the amount of the DTL taken into account under step 2 should be reduced to nil under subsection 705-70(1A).

In relation to the foreign currency loan, there would appear to be an increase to the entry ACA of $6 under section 705-80. This is because if the unrealised foreign exchange gain on the loan were taken into account at the same time as under the accounting standards, there would have been taxable income of $20 that would have given rise to a provision for income tax of $6. Unlike a DTL, this amount would not be adjusted under subsection 705-70(1A). The entry ACA under the notional ACA calculation would be $206.

The final ACA of $206 that would be allocated to cash at bank ($100) and to land ($106).

When the loan is repaid, Purchaser Co should not make any gain or loss under Division 775 (forex realisation event 4). This assumes that the 'assumption of liability' rule that is introduced allows the accounting value of the loan to fall within the definition of 'proceeds of assuming the obligation in section 775-95. If so, that amount would be $80, which would equal the amount paid in respect of the event.

If Company A were then liquidated, Purchaser Co would receive cash of $120. Accordingly, Purchaser Co would make no economic gain or loss since it provided consideration of $120 to acquire Company A. It is noted, however, that it would make a tax loss of $6 on the land.

It can be seen that under Example 1.2, the foreign exchange gain of $20 would not be duplicated if an appropriate 'assumption of liability' rule were introduced. The gain is effectively recognised only once by Vendor Co on the disposal of the shares in Company A. However, for the reasons given earlier, we consider that most taxpayers would be prepared to overlook this duplication of gains given the practical difficulties and compliance costs involved with the Board's preferred solution (and given that the expected tax liability would be factored into the price).

1.2 Progressive acquisitions

We also note that the ATO has prepared a number of examples that are not contained in the Board's report. In the context of progressive acquisitions, the examples do not cover an unrealised gain on a foreign currency loan. We have considered a foreign exchange gain scenario below.

Example 1.3

The facts are:

- A Co is 40% owned by Z Co and 60% owned by X Co
- Z Co contributed $40 of share capital and X Co contributed $60
- A Co borrows the equivalent of A$100 in a foreign currency which it uses to acquire land
- A Co's balance sheet at this time is as follows:

Assets	**$**	**Liabilities and equity**	**$**
Cash at bank	100	Foreign currency loan	100
Land	100	Share capital	100
	200		200

- Z Co later acquires all of X Co's shares in A Co and forms a consolidated group
- A Co's balance sheet at the joining time is:

Assets	**$**	**Liabilities and equity**	**$**
Cash at bank	100	Foreign currency loan	50
Land	100	DTL	15
		Retained earnings	35
		Share capital	100
	200		200

- The consideration given by Z Co is $81. This is 60% of the net assets of $135 as per the balance sheet above (assuming the DTL is taken into account in pricing the transaction)
- Assume none of the entities are subject to the TOFA rules.

X Co's disposal of A Co

X Co's tax position is as follows:

	$
Capital proceeds	81
Cost base	60
Capital gain/(loss)	21

The capital gain effectively represents 60% of the unrealised gain of $50 on the foreign currency loan ($30)

less 60% of the DTL of $15 in respect of that unrealised gain ($9).

Z Co's acquisition of A Co

Z Co's entry ACA for its shares in A Co is currently worked out under Division 705 as follows:

Step	Description	$	Provision
1	Cost of membership interests	121[3]	
2	Accounting liabilities	65	705-70
2	Adjustment for future deduction	-	705-75
2	Adjustment for unrealised gains and losses	-	705-80
8	Entry ACA	186	

The adjustment under section 705-80 is worked out as follows:

Step	Description	Initial $	Notional $
1	Cost of membership interests	121	121
2	Accounting liabilities	65	65[4]
8	Entry ACA	186	186

The ACA of $186 would be allocated to cash ($100) and land ($86).

If the foreign currency loan is repaid, Z Co would recognise a foreign exchange gain of $50.

It can be seen from Example 1.3 that duplication of the foreign exchange gain also arises in a progressive acquisition scenario. X Co has effectively recognised 60% of the unrealised gain as a capital gain on the disposal of its shares in A Co. Notwithstanding this, when the loan is repaid, Z Co still recognises the entire unrealised gain of $50 when the loan is repaid.

The position under Example 1.3 where an 'assumption of liability' rule applies is considered below.

Example 1.4

Assume the same facts as in Example 1.3 but that Z Co is taken to assume the foreign currency loan of A Co for its accounting value of $50 under a specific 'assumption of liability' rule. Z Co would not, therefore, be assessable on the foreign exchange gain of $50 on repayment of the loan. Accordingly, the purchase price would be increased from $81 to $90 (assuming the DTL is no longer taken into account, it would not reduce the consideration).

X Co's disposal of A Co

X Co's tax position is as follows:

3 $81 + $40
4 DTL of $15 converts to a provision for tax of the same amount

	$
Capital proceeds	90
Cost base	60
Capital gain/(loss)	30

The capital gain represents 60% of the unrealised gain of $50 on the foreign currency loan ($30).

Z Co's acquisition of A Co

Z Co's entry ACA for its shares in A Co is currently worked out under Division 705 as follows:

Step	Description	$	Provision
1	Cost of membership interests	130[5]	
2	Accounting liabilities	65	705-70
2	Adjustment for future deduction	-	705-75
2	Adjustment for unrealised gains and losses	-	705-80
8	Entry ACA	195	

The adjustment under section 705-80 is worked out as follows:

Step	Description	Initial $	Notional $
1	Cost of membership interests	130	130
2	Accounting liabilities	65	65[6]
8	Entry ACA	195	195

The ACA of $195 would be allocated to cash ($100) and land ($95). If A Co were wound up, Z Co would make an pre-tax economic gain of $20[7]. However it would only make a tax gain of $5 on the disposal of the land. Z Co would not recognise any foreign exchange gain or loss on repayment of the loan.

It can be seen that the duplication of the foreign exchange gain is removed in Example 1.4. Again, we do not consider that the avoidance of gain or loss duplication justifies the compliance costs that will arise from the Board's preferred solution.

Question 2.1(b)

Do stakeholders agree with the Board's preferred solution to the issues? Why, or why not?

[5] $90 + $40
[6] DTL of $15 converts to a provision for tax of the same amount
[7] Cash on wind up of $150 less the acquisition cost of $130

For the reasons given earlier, we do not agree with the Board's preferred solution.

Our comments on the other options are set out below.

1.3 Other options

1.3.1 Option 2

This option involves denying the deduction for deductible liabilities (equal to the step 2 amount) after the entity has joined the consolidated group

We agree that this option would require tracking of deductible liabilities after the joining time and, for the reasons given earlier in relation to the Board's preferred solution, we do not support it.

We also note that the option only refers to deductible liabilities. We note that there may also be unrealised gains on foreign exchange loans which, as noted earlier, may currently be duplicated. This option would also need to ensure that those gains were not assessable when the loan is settled after the joining time.

Consideration would also need to be given to foreign exchange loans where there is an unrealised loss at the joining time which moves to an unrealised gain by the time of settlement (or vice versa).

1.3.2 Option 3

This option proposes to disregard deductible liabilities at step 2 of the entry ACA. Although from a compliance costs perspective, this option is more attractive than the Board's preferred option and option 2, we do not endorse this option at all. In addition to the risk of significant distortions to the tax cost setting amounts of assets, is also likely to give rise to greater incidences of CGT event L3.

1.3.3 Option 4

Under this option, the acquiring consolidated group will be deemed to have realised a capital gain at the joining time equal to the final step 2 amount for deductible liabilities.

