Greenwoods
& Freehills

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

26 October 2012

**By email: taxboard@treasury.gov.au**

Dear Sir/Madam

## Post-Implementation Review of Certain Aspects of the Consolidation Tax Cost Setting Process - Discussion Paper

Thank you for the opportunity to comment on the Discussion Paper.

This brief submission is directed to a particular issue which is connected with the discussion in Chapter 6 of the Paper – the discussion of predetermined limits on the cost base of assets arising from the cost base setting process. The discussion in chapter 6 is directed to placing a cap on the reset cost. This submission argues for a further limit on the cost base resetting process where the relevant asset is trading stock.

The proposition put forward in this submission is that trading stock should be classified as a retained cost base asset for the purposes of the tax cost setting process. This intended treatment would have the effect that trading stock would enter a consolidated group with a tax cost for the head entity of its 'terminating value' (generally, its historical cost or last closing value if the stock has been revalued to, say, market value).

This treatment would reflect the commercial outcome that typically occurs on the sale of a business. In an asset sale, the contract will usually allocate the purchase price so that trading stock passes between vendor and purchaser for the cost of the trading stock in the vendor's accounts. In a share sale, the same process will usually underlie the determination of the price between the parties – that trading stock is worth its cost, and any premium being paid is attributable to more enduring assets such as land and goodwill, and monopoly rights, often arising from intangibles. In other words, trading stock is just a store of value that will quickly be realised and is worth no more to a buyer than its cost to the seller. Moreover, trading stock is invariably acquired shortly before the joining time and therefore its economic cost to the acquiring group more correctly reflects its actual cost.

### Current rules

The current rules provide for limited tax neutral treatment for trading stock:

- on entering a consolidated group, the subsidiary member does not make a gain or loss when the ownership of trading stock notionally passes to the head entity – s. 701-35;
- when trading stock leaves a consolidated group when a subsidiary member departs the group, the head entity does not make a gain or loss – s. 701-25;

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- when ACA is pushed down onto trading stock of a joining entity, there is a cap of the greater of (i) the market value of the trading stock and (ii) the tax value in the hands of the joining entity – s. 705-40.

The missing step is a *floor* on the cost base push down. Without such a floor, the allocation of ACA between assets based on their relative market values (in s. 705-35) means that tax cost can be inappropriately drawn away from trading stock and allocated to the enduring assets such as goodwill and monopoly rights which is where the greatest value lies.

The examples below demonstrate the problem in an entry case and an exit case:

**Example 1**

Assume Head Co incorporates Sub Co with $100 which is invested in trading stock that is turned over on a regular basis. After 5 years, Sub Co has grown in value to $500 and Buyer Co acquires 50% of Sub Co for $250 at that time:

| Year 5 | Cost | Value |
|---|---|---|
| Inventory | 100 | 100 |
| Goodwill | nil | 400 |

Five years later, Sub Co's value has grown to $1,000. Buyer Co acquires the remaining 50% of Sub Co for $500:

| Year 10 | Cost | Value |
|---|---|---|
| Inventory | 100 | 100 |
| Goodwill | nil | 900 |

Buyer Co will have ACA of $750 but will find that it has to allocate the ACA in the ratio of 10:90:

| Year 10 | ACA | Value |
|---|---|---|
| Inventory | 75 | 100 |
| Goodwill | 675 | 900 |

This has the result that Buyer Co will suffer a taxable gain of $25 in the short term on the sale of the trading stock without a matching economic gain. Such an outcome would not occur in an asset sale because the trading stock is invariably sold for its existing tax cost.

The more appropriate allocation of ACA would be to treat the trading stock as a retained cost base asset:

| Year 10 | ACA | Value |
|---|---|---|
| Inventory | 100 | 100 |
| Goodwill | (750-100) = 650 | 900 |

**Example 2**

Assume Head Co incorporates Sub Co with $100 which is invested in Sub 2 Co which invests the amount in trading stock. After 5 years, Sub 2 Co has grown in value to $500:

| Year 5 | Cost | Value |
|---|---|---|
| Inventory | 100 | 100 |
| Goodwill | nil | 400 |

If Head Co were to demerge Sub Co (and thus Sub 2 Co) to its shareholders:

- Sub Co would be treated as having a cost in its shares in Sub 2 Co of 100;
- when Sub Co forms a new consolidated group that 100 cost base is pushed down as cost onto the assets of Sub 2 Co, the same misallocation of ACA occurs:

| | **Cost** | **Value** |
|---|---|---|
| Inventory | 25 | 100 |
| Goodwill | 75 | 400 |

- the more appropriate allocation of ACA would be to treat the trading stock as a retained cost base asset:

| | **Cost** | **Value** |
|---|---|---|
| Inventory | 100 | 100 |
| Goodwill | nil | 400 |

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Thank you for the opportunity to comment on the Discussion Paper.

Yours sincerely

**Richard Hendriks**
Director
Greenwoods & Freehills

+61 2 9225 5971
richard.hendriks@gf.com.au