Institute of Chartered Accountants Australia

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Dear Sir

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

The Institute of Chartered Accountants in Australia is pleased to provide our submission in response to the Board's post-implementation review of certain aspects of the consolidation tax cost setting process.

If you would like to discuss any aspect of our submission with us would you please contact me on 02 9290 5609 or Susan Cantamessa on 02 9290 5625.

Yours sincerely

Paul Stacey
Tax Counsel
The Institute of Chartered Accountants in Australia

Board of Taxation's post-implementation review of certain aspects of the consolidation tax cost setting process

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1. Introduction

1.1 Comments

The Institute of Chartered Accountants in Australia (the **Institute**) welcomes the fact that some of the longstanding complex issues associated with the consolidation regime are now being addressed by the Board.

Our comments on each chapter of the Discussion Paper are set out below, followed by our response to the specific questions posed by the Board.

In the comments which follow, references are to the *Income Tax Assessment Act 1997* unless otherwise stated.

1.2 Date of application

Because the proposals contained in the Discussion Paper represent a significant change from the existing regime, the proposed commencement date of any changes the Board recommends to Government need to recognise the lead time for legislation and changes to commercial practices.

In our view, with limited exceptions, any changes should apply on a prospective basis, ideally from the date of enactment of the amending legislation or possibly its earlier introduction into Parliament, with appropriate transitional provisions for transactions which span the start date.

As the Board is aware, there has been an increasing tendency for amending legislation to apply from the date of its announcement by the Government. In broad terms, commencement from date of announcement is generally accepted as appropriate to limit tax avoidance, in circumstances where an early announcement/later commencement date will inappropriately alter taxpayer behaviour or where the changes rectify errors in favour of taxpayers. Even in these circumstances it is critical that any changes announced by the Government:

- provide sufficient clarity around how the changes will apply; and
- be legislated speedily.

However, tax consolidation is complex and, the issues being considered by the Board are particularly complex. We doubt, therefore, that any announcement by the Government could address in sufficient detail how any changes will apply, given the need for refinement of proposals through comprehensive consultation. Moreover, history shows that consolidation amendments are rarely legislated speedily. Given the depletion to Treasury resources which we are currently witnessing, as evidenced by the number of unlegislated amendments, we are not confident that this situation will be remedied in the near future.

In these circumstances it is inappropriate for stakeholders to be faced with further extended periods of uncertainty as a result of any tax consolidation announcements by Government which remain unlegislated for long periods of time. Stakeholders include:

- taxpayers negotiating merger and acquisition (M&A) transactions. Tax consolidation impacts transactions involving unrelated parties, affecting the pricing and indeed the willingness of parties to transact. Tax consolidation is not merely a regime which regulates internal transactions or tax positions of consolidated groups; and
- the Australian Taxation Office (**ATO**) and advisers.

For these reasons the Institute seeks a clear Board recommendation that:

- any changes should apply at the earliest from the date amending legislation is introduced into Parliament; and
- transitional measures should protect transactions under way in relation to the pre-existing law.

To the extent that further consultation identifies measures which should appropriately apply from the date of announcement, these measures should be legislated promptly.

2. Liabilities held by an entity that joins a consolidated group

2.1 Comments

The Institute acknowledges the potential for the effective ‘double recognition’ of liabilities as set out in Examples 2.1 and 2.2 of the Discussion Paper.

The great range of circumstances giving rise to accounting liabilities does not lend itself to a single ‘in-principle’ approach under tax consolidation rules.

While liabilities falling under the TOFA regime are subject to defined parameters and prescribed taxation consequences, the broad range of non-TOFA liabilities is comprised of liabilities recognized for accounting purposes which can have very different characteristics. Some of these include:

- Accrued expenses
- Provisions for specific future outlays
- Provisions for general estimated future outlays
- Provisions for onerous contracts or future loss
- Deferred income/income received in advance
- Current loss on a derivative contract
- Superannuation fund shortfall liabilities
- Finance lease liabilities
- Securitisation arrangement liabilities

Any attempt to introduce a broad ‘in principle’ approach to reset the tax position of a liability is likely to require significant complexity and lead to future uncertainty. It is for this reason that the Institute does not agree with option 1 as the preferred option.

2.1.1 Consideration of proposed options

Although option 1 might appear simple in its design, it would still require taxpayers to track relevant liabilities that existed at the joining time for purposes of working out any subsequent tax deduction. The option 1 approach seems to be modeled on the TOFA rule in section 715-375 (noting that TOFA seeks to recognize a net gain or loss from a financial arrangement), but such an approach is not suited to non-TOFA liabilities where future deductions are generally claimed, for example, as incurred under section 8-1.