We do not support this option. There would be a mismatch between the timing and characterisation of the deemed capital gain and the deduction that would be available upon settlement of the deductible liabilities. Furthermore, in the case of an unrealised foreign exchange gain on a foreign currency loan, this option would presumably recognise a capital loss at the joining time which, although can be carried forward, would not be offset against the amount included in assessable income in respect of the gain when the loan is settled.

Question 2.1(c)

Are there additional types of liabilities (other than those covered by the TOFA and insurance regimes) that should be excluded from the operation of the Board's preferred solution? If so, what are these liabilities? Should these particular types of liabilities have a particular solution?

We are not aware of any liabilities that should be excluded.

Question 2.1(d)

The Board considered that the implementation of the preferred solution should have manageable ongoing compliance costs. Do stakeholders agree? If not please provide specific details of the compliance costs involved.

We have highlighted our concerns with the expected compliance costs that will arise from the Board's preferred solution and do not consider that they will be manageable. Given that the liabilities to which any 'assumption of liability' rule applies are not likely to be identified separately in the accounts from similar

liabilities that arise after the joining time, the difficulties in tracking those liabilities are evident. For example, if a joining entity with a provision for annual leave is acquired by a consolidated group, that provision is unlikely to be separately recognised from other provisions for annual leave that are subsequently raised (which was one of the issues identified with CGT event L7). Furthermore, the provision may be settled for more or less than its accounting value at the joining time.

Question 2.1(e)

If the Board's preferred solution is adopted, do any inappropriate consequences arise when the acquirer or the purchaser is not a member of a consolidated group? If so, what are those consequences and how can they be resolved?

We note that inappropriate consequences can arise if the vendor is not a member of a consolidated group. Consider the following examples:

Example 1.5

The facts are:

- A Co is held by a discretionary trust
- A Co's balance sheet is:

Assets	$	Liabilities and equity	$
Cash at bank	100	Provision	100
Deferred tax asset (**DTA**)	30	Retained earnings	(70)
		Share capital	100
	130		130

- Purchaser Co, which is the head company of a consolidated group, would currently acquire all of the trust's shares in A Co for $30
- Assume Purchaser Co is not subject to the TOFA rules
- The trust would make a capital loss of $70, which would equal its economic loss.

Purchaser Co's acquisition of A Co

Purchaser Co's entry ACA for its shares in A Co is currently worked out under Division 705 as follows:

Step	Description	$	Provision
1	Cost of membership interests	30	
2	Accounting liabilities	100	705-70
2	Adjustment for future deduction	(30)	705-75
2	Adjustment for unrealised gains and losses	-	705-80
8	Entry ACA	100	

The adjustment under section 705-80 is worked out as follows:

Step	Description	Initial $	Notional $
1	Cost of membership interests	30	30
2	Accounting liabilities	70	100
6	Acquired losses		(30)
8	Entry ACA	100	100

The final ACA of $100 would be allocated to cash. Purchaser Co would also recognise a deduction of $100 on settlement of the provision.

Example 1.6

- Consider the facts in Example 1.5 except that Purchaser Co is taken to have assumed the provision for its accounting value of $100 at the joining time
- Purchaser Co would give nil consideration as it would no longer pay for an expected future deduction for the provision
- The trust would make a capital loss of $100, which would equal its economic loss.

Purchaser Co's acquisition of A Co

Purchaser Co's entry ACA for its shares in A Co would be worked out under Division 705 as follows:

Step	Description	$	Provision
1	Cost of membership interests	-	
2	Accounting liabilities	100	705-70
2	Adjustment for future deduction	-	705-75
2	Adjustment for unrealised gains and losses	(30)	705-80
8	Entry ACA	70	

The adjustment above under section 705-80 for unrealised gains and losses is worked out as follows:

Step	Description	Initial $	Notional $
1	Cost of membership interests	-	-
2	Accounting liabilities	100	100
6	Acquired losses		(30)
8	Entry ACA	100	70

It can be seen that, in addition to being denied a deduction on settlement of the provision, Purchaser Co

would make a capital gain under CGT event L3 of $30 since the tax cost setting amount of the cash at bank would be $100 would there would only be ACA of $70.

Although the outcome under Example 1.6 demonstrates an anomaly should the 'assumption of liability' rule to the facts of that example, we note that the Board's paper is considering the removal of section 705-80 in full acquisition scenarios. If this change were introduced, the entry ACA under Example 1.6 would be $100, which would be allocated entirely to the cash at bank. CGT event L3 would not happen and the correct tax and economic outcome would arise.

Question 2.1(f)

If the Board's preferred solution is adopted, do any transitional issues arise? If so, what are those transitional issues? How should they be resolved?

A key transitional issue will be the pricing of transactions that are being negotiated at or around the time from which any proposed changes takes effect. It will be important to avoid a scenario where the parties have agreed a price that takes into account, for example, a future deduction on a liability but the purchasing consolidated group finds itself subject to an 'assumption of liability' rule that means it will no longer be entitled to the benefit of that deduction.

Accordingly, we propose that there should be a rule similar to that introduced when the changes to the scrip for scrip roll-over rules in Subdivision 124-M for corporate restructures were introduced. The changes were announced on 13 May 2008[8] and applied to arrangements entered into after 7:30pm on that day. The legislation, once enacted, provided that:

- If an arrangement involves a scheme of arrangement (within the meaning of the *Corporations Act 2001*), the amendments will apply in relation to the arrangement if a court orders, under subsection 411(1) of the *Corporations Act 2001*, a meeting of a company's members, or one or more classes of a company's members, about the arrangement and the application for the order was made after 7.30 pm on 13 May 2008
- If an arrangement does not involve a takeover bid or a scheme of arrangement, the amendments will apply in relation to the arrangement if a decision to enter into the arrangement was not made before 7.30 pm on 13 May 2008.

Similar detail could be provided in any announcement of changes to the treatment of deductible liabilities so that taxpayers had certainty as to whether or not the changes applied to their transaction.

[8] Media Release No. 33 of 2008

2 Deferred tax liabilities

Question 3.1(a)

Do you agree with the Board's proposal to remove deferred tax liabilities from the entry and exit allocable cost calculations? If not please provide examples outlining when and why these liabilities need to be retained in the calculations.

We agree with the Board's proposal to remove DTLs from the entry and exit ACA calculations. For the purposes of completeness, we have highlighted some further examples for the Board's consideration.

2.1 DTLs in respect of unrealised gains

We note that the modelling undertaken by the Board did not wholly address each of the scenarios that may arise where a joining entity carries a DTL in its accounts in respect of an unrealised gain and both:

- The purchase price takes into account the future taxable amount
- The allocable cost calculations exclude DTLs.

Accordingly, we have undertaken additional modelling in order to determine the implications of such a scenario. At the outset we note that scenarios A and B of Examples 2.1 and 2.2 effectively replicate the modelling in examples 1 and 2 of set 5. Our results are analogous to those obtained under those scenarios. We have included scenario C, however, which contemplates a scenario where DTLs are excluded from the ACA calculations and do not affect the purchase price (which might arise if the Board's proposed 'assumption of liability' rule is adopted).

Example 2.1

The facts are:

- Company A is a subsidiary of Vendor Co and a member of the Vendor Co consolidated group
- Company A was incorporated within that consolidated group with issued share capital of $100
- Company A subsequently borrowed the equivalent of A$100 in a foreign currency to purchase land
- Vendor Co sells its shares in Company A to Purchaser Co
- The balance sheet of Company A prior its sale is as follows:

Assets	**$**	**Liabilities and equity**	**$**
Cash at bank	100	Share capital	100
Land	100	Loan	70
		Forex reserve	21
		DTL	9
	200		200

- The example considers three scenarios:
  - Scenario A – DTL included in ACA and factored into purchase price
  - Scenario B – DTL not included in ACA but factored into purchase price
  - Scenario C – DTL not included in ACA and not factored into purchase price (based on Board's 'assumption of liability' rule).

Vendor Co's disposal of Company A

Vendor Co's exit ACA for its shares in Company A will be determined under Division 711 as follows:

Step	Description	Scenario A	Scenario B	Scenario C	Provision
1	Terminating value of assets	200	200	200	
4	Accounting liabilities	(79)	(70)	(70)	711-45(1)
4	Adjustment for unrealised gains and losses	(30)	(30)	(30)	711-45(5)
5	Exit ACA	91	100	100	

The tax and economic outcomes for Vendor Co are set out below:

	Scenario A	Scenario B	Scenario C
Proceeds	121	121	130
Investment in Company A	100	100	100
Economic gain/(loss)	21	21	30
Proceeds	121	121	130
Tax cost of shares	91	100	100
Tax gain/(loss)	30	21	30

It can be seen that where the DTL is ignored in the exit ACA calculation (Scenarios B and C), the tax and economic outcomes for Vendor Co are equal. However, under Scenario A, the tax gain is $30, the excess of $9 over the economic gain of $21 being attributable to inclusion of the DTL at step 4 of the exit ACA calculation.

Purchaser Co's acquisition of Company A

Purchaser Co's entry ACA for its shares in Company A will be determined under Division 705 as follows:

Step	Description	Scenario A	Scenario B	Scenario C	Provision
1	Cost of membership interests	121	121	130	
2	Accounting liabilities	79	70	70	705-70
2	Adjustment for unrealised gains and losses	-	9	9	705-80
8	Entry ACA	200	200	209	

In relation to Scenario A, section 705-80 would not result in any adjustment to the entry ACA. This is because the DTL would be replaced by a provision for tax of $9 under the notional ACA calculation. However, in relation to Scenarios B and C, as there is no DTL that is currently recognised, there would be an upwards adjustment to the ACA of $9 under section 705-80 due to the recognition of a provision for tax of

$9 would be recognised under the notional ACA calculation.

The final ACA will be allocated to Company A's assets as follows:

Asset	Scenario A	Scenario B	Scenario C
Cash	100	100	100
Land	100	100	109

Sale of shares in Company A

Purchaser Co subsequently disposes of its shares in Company A.

Having regard to each of the three scenarios discussed above, Purchaser Co's exit ACA would be determined under Division 711 as follows:

Step	Description	Scenario A	Scenario B	Scenario C	Provision
1	Terminating value of assets	200	200	209	
4	Amount of liability used purposes of calculating ACA on entry	(79)	(79)	(79)	711-45(8)
5	Exit ACA	121	121	130	

Assuming that Purchaser Co held the shares in Company A are held on capital account, the following table sets out the relevant tax and economic outcomes:

	Scenario A	Scenario B	Scenario C
Proceeds	121	121	130
Cost of acquiring Company A	121	121	130
Economic gain/(loss)	-	-	-
Proceeds	121	121	130
Tax cost	121	121	130
Tax gain/(loss)	-	-	-

Overall, while the income tax outcome for Purchaser Co is consistent with the economic outcome, as noted earlier, the inclusion of the DTL in the exit ACA calculation for Vendor Co results in a mismatch between the tax and economic outcomes.

Liquidation of Company A

Head Co may instead choose to realise its investment in Company A by way of liquidating the company. The tax and economic outcomes are as follows:

	Scenario A	Scenario B	Scenario C
Proceeds	130	130	130
Investment in Company A	121	121	130

Economic gain/(loss)	9	9	-
Proceeds on sale of land	100	100	100
Tax cost of land	100	100	109
Tax gain/(loss) on land	-	-	(9)
Amount repaid on loan	70	70	70
Tax cost of loan	100	100	70
Tax (gain)/loss on repayment of loan	(30)	(30)	-

Two conclusions can be drawn from Example 2.1. First, the example supports the proposition that the removal of DTLs from the entry and exit ACA process results in a closer alignment of tax and economic outcomes in an acquisition case. However, scenario C, suggests that the removal of DTLs in combination with the introduction of an ‘assumption of liability’ rule may still result distort result in distortions in the tax outcome where no corresponding adjustment is made to obviate the effect of section 705-80. Despite the purchase price accurately reflecting the assumption of liability rule, the making of a section 705-80 adjustment in scenario C appears to unnecessarily compensate Purchaser Co for a forex gain that it will not be taxed on due to the operation of that rule.

Example 2.2, below, considers the effect of a DTL arising due to an unrealised gain in the context of a formation case.

Example 2.2

The facts are:

- Company A is a wholly-owned subsidiary of Head Co
- Company A borrowed the equivalent of A$100 in a foreign currency to purchase land
- Head Co elects to form a tax consolidated group of which Company A will be a subsidiary member
- The example considers two scenarios:
  - Scenario A – DTL included in ACA and factored into purchase price
  - Scenario B – DTL not included in ACA but factored into purchase price

The balance sheet of Company prior to formation of the Head Co consolidated group is as follows:

Assets	**$**	**Liabilities and equity**	**$**
Cash at bank	100	Share capital	100
Land	100	Loan	70
		Forex reserve	21
		DTL	9
	200		200

Formation of Head Co group

Head Co’s entry ACA for its shares in Company A will be worked out under Division 705 as follows:

Step	Description	Scenario A	Scenario B	Provision
1	Cost of membership interests	100	100	
2	Accounting liabilities	79	70	705-70
2	Adjustment for liability valued differently for joined group	0	0	705-70(1A)
2	Adjustment for unrealised gains and losses	21	30	705-80
8	Entry ACA	200	200	

The notional ACA calculation performed for the purposes of the adjustment required pursuant to section 705-80 is as follows:

Step	Description	Scenario A	Scenario B	Provision
1	Cost of membership interests	100	100	
2	Accounting liabilities	79	79	705-70
3	Undistributed taxed profits accruing to joined group	21[9]	21	705-90
8	Entry ACA	200	200	

The notional ACA calculation treats the unrealised gain as having been realised for income tax purposes resulting in the inclusion of the step 3 amount. The step 2 amount for each scenario is comprised of the loan liability of $70 as well as a notional provision for income tax of $9.

The final ACA will be allocated to Company A's assets as follows:

Asset	Scenario A	Scenario B
Cash	100	100
Land	100	100

Head Co sells shares in Company A

Head Co subsequently disposes of its shares in Company A.

Having regard to each of the scenarios discussed above, Head Co's exit ACA would be determined under Division 711 as follows:

Step	Description	Scenario A	Scenario B	Provision
1	Terminating value of assets	200	200	
4	Amount of liability used purposes of calculating ACA on entry	(100)	(100)	711-45(8)
5	Exit ACA	100	100	

[9] Subsection 705-90(4) applies to assume that Company A's notional franking account balance includes credits of $9 arising in respect of income tax payable on the foreign exchange gain. This same provision applies similarly for each scenario considered in Example 2.2.

Assuming that Purchaser Co held the shares in Company A are held on capital account, the following table sets out the relevant tax and economic outcomes:

	Scenario A	Scenario B
Proceeds	121	121
Investment in Company A	100	100
Economic gain/(loss)	21	21
Proceeds	121	121
Tax cost	100	100
Tax gain/(loss)	21	21

The tax and economic outcomes align in both scenarios.