Rather, options 2 or 3 would seem less likely to require significantly complex drafting, yet should still achieve a significant reduction in the scenarios that might give rise to a duplication of deductions arising in relation to liabilities.

However, the Institute is very concerned that option 2 will create significant additional compliance costs for consolidated groups. In particular, provisions such as long service leave can accrue over decades. Other provisions are not calculated based on specific future outlays, but on a broad actuarial or global basis to estimate future costs or losses. Often such provisions of a joining entity will be merged with the corresponding provision of the head company. A requirement to trace the reduction in these types of provisions which existed at joining time (even applying a ‘first in first out’ approach) would be very onerous.

Consideration should be given to the introduction of shortcuts to ease the compliance burden. In this regard we agree with the following recommendations which we understand are proposed in the submission lodged with the Board by the Corporate Taxpayers Association:

- where a taxpayer chooses to do so, future outcomes in respect of future deductible liabilities could be individually tracked such that deductions are progressively denied up to the quantum of the associated liability provision at the joining time;
- otherwise, liabilities would be fully deductible as incurred but an amount equivalent to the quantum of the associated joining time liability would be assessable progressively as follows:
    - over 12 months from the joining time in respect of a liability that was recognised as a current liability in the accounts of the joining entity at the joining time; or
    - otherwise over four years in respect of non-current future deductible liabilities.

While we agree that option 3 may give rise to potential distortions in the tax cost setting amounts allocated to assets, it should achieve a significant reduction in the scenarios that might give rise to a duplication of deductions arising in relation to liabilities. Option 3 also has the benefit of easily fitting into the existing legislative framework, likely requiring only minor amendments to section 705-75, and is simple in its application as there is no ongoing monitoring of liabilities that existed at the joining time.

The Institute believes that option 4 would give rise to inappropriate outcomes which are not in accordance with underlying policy. In particular, it seems highly inappropriate to create a tax liability at the joining time when the underlying future deduction may not arise until many years later.

2.1.2 Other considerations

- The Board makes a number of references to possible adjustment mechanisms where a liability is settled for less than its step 2 amount. The Institute would strongly oppose any such mechanism on the basis it would give rise to a significant compliance burden as well as the potential for outcomes not in accordance with underling policy.
- Any new mechanism to either reduce the future deduction for liabilities (option 2) or reduce the corresponding step 2 amount (option 3) should include provisions to avoid any double-counting of adjustments (similar to the “double counting adjustment” set in out in the current section 705-75(1)).
- There should be no adjustment to liabilities which arise during a period in which the relevant joining company is part of a wholly owned group with the future head company.
- Section 711-45 will require modification to adjust liabilities taken into account in exit calculations where such liabilities were either excluded on entry or rendered non-deductible to the consolidated group.

2.2 Response to specific questions

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

The Institute agrees with the Board's identification of the issue of potential duplication of liabilities as part of the tax consolidation cost setting processes.

It will be important to ensure that if any legislative changes are adopted, the types of liabilities which are subject to any adjustment are clearly defined. It is our understanding that these liabilities would consist of those which fall within current section 705-75(1), but this should be made clear.

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

The Institute does not agree with the Board's preferred option (option 1) but rather suggests that consideration be given to the implementation of option 2 with appropriate short-cuts built into the legislation; or, failing acceptance of any administrative shortcuts, option 3.

(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?*

As noted above, there are a broad range of liabilities recognized for accounting purposes and therefore a significant risk that option 1 would require complex legislative change as well as greater risk of unintended outcomes. The more narrow scope of liabilities addressed by options 2 and 3 would seem appropriate and reasonable.

(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.*

The Institute is very concerned about the additional compliance costs associated with either of options 1 and 2 and therefore recommend either option 2 but with administrative shortcuts or option 3.

(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 have not identified any inappropriate consequences arising in these circumstances.

(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?*

Because such a change in approach is a fundamental shift in the manner in which the tax consolidation rules have applied since inception, any new provisions should ideally commence from the date legislation is introduced or enacted. In the event that any changes commence to apply from the date a specific announcement is made by Government, it is critical that there is sufficient clarity around how the changes will apply.

This should ensure that taxpayers that made investment decisions in relation to the acquisition of an entity are not unduly disadvantaged by any retrospective change which would limit the acquiring group's entitlement to a deduction in relation to deductible liabilities of the joining entity (a factor which may have been taken into account in pricing), or subject to additional compliance costs in amending prior year income tax assessments.