Liquidation of Company A

Head Co may instead choose to realise its investment in Company A by way of liquidating the company. The tax and economic outcomes are as follows:

	Scenario A	Scenario B
Proceeds	130	130
Investment in Company A	100	100
Economic gain/(loss)	30	30
Proceeds on sale of land	100	100
Tax cost of land	100	100
Tax gain/(loss) on land	-	-
Amount repaid on loan	70	70
Amount borrowed	100	100
Tax (gain)/loss on repayment of loan	(30)	(30)

The tax and economic outcomes align in both scenarios.

In a formation case, the inclusion of DTLs do not appear to result in a mismatch between the tax and economic outcomes.

Question 3.1(b)

Are there other situations where deferred tax liabilities should continue to be recognised? Are there

alternative solutions that could achieve the same result?

We advocate for the uniform removal of DTLs from the entry and exit ACA calculations. Exceptions to such an approach would more likely result in confusion amongst taxpayers than achieve any significant benefits.

Question 3.1(b)

If deferred tax liabilities were removed from the entry and exit tax cost setting calculations do you think any additional modifications would be needed to the tax cost setting process on exit or on entry? If so, please provide detailed examples showing the need for such modifications.

We have not identified any modifications that would be required. Again, we disclose our support for the uniform removal of DTLs from the entry and exit ACA calculations and note that further modifications are likely to give rise to further confusion amongst taxpayers.

3 Adjustments to the value of liabilities

Question 4.1

The Board seeks stakeholder comment on:

(a) **Do you think that the adjustment which applies if the head company's accounting value of a liability is different to the joining entity's accounting value is relevant only to deferred tax liabilities? If so, do you think that the adjustment should be removed?**

(b) **If you do not think that the adjustment which applies if the head company's accounting value of a liability is different to the joining entity's accounting value is relevant only to deferred tax liabilities, in what other circumstances is the adjustment relevant? How can the adjustment be modified to clarify its operation?**

We have not encountered any circumstances where subsection 705-70(1A) applies to liabilities other than DTLs. Accordingly, if the consolidation rules are amended such that DTLs cease to be recognised for tax cost setting purposes, this provision would no longer be required.

Question 4.2(a)

Do you agree with the Board's proposal to remove the adjustment for unrealised gains and losses on liabilities in full acquisition cases? If not, why not?

The Board's recommendation is to remove the application of section 705-80 to full acquisition cases (involving the acquisition of membership interests in a joining entity that is not a member of another consolidated group) as they generally result in no adjustment under section 705-80. We note that the Board's reference use of the word 'generally' suggests that there are some circumstances where an adjustment may still arise. Accordingly, further details of those circumstances in which an adjustment may still arise should be considered before removing the adjustment entirely in full acquisition cases.

We have considered some examples below.

Example 3.1

The facts are:

- Sub Co is owned by two individuals
- It was incorporated with share capital of $200 and has made a loss of $100 and recognised a provision for annual leave of $100
- Sub Co was fully acquired by Parent Co, the head company of a consolidated group, for $60
- Sub Co had the following balance sheet on entry:

Assets	**$**	**Liabilities and equity**	**$**
Cash at bank	100	Provision for annual leave	100
Deferred tax asset	60	Retained earnings	(140)
		Share capital	200
	160		160

Parent Co's entry ACA for its shares in Sub Co is currently worked out under Division 705 as follows:

Step	Description	$	Provision
1	Cost of membership interests	60	
2	Accounting liabilities	100	705-70
2	Adjustment for future deduction	(30)	705-75
2	Adjustment for unrealised gains and losses	-	705-80
6	Acquired losses	(30)	
8	Entry ACA	100	

The adjustment under section 705-80 is worked out as follows:

Step	Description	Initial $	Notional $
1	Cost of membership interests	60	60
2	Accounting liabilities	100	100
2	Adjustment for future deduction	(30)	
5	Owned losses	-	-
6	Acquired losses	(30)	(60)
8	Entry ACA	100	100

No adjustment would be required under section 705-80. The entry ACA of $100 would be allocated to the cash at bank of $100.

A further point for consideration is the implications of section 705-80 as a result of the cancellation of losses under step 6 of the entry ACA calculation. Pursuant to section 707-145, a head company of the joined group can make an irrevocable choice to cancel the transfer of the loss by the joining entity such that no amount is taken into account at step 6. As demonstrated by Example 3.2 below, a section 705-80 adjustment may still arise currently.

Example 3.2

Assume the same facts as in Example 3.1 except that Parent Co made a choice pursuant to section 707-145 to cancel the loss generated by Sub Co prior to the joining time. Assume that the consideration for the acquisition is reduced from $60 to $30.

The entry ACA would be as follows:

Step	Description	$	Provision
1	Cost of membership interests	30	
2	Accounting liabilities	100	705-70
2	Adjustment for future deduction	(30)	705-75

2	Adjustment for unrealised gains and losses	30	705-80
6	Acquired losses	-	
8	Entry ACA	130	

The adjustment under section 705-80 is worked out as follows:

Step	Description	Initial $	Notional $
1	Cost of membership interests	30	30
2	Accounting liabilities	100	100
2	Adjustment for future deduction	(30)	-
5	Owned losses	-	-
6	Acquired losses	-	-
8	Entry ACA	100	130

In this case, as Parent Co makes a choice to cancel any acquired losses (it is noted that the choice is made on a loss by loss basis), although Sub Co would be taken to have incurred the provision at the same time as it was raised for accounting purposes, any additional loss would not give rise to an amount at step 6 of the notional ACA calculation.

Accordingly, Example 3.2 indicates that section 705-80 may still result in an adjustment in full acquisition cases. The Board should consider whether testing is required to determine if these adjustments are required to achieve the correct tax and economic outcomes.

We have also considered the outcome under Example 3.1 if an 'assumption of liability' rule is adopted (per the Board's proposal in chapter 2 of the report).

Example 3.3

Assume the same facts as Example 3.1 except that Parent Co is taken to have assumed the provision for its accounting value of $100 at the joining time. The main difference is that Parent Co would only give consideration of $30 for Sub Co as it would no longer pay for the $30 tax benefit associated with the provision.

Parent Co's entry ACA for its shares in Sub Co would be worked out under Division 705 as follows:

Step	Description	$	Provision
1	Cost of membership interests	30	
2	Accounting liabilities	100	705-70
2	Adjustment for future deduction	-	705-75
2	Adjustment for unrealised gains and losses	(30)	705-80
6	Acquired losses	(30)	
8	Entry ACA	70	

The adjustment under section 705-80 is worked out as follows:

Step	Description	Initial $	Notional $
1	Cost of membership interests	30	30
2	Accounting liabilities	100	100
2	Adjustment for future deduction	-	-
5	Owned losses	-	-
6	Acquired losses	(30)	(60)
8	Entry ACA	100	70

Although Parent Co would be taken to have assumed the provision for $100 at the joining time such that no deduction will arise on settlement of the provision, section 705-80 requires the notional ACA to be worked out on the assumption that the provision was taken into account for tax purposes at the same time as under the accounting standards. As this would have been when the provision was raised, Sub Co would have made a further loss of $100, hence the additional amount of $30 taken into account at step 6.

Section 705-80 results in a reduction to the entry ACA of $30. This means that there is insufficient ACA to allocate to cash at bank of $100 such that a capital gain of $30 arises under CGT event L3.

It is noted that an anomalous outcome arises under Example 3.3. That is, if the Board introduces an ‘assumption of liability’ rule, it would not be correct to say that full acquisition cases (involving the acquisition of membership interests in a joining entity that is not a member of another consolidated group) would not result in any adjustment under section 705-80. Having said that, if section 705-80 were not applied in Example 3.3, the correct tax outcome would be achieved. There would be entry ACA of $100 that would be allocated to cash at bank.

We also note that if an ‘assumption of liability’ rule is introduced (which we are not advocating for the reasons mentioned earlier), it may be possible to remove the application of section 705-80 in creeping acquisition scenarios. Consider the example below:

Example 3.4

Assume the following facts:

- Sub Co is held by a discretionary trust
- Sub Co is acquired by Purchaser Co, the head company of a consolidated group, but this acquisition takes place in two tranches – 40% initially and then 60% subsequently
- Purchaser Co is not subject to the TOFA rules
- Purchaser Co is deemed to assume the liability for its accounting value at the time that Sub Co joins its consolidated group
- Sub Co’s balance sheet at the time of the 40% acquisition is:

Assets	$	Liabilities and equity	$
Cash at bank	100	Share capital	200
Land	100		

	200		200

Accordingly, Purchaser Co pays $80 for 40% of the shares in Sub Co. There is no tax gain or loss since the cost base of the shares is $80. There is also no economic gain or loss.

Assume that:

- When the balance of 60% of the shares in Sub Co is acquired, it has the following balance sheet:

Assets	**$**	**Liabilities and equity**	**$**
Cash at bank	100	Share capital	200
Land	100	Provision	40
DTA	12	Retained earnings	(28)
	212		212

- Purchaser Co pays $96[10] for the remaining 60% of the shares in Sub Co

Sub Co joins Purchaser Co's consolidated group. Purchaser Co's entry ACA for its shares in Sub Co would be worked out under Division 705 as follows:

Step	**Description**	**$**	**Provision**
1	Cost of membership interests	176[11]	
2	Accounting liabilities	40	705-70
2	Adjustment for future deduction	-	705-75
2	Adjustment for unrealised gains and losses	(23.2)	705-80
6	Acquired losses	-	
8	Entry ACA	192.8	

The adjustment under section 705-80 is worked out as follows:

Step	**Description**	**Initial $**	**Notional $**
1	Cost of membership interests	176	176
2	Accounting liabilities	40	40
2	Adjustment for future deduction	-	-
5	Owned losses	-	(16)
6	Acquired losses	-	(7.2)
8	Entry ACA	216	192.8

[10] 60% of cash at bank of $100 and land of $100 less the provision of $100. The DTA is not taken into account because Purchaser Co will not obtain a deduction for the provision

[11] $80+$96

If section 705-80 applied, the final ACA of $192.8 would be allocated $100 to cash at bank at $92.8 to land. If Sub Co were wound up, Purchaser Co would make a tax gain of $7.2 on the land and no gain or loss on cash at bank or the provision. However, it would make an economic loss of $16 (cash of $160 received on the wind up less the purchase price of Sub Co of $176).

However, if section 705-80 were disregarded, the final ACA would be $216, which would be allocated $100 to cash at bank and $116 to land. Accordingly, on a wind up of Sub Co, there would be a tax loss of $16 on the land. The economic loss, as mentioned earlier, would also be $16.

The other scenario in which the Board proposes to remove the application of section 705-80 is where an entity is acquired by one consolidated group from another consolidated group. The Board states that section 705-80 currently gives rise to unintended outcomes because the step 2 adjustment is not replaced by a step 6 adjustment as tax losses are not transferred from the old group to the new group. We note that this would not be the case where the joining entity is the head company of a consolidated group.

4 Assets and liabilities recognised on different bases

Question 5.1(a)

Are there other instances giving rise to the asymmetry of assets and liabilities in a consolidation context? If so please outline the circumstances where this occurs.

We are not aware of any other instances giving rise to asymmetry of assets and liabilities in a consolidation context.

In relation to the securitisation example contained in the Board's report, we note that the Board's concern is that the mortgage loans of $100 held by Company B have a market value of something less than their face value due to their equitable assignment to the trust. However, the example assumes that Head Co purchases Company B for $100. This amount is based on the net asset position of Company B disclosed in its balance sheet, namely:

	$
Cash at bank	100
Mortgage loans	100
Less: Imputed loan to Trust A	(100)
	100

The example then queries whether the mortgage loans are assets or, if they are assets, that their market value is questionable. However, if Head Co is prepared to pay consideration of $100 for Company B, this suggests that the market value of the mortgage loans is $100.

If it is correct to suggest that the mortgage loans have a market value of something less than $100, say, $20, Head Co would only pay $20 for Company B. The entry ACA would be as follows:

Step	**Description**	**$**	**Provision**
1	Cost of membership interests	20	
2	Accounting liabilities	100	705-70
8	Entry ACA	120	

This would be allocated to cash ($100) and to the mortgage loans ($20). There would be no excess ACA to allocate to other assets. In this case, if the liability of $100 were not recognised at step 2, the entry ACA would be understated.

Question 5.1(b)

Do you agree with the Board's preliminary view for resolving this issue? If not, are there other approaches that should be considered?

As discussed earlier, we query whether the Board's proposal will be appropriate in relation to the securitisation example. If the Imputed loan to Trust A were not recognised, it would appear the entry ACA would be understated (assuming Head Co does not pay $100 for the Mortgage Loans on the basis that their market value is something less).

Question 5.1(c)

What are the appropriate circumstances in which assets and liabilities can be said to be related?

No comments.

5 Capping the tax cost setting amount of assets

Question 6.1(a)

Do you consider that rules should be introduced to cap the tax cost of all assets?

We do not consider that rules should be introduced to cap the tax cost of all assets. There were specific policy reasons for introducing the capping rule for trading stock, depreciating assets and revenue assets. As indicated in the Board's report, the objective of this rule was to address the potential for unrealised capital losses to be converted to revenue losses when an entity joins a consolidated group. However, paragraph 5.37 of the explanatory memorandum to the New Business Tax System (Consolidation) Bill (No 1) 2002 also stated that this "can occur where assets still held by a joining entity have declined in value after the group it is joining purchased membership interests in it". Accordingly, the rule appears to have been primarily targeted at progressive acquisition scenarios.

Question 6.1(b)

Would capping the tax cost setting amount for all assets result in greater neutrality between consolidated groups that acquire a business (by acquiring the entity that carries on the business) and entities that acquire a business directly?

Yes, but only minimally and in limited circumstances. In general, there are minimal distortions in the tax cost setting amounts of assets between consolidated groups that acquire a business (by acquiring the entity that carries on the business) and entities that acquire a business directly if the entity is acquired by way of a 100% acquisition into an existing tax consolidated group. In our view, the distortions in the tax cost of assets which are alluded to were more prevalent in cases of formation of consolidated groups, most of which occurred when the consolidation rules were first introduced on 1 July 2002.

In our opinion, capping the tax cost of assets to their market value will be inappropriate in progressive acquisition cases, because as indicated in the discussion paper, "the market value of the asset of the business at the joining time may not reflect the price paid by the acquirer over the course of the acquisition".

Consider the following example.