Additionally, so as not prejudice transactions which may be in train at the commencement date, a suitable transitional rule might be an approach similar to that adopted in clause 52 of *Tax Laws Amendment (2012 Measures No. 2) Act 2012* in determining whether an arrangement had been entered into.

3. Deferred tax liabilities

3.1 Comments

Example 3.1 in the Discussion Paper assumes that a consolidated group purchaser would factor into the purchase price of the shares in Company D the vendor's determination of the DTL balance. However, in practice, there have been cases where entity valuations have factored-in adjusted DTLs, that would be recognised in the hands of the buyer on the assumption that the DTL was expected to change as a result of tax cost setting of relevant assets that give rise to the DTL (hence potential for a higher price to be offered).

We recommend that the example should provide some additional explanation as to the assumptions applied in determining the purchase price for Company D.

The Institute notes that any discussion of potential changes in respect of DTLs should be limited to DTLs in respect of Australian income tax. They should not extend to DTLs in respect of any other taxes (e.g. minerals resources rent tax, foreign taxes and state taxes).

3.2 Response to specific questions

(a) *Do you agree with the Board's proposal to remove deferred tax liabilities from the entry and exit allocable cost amount 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 (relating to income tax of the relevant entities) from exit ACA calculations, as the lack of an equivalent to the existing section 705-70(1A) in the exit rules may produce inequitable outcomes. However, introducing an equivalent to section 705-70(1A) in an exit scenario is inappropriate as the vendor would need to factor in the tax treatment actually adopted by the purchaser which may not be ascertainable. Therefore, the best practical solution appears to be a complete exclusion of DTLs from exit ACA calculations.

In relation to the treatment of DTLs in entry ACA calculations, there is merit in excluding DTLs that arise from assets that have their tax cost reset. However, this is subject to the comments which appear in section (b) below.

(b) *Are there are other situations where deferred tax liabilities should continue to be recognised? Are there alternative solutions that could achieve the same result?*

The proposed changes should be limited to DTLs in respect of Australian income tax and not extend to DTLs in respect of any other taxes (e.g. minerals resources rent tax and foreign taxes).

The Institute notes that there will be DTLs in relation to assets whose tax cost is not reset under the tax consolidation tax cost setting rules, or for DTLs arising otherwise than in relation to assets. This is particularly relevant in relation to the 2012 changes to right to future income (RFI) assets. There may be significant DTLs arising for a wide range of accounting RFI assets which will have no tax base as a consequence of the operation of the 'prospective rules' contained in Part 3, Schedule 3 of *Tax Laws Amendment (2012 Measures No 2) Act 2012.*

- If there was no limited recognition of such DTLs then purchasers would factor any potential DTL exposures into the calculation of the purchase price of the target entity to compensate for any exclusion of any relevant DTLs from entry ACA calculations (as was noted in our opening comments). On balance this would be our preferred approach.
- Another approach to deal with this would be to allow for a limited recognition of DTLs for assets whose tax cost is not reset under the tax consolidation tax cost setting rules and/or for DTLs arising otherwise than in relation to assets.

(c) *If deferred tax liabilities were to be removed from the exit and entry tax cost setting calculations do you think that 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.*

No additional comments to those raised in section (b) above.

(d) *What alternatives, if any, are there for reducing the complexity introduced by deferred tax liabilities?*

No additional comments to those raised in section (b) above.

4. Adjustments to the value of liabilities under the tax cost setting rules

4.1 Comments

Refer to specific comments below.

4.2 Response to specific questions

Question 4.1

(a) *Do you agree with the Board's view 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 agree that the adjustment should be removed?*

In the Institute's view section 705-70(1A) is not limited in its application to DTLs. The adjustment may apply where the head company's accounting value of a liability is different to the joining entity's accounting value, provided that the head company's value is determined in accordance with the joining entity's accounting principles.

Retaining section 705-70(1A) is necessary particularly if proper regard is to be given to all the factors that have influenced the purchaser's determination of the purchase price of the acquired entity/group (including the reset tax base of underlying assets and the purchaser's assessment of the entity's liabilities): this is particularly valid for 100% acquisition cases (but should not be limited just to those cases).

We note that, to the extent that an accounting liability may be wholly or partly deductible in the hands of the head company, the adjustments considered in Chapter 2 of the Discussion Paper should also be applicable in determining the amount recognised under section 705-70(1A).

(b) *If you do not agree with the Board's preliminary view 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?*

Consideration should be given to enhancing the notes to subsection 705-70(1A) that appear in the legislation.