Example 5.1

- Sub Co is a member of a tax consolidated group of which Vendor Co is the head company
- Vendor Co disposes of 60% of Sub Co to Purchaser Co
- Sub Co has the following balance sheet at the time of disposal:

Assets	**$**	**Liabilities and equity**	**$**
Cash at bank	100	Deferred tax liability	15
Land	150	Asset revaluation reserve	35
		Share capital	200
	250		250

- Based on the above, Purchaser Co gives consideration of $141 (60% of net assets of $235)

Vendor Co's disposal of Sub Co

Vendor Co's exit ACA for its shares in Sub Co will be worked out under Division 711 as follows:

Step	Description	$	Provision
1	Terminating value of assets	200	
4	Accounting liabilities	(15)	711-45(1)
5	Exit ACA	185	

As Vendor Co initially only disposes of 60% of its shares in Sub Co, its tax cost is $111 (60% of $185). Accordingly, Vendor Co makes a capital gain of $30.

Assume:

- Vendor Co later disposes of the remaining 40% of the shares in Sub Co to Purchaser Co
- Sub Co's balance sheet at the time of this later disposal is:

Assets	$	Liabilities and equity	$
Cash at bank	100	Deferred tax liability	3
Land	110	Asset revaluation reserve	7
		Share capital	200
	210		210

- Purchaser Co gives consideration of $82.8 (40% of the net assets of $207)

Vendor Co's tax cost for the remaining 40% of its shares is $74 (40% of $185). Accordingly, Vendor Co makes a capital gain of $8.8.

As Purchaser Co now owns 100% of Sub Co, the latter joins the former's consolidated group. Purchaser Co's entry ACA is as follows:

Step	Description	$	Provision
1	Cost of membership interests	223.8[12]	
2	Accounting liabilities	3	705-70
2	Adjustment for DTL	(3)	705-70(1A)
8	Entry ACA	223.8	

The ACA would be allocated to cash at bank ($100) and land ($123.8). If the land were disposed of for its market value of $110, Purchaser Co would make a capital loss of $13.8.

If Sub Co were wound up, Purchaser Co would make an economic loss of $13.8. This is based on the proceeds of $210 that would be received on winding up Sub Co less the cost of acquiring Sub Co of $223.8. Accordingly, the tax and economic outcomes are currently the same.

[12] $141 + $82.8

In Example 5.1, if the cost of the land were capped at its market value at the joining time of $110, under the Board's proposal, there would be a capital loss of $13.8 at the joining time (assuming there is no goodwill to which the excess ACA can be allocated). No capital gain or loss would arise if the land is subsequently disposed of for $110. However, if there was goodwill, any recognition of the excess ACA would be deferred until such time as Sub Co or the business itself is disposed of. This deferral is, in our view, inappropriate as discussed below.

Question 6.1(c)

What difficulties, if any, could arise if the tax cost setting amount for all assets was capped?

Of itself, we do not believe that there would be any difficulties if the tax cost of all assets were capped. However, such a capping and the subsequent allocation of any excess allocable cost amount to goodwill may potentially result in the deferral of capital losses of the head company of a consolidated group to the eventual disposal of its business (and the corresponding goodwill). Under the current treatment, unrealised capital losses are "spread" over all of the joining entity's assets, and they are realised as each asset is sold which, in our opinion, is a more appropriate outcome.

Question 6.1(d)

Do you agree with the Board's suggestion to allocate any excess allocable cost amount to goodwill? If so, what should happen to the excess if a company does not have goodwill?

No. Refer to (e).

Question 6.1(e)

If you do not agree with the Board's suggestion to allocate any excess allocable cost amount to goodwill, what should happen to the excess allocable cost amount?

In our view, if the current treatment for revenue type assets is extended to all tax assets, a better approach would be to cap the tax cost of all assets (including goodwill) at the greater of their terminating value or market value. Any excess remaining ACA can then, at the choice of the head company, be either:

- Allocated to goodwill
- Realise a capital loss under CGT event L4 or L8.

In our view, the provision of a choice will ensure that where goodwill exists, the head company will still be able to realise a capital loss under CGT event L8. We believe that it would be an inappropriate outcome for a capital loss to arise only in circumstances where a company does not have goodwill.

Further, in our opinion allocating of all of the excess ACA to goodwill above its market value does not result in greater neutrality between consolidated groups that acquire a business (by acquiring the entity that carries on the business) and entities that acquire a business directly. A consolidated group would not pay in excess of the market value of goodwill at the date of consolidation so, therefore, to allocate the allocable cost amount to goodwill in excess of its market value would not meet what we understand to be the policy intent in capping the tax cost of all assets.

Question 6.1(f)

Are there circumstances in which capping at the greater of market value or terminating value of an asset would produce undesirable outcomes?

No. The only undesirable outcome, in our opinion, would be in the deferral of any capital losses to the eventual disposal of the joining entity's business (and the corresponding goodwill), instead of the current treatment of "spreading" the unrealised loss over all of the joining entity's assets.

6 CGT issues

Question 7.1

The Board seeks stakeholder comment on:

a) Do you agree with the CGT rollover interaction issues that are outlined in this chapter?

b) Do you agree with the Board's proposal to introduce systemic rules dealing with CGT rollovers of entities into consolidated groups? If not, please outline why you do not believe that it is appropriate.

c) Do you agree with the Board's suggested rules for dealing with CGT rollovers into consolidated groups? If you do not agree with one or more of the rules, why do you disagree?

d) Are there any consequential issues which arise if the Board's suggested rules for dealing with CGT rollovers into consolidated groups are adopted?

We have no comments on the interaction between the CGT roll-over rules and the consolidation regime.

Question 7.2(a)

Do you have any suggestions as to how the difficulties that arise with CGT event J1 can be addressed? If so, what do you suggest?

We have previously made comments to the Board on issues arising from CGT event J1. These are contained in the appendix.

7 Other liability issues

7.1 Retirement villages

We have highlighted below an issue that is specific to the retirement village industry. The following example demonstrates potential issues in applying Division 711 to the head company of a tax consolidated group which acquires all of the shares in a company operating a retirement village business, and subsequently disposes of those shares.

Example 6.1

The relevant retirement village contract used for the example is of the type referred to as a Loan/License contract with key terms as described in paragraph 92 of TR 2002/14. Further, the contract grants the resident 100% entitlement to the capital growth of the independent living unit (**ILU**) upon exit

The accrual of deferred management fees has not been considered.

The facts are:

- In year 1, Company A is established with $100 of share capital and subsequently acquires an ILU for $100
- A resident enters the ILU immediately after the acquisition and provides a loan of $100 to Company A and enters into a license. The ATO view in TR 2002/14 is that the amount provided by the resident on entry under the Loan/License arrangement is not assessable and the repayment of the principal plus any payment made for the capital growth of the ILU will be considered capital and non-deductible
- At the beginning of year 2, an increase in value of the ILU of $50 and correspondingly an increase in the resident obligation of $50 are recognised on the balance sheet. At this time, the membership interests in Company A are acquired by Head Co for $100 (being the net asset value of the company)
- Target Co's balance sheet at the time of disposal is as follows:

Assets	**$**	**Liabilities and equity**	**$**
Cash at bank	100	Resident loan	100
ILU	150	**CGP**Capital growth payment (**CGP**)[13]	50
		Share capital	100
	250		250

The entry ACA for Company A under Division 705 is as follows:

Step	**Description**	**$**	**Provision**
1	Cost of membership interests	100	
2	Accounting liabilities	150[14]	705-70
8	Entry ACA	250	

The entry ACA is allocated to cash ($100) and to the ILU ($150).

[13] The resident's entitlement to a payment on exit reflecting capital growth

[14] In accordance with TR 2002/14, no part of the resident liability will result in a deduction to the head company in the future and, therefore, there will be no reduction in the liability under section 705-75

At the beginning of year 3, the ILU has increased in value by a further $50 with a corresponding increase in the resident liability. At that time, Head Co sells all the membership interests in Company A for $100 (being the net value of the company). Importantly, Company A has not increased in value while it was a member of the tax consolidated group (its net asset position is still $100).

The balance sheet of Company A just before the leaving time is as follows:

Assets	$	Liabilities and equity	$
Cash at bank	100	Resident loan	100
ILU	200	Value adjusted sum (**CGP**)[15]	100
		Share capital	100
	300		300

It is submitted that the tax cost of the shares in Company A should be calculated in accordance with Division 711 as follows:

Step	Description	$	Provision
1	Terminating value of assets	250	
4	Accounting liabilities	(200)	711-45(1)
4	Adjustment where amount of liability differed on entry	50	711-45(8)
5	Exit ACA	100	

The consolidated group should make no gain or loss on disposing of Company A for $100, which is consistent with the fact that Company A has not increased in value while it has been a member of the consolidated group.

The concern is that subsection 711-45(8) may not apply to the CGP. That provision only applies to certain liabilities mentioned in subsection 711-45(5).

Subsection 711-45(5) states the following:

If, for income tax purpose, an accounting liability, or a change in the amount of an accounting liability (other than one owed to a member of the old group), is taken into account at a later time than is the case in accordance with accounting principles, the amount to be added for the accounting liability is equal to the payment that would be necessary to discharge the liability just before the leaving time without an amount being included in the assessable income of, or allowable as a deduction to, the head company.

As noted above, paragraph 50 of TR 2002/14 states that CGP payments made to outgoing residents are capital in nature and are not deductible. In this regard, it is unclear whether an increase in a liability such as CGP, which is treated as an expense for accounting purposes but of a capital nature for tax purposes, is a liability mentioned in subsection 711-45(5) for the purposes of amended subsection 711-45(8), i.e. whether the change in the amount of the accounting liability is "taken into account" at a later time for tax purposes. As demonstrated by the example, to reach the correct taxation outcome, subsection 711-45(5) should apply to the CGP liability which is in existence just before the leaving time of an entity leaving a tax consolidated group.

If the ATO is of the view that an increase in a liability such as CGP, which is capital in nature for tax

[15] The resident's entitlement to a payment on exit reflecting capital growth

purposes, is not 'taken into account' for the purposes of subsection 711-45(5), a possible legislative solution might be to amend the provision as follows::

*If, for income tax purposes, an accounting liability, or a change in the amount of an accounting liability, (other than one owed to a *member of the old group) ~~is taken into account~~* ***gives rise to, or would but for subsection 8-1(2) give rise to, a *deduction*** *at a later time than is the case in accordance with the leaving entity's *accounting principles for tax cost setting, the amount to be added for the accounting liability is equal to the payment that would be necessary to discharge the liability just before the leaving time without an amount being included in the assessable income of, or allowable as a deduction to, the *head company.*

7.2 Liabilities representing income received in advance

We note that liabilities may be recognised in the accounts that represent income received in advance. Furthermore, that income may already have been treated as derived for income tax purposes (and, therefore, included in assessable income and subject to tax at the company tax rate). The issue is that it would appear that these liabilities would be fully subtracted at step 4 of the exit ACA even though they represent an amount in respect of which tax has already been paid.

Consider the following example:

Example 6.2

The facts are:

- Sub Co is a member of the Vendor Co consolidated group
- Sub Co was incorporated with share capital of $50
- After joining the group, Sub Co entered into a contract to provide services and received $100 upfront
- This amount was considered to be derived for income tax purposes. The tax liability of $30 has already been paid
- At the time of the acquisition, Sub Co's balance sheet is:

Assets	$	Liabilities and equity	$
Cash at bank	120	Income received in advance	100
		Retained earnings	(30)
		Share capital	50
	120		120

The purchaser may give consideration of $120 or it may be something less if they take into account the costs of providing the services for which the income has been received.

The tax cost of the shares in Sub Co would currently be calculated in accordance with Division 711 as follows:

Step	Description	$	Provision
1	Terminating value of assets	120	
4	Accounting liabilities	(100)	711-45(1)
5	Exit ACA	20	

If the consideration is $120, Vendor Co would be subject to double taxation on the same economic gain. It does not appear that subsections 711-45(3) or 711-45(5) would apply in this example. No future deduction for the liability is expected. Furthermore, there is no change in the liability that will be taken into account at a later time for tax purposes than is the case in accordance with the leaving entity's accounting principles.

The Board should consider the appropriateness of the current treatment of liabilities that represent amounts that have already been subject to tax before the leaving time.

Appendix

Eligible tier-1 company leaves a MEC group

Position 4.10

The Board agrees that double taxation may arise when an eligible tier-1 company leaves a consolidated group with assets that were rolled over prior to the entity joining a consolidated group because of the pooling rules.

Question 4.10(a)

Do stakeholders agree with Position 4.10? If not, why not?

We agree with Position 4.10 (this position is illustrated in the example below under question 4.10(b)). However, we note that the example provided in the DP submission at Appendix D (MEC group roll-downs) has not been considered in the Position Paper.

The example at Appendix D in the DP submission (Appendix D example) assumes that the Subdivision 126-B rollover occurs within a MEC tax consolidated group, rather than prior to an entity joining a consolidated group as provided in the CTA/MCA submission.

In the Appendix D example, double taxation arises because the Subdivision 126-B rollover triggers the application of the MEC pooling rules (subparagraph 719-555(1)(b)(ii)), even though no capital gain or loss arises on the rollover. That is, the MEC pooling rules apply even though the capital gain that arises from the CGT event is disregarded under Subdivision 126-B. On subsequent disposal of the shares in the rolled down ET-1 company, a proportion of the CGT event J1 gain is duplicated.

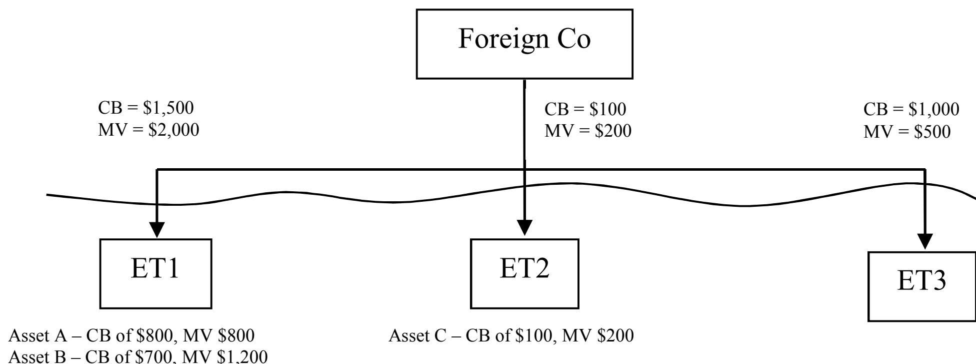
To address this issue, consideration could be given to an amendment to subparagraph 719-555(1)(b)(ii) to exclude a CGT event where a Subdivision 126-B rollover is chosen.

Question 4.10(b)

What changes can be made to ensure deferred capital gains and losses are not taxed twice when an ET-1 company leaves a consolidated group with assets that were rolled over?

The solution to the problem which arises when an ET-1 company leaves a consolidated group with assets that were rolled over prior to the entity joining a consolidated group is complicated because of the interaction of the consolidation rules with CGT event J1. Perhaps there needs to be some mechanism in Division 855 to reduce a capital gain where CGT event J1 and another CGT event applies, and the capital gain which arises under the other CGT event is calculated by applying the cost setting amount for the reset interest under the MEC pooling rules. Alternatively, a new provision in the anti-overlap provisions in Division 118 could be inserted to reduce the duplicated gain. This will allow for the deferred gain or loss to be assessed under CGT event J1 at the appropriate time without duplication of the gain.

For example, assume the following group structure and details prior to consolidation on 1 July 2000:



Assume that Asset B, being real property, is transferred from ET1 to ET2 on 1 July 2000 (prior to ET1 and ET2 forming a MEC group) for market value consideration utilising Subdivision 126-B rollover relief. As a result, a debt is owed by ET2 to ET1 equal to the market value of the asset transferred ($1,200).

Assume that a MEC group is formed on 1 July 2002 and the shares in ET2 are disposed on 31 December 2002, at which time the market value of Asset B is $1,500 (assume all other market values have not changed).

Subdivision 719-K applies on the exit of ET2 from the MEC group. The pooling rules would act to reset the cost base of the shares in ET2 to $433 as follows (section 719-570):

Market value of reset interest (ET2 = $500) * Pooled cost amount ($2,600) = $433

Market value of the group ($3,000)

The sale of ET2 gives rise to a taxable event given that the shares in ET2 are TARP under section 855-25. Foreign Co derives a capital gain of $67 under CGT event A1, being equal to the difference between the market value of the shares of $500 ($200 plus the appreciation in the market value of Asset B of $300) and the pooled cost base of $433. CGT event J1 will apply to crystallise a capital gain of $800, being the market value of the asset ($1,500 and the cost base of Asset B ($700).

The total taxable gain in respect of the sale of ET2 is $867. In this example, the combined economic gain is only $400, being the combined market value of ET1, ET2 and ET3 separately ($3,000) less the combined original cost base of the shares in ET1, ET2 and ET3 of $2,600. This is ignoring the potential capital gain that may arise upon disposal of ET1 and ET3 in the future (if these shares are TARP).

Another provision could be inserted into Division 855 as follows:

Disregard that portion of a capital gain or capital loss from a CGT event if:

(a) the relevant CGT asset is shares in an eligible tier-1 company;

(b) CGT event J1 happens at the same time; and

(c) A capital gain is made under CGT event J1.

The portion of the capital gain that is disregarded is calculated as follows:

Market value of roll-over asset to which CGT event J1 applies

Total market value of all assets that are taxable Australian real property

In our example above the full $67 capital gain would be disregarded since the only TARP asset held by ET2 is the roll-over asset to which CGT event J1 applies. This draft provision would need to be considered in further detail to ensure that there are no unintended ramifications.

Head company leaves the wholly-owned group

Position 4.11

The Board considers that:

(a) CGT event J1 should apply to rolled over membership interests when the non-resident owner disposes of its interests in the head company; and

(b) further work is needed to determine how the cost base of these membership interests in the subsidiary member should be calculated.

Question 4.11(a)

Do stakeholders agree with Position 4.11? If not, why not?

We agree with Position 4.11.

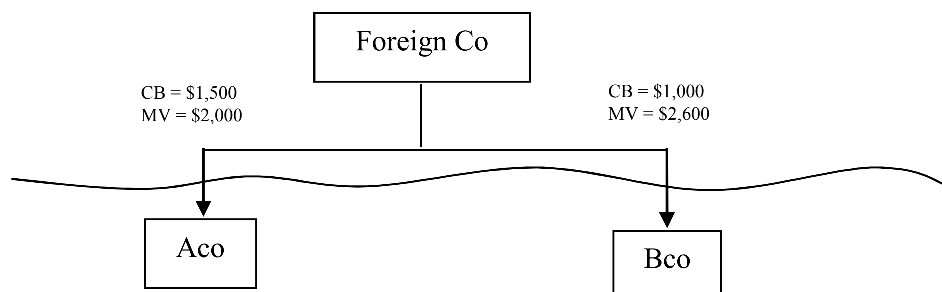
Question 4.11(b)

How should the cost base of the membership interests in the subsidiary member of the consolidated group be determined?

We believe that a number of amendments should be made in order to determine the cost base of the membership interests in the subsidiary member of the consolidated group:

- CGT event J1 could state that where a non-resident owner disposes of its interest in the head company of a consolidated group with a rolled over membership interest assume that the head company and its subsidiary members are not, and were never consolidated. Accordingly, this amendment would “switch off” the operation of the SER only for the purpose of determining the gain under CGT event J1. As such, if it is assumed that the consolidation rules never applied, the normal consequences of Subdivision 126-B would apply and the cost base of the membership interests in the relevant subsidiary member would be determined under the normal cost base rules, and any resulting CGT event J1 gain could be calculated
- In order to ensure that the CGT event J1 gain is not duplicated upon subsequent disposal of shares in the rolled over membership interest, there needs to be some mechanism to pick up the market value of the rolled over membership interests at the time that CGT event J1 happens.

For example, assume the following structure:



Assume that the shares in Bco are transferred to Aco for market value ($2,600) utilising Subdivision 126-B rollover relief and Aco and Bco form a tax consolidated group. Foreign Co later sells the shares in Aco. At that time the market value of the shares in Bco is $3,000.

CGT event J1 should apply in this scenario, however, the membership interests in Bco (being the rolled over asset to which CGT event J1 should apply) are not recognised for tax purposes under the SER.

Applying our recommendations:

- The SER would be switched off for the purpose of determining the gain under CGT event J1. A capital gain of $2,000 would be crystallised by Foreign Co under CGT event J1, being the difference between the market value of the shares in Bco ($3,000) and the cost base of the shares in Bco as inherited by Aco under Subdivision 126-B ($1,000)
- When the shares in Bco are transferred to Aco and a tax consolidated group is formed the tax cost setting rules are applied. The step 1 amount on entry under section 705-65 would have been $2,600. This amount will be pushed down to the assets of Bco. However, since a CGT event J1 gain was crystallised upon disposal of Foreign Co's shares in Aco, the market value of the shares in Bco as at this date of $3,000 will be subject to tax. If Aco subsequently disposed of the shares in Bco and Division 711 was applied, double taxation would arise (since the tax costs of the assets of Bco would have initially been set on entry based on a step 1 amount of $2,600, which then becomes the step 1 amount on exit). Accordingly, in order to ensure that no double taxation arises, there needs to be some mechanism to a take into account the difference between the market value of the shares in Bco of $3,000 when Aco is sold and the initial tax cost setting amount for Bco of $2,600. For example, consideration could be given to allowing a Division 705 calculation to be performed at the time CGT event J1 occurs based on a revised step 1 amount of $3,000.

Question 4.11(c)

Is there another method that could be used to determine the capital gain or capital loss made on the disposal of those membership interests, including for a partial disposal of membership interests?

The amendments as proposed in our response to Question 4.11(b) should address the issue of a partial disposal of the membership interests.

Other changes to the operation of CGT event J1

Question 4.12

Do stakeholders consider that issues which currently arise because of CGT event J1 could be resolved if:

- A time limit applied to the provision;
- Minority interest divestments were exempted from the provision; and
- The sub-group break-up exemption applied where less than 100 per cent of the interests in the sub-group are disposed of to non-group entities?

The measures proposed in Position 4.12 would reduce the compliance costs for taxpayers. However, given the uncertainty that currently exists with the application of CGT event J1, we consider that the Board should undertake further consultation to determine if broader changes are required to CGT event J1.