Question 4.2

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

The Institute understands that the Board proposes to modify the application of section 705-80 so that it does not apply to unrealized gain/loss liabilities in a full acquisition case, but will continue to be enacted for all other cases (i.e. creeping acquisition and formation cases).

We highlight that, in the event that any of the options in Chapter 2 are adopted in relation to future deductible (or unrealised loss) liabilities (which we understand may be applied to all acquisition/joining cases) then such liabilities in all acquisition cases will be affected. Therefore, the scope of this proposal (whether the repeal of section 705-80 should be extended to creeping acquisitions) will need to be analysed in the light of the final decision in relation to the matters at Chapter 2.

We support the repeal of section 705-80 in relation to unrealized gain/loss liabilities in a full acquisition case (as the adjustments would typically be nil for either an unrealized gain or loss situation).

In respect of the treatment of liabilities with unrealized gains, arising in creeping acquisition or formation cases, we agree that section 705-80 should be retained in order to provide the correct economic reflex.

In the event that section 705-80 is retained (for creeping acquisition and/or formation cases), then a modification or clarification of its application may be required for liabilities that would otherwise be deductible (in whole or part) but for the application of either:

- any of the options in Chapter 2; or
- TOFA 3&4 consolidation interaction rules which deem the receipt of an amount in relation to liabilities held by the joining entity that are financial arrangements where TOFA applies to the consolidated group[1]

to avoid the potential distortion caused by effective double counting. The potential problem is illustrated below.

Example:

- Xco joins D consolidated group in 2012 (creeping acquisition)
- Xco is subject to TOFA (assume default methods apply)
- Xco holds an out of the money derivative liability of $50M
- under section 715-375(2) the D group will be taken to have received a payment of $50M in relation to the liability (effectively eliminating any future deduction for the loss).

In calculating the ACA Step 2 liability amount for Xco:

- the section 705-70 opening amount in relation to the liability is $50M
- section 705-75 does not apply because there will be no future deduction for the head company of the consolidated group in relation to the liability
- however, there is a risk that section 705-80 may apply in this case and result in an inappropriate reduction amount of $15M to reflect the notional tax impact of the derivative on Xco (the joining entity) if the liability was recognised for tax at the same time as it was for accounting (reduction amount is based on a notional tax loss which may give rise to an acquired loss in ACA Step 6)[2]. On a literal reading of section 705-80, the derivative liability may be considered to be "taken into account" (in the future in the hands of the head company) when there is an application of the TOFA balancing adjustment provisions, even though the result may be no gain or loss, in respect of *the amount of the liability at the joining time*.

From a policy perspective section 705-80 should not apply where the amount of the liability or change in the value of the liability (as at the joining time) does not give rise to an amount of income/gain/loss or outgoing in relation to the liability (as at the joining time): the mere *process of calculating any such amounts should not trigger the application of section 705-80*.

Whilst the example is directed at unrealised loss liabilities subject to the TOFA 3&4 consolidation interaction rules, it would appear that similar problems may arise for liabilities considered in Chapter 2.

We would recommend that it would be useful to clarify, in any amendment process, the scope of any residual application of section 705-80 to avoid any inappropriate distortion of the ACA Step 2 amount.

[1] Where a subsidiary member joins a consolidated group with a TOFA liability that would otherwise be deductible in the future (e.g. FX loss or out of the money derivative), the 2012 changes to the TOFA consolidation interaction rules will have the effect that the consolidated group will be taken to have received an amount in relation to the liability equal to its accounting value (if default rules or hedge rules apply) or Div 230 value (if other elective rules apply). This will generally have the effect of eliminating any unrealised loss as at the consolidation joining time. There is an exception for pre-TOFA formation cases (deemed receipt is equal to pre-joining tax base).

[2] In an owned formation case (where there is a notional owned loss in ACA Step 5) the adjustment could be up to $50M.

5. Assets and liabilities recognized on different basis

5.1 Comments

The treatment of common securitisation arrangements under the tax cost setting framework is complicated. The proposal for a systemic approach which ensures the congruous treatment of an asset/liability is welcomed.

5.1.1 Liability but no asset

The Institute agrees that a significant issue may arise when an accounting liability is recognised on consolidation (exit or entry) but the related or linked asset is disregarded.

Securitisation of diverse receivables, including mortgages, may create an asymmetry in asset/liability recognition. The example employed to illustrate this (Example 5.1) may not instance the problem; under an equitable assignment there will be an asset remaining in the joining entity which may be a retained cost base asset. To the extent that there is such an asset of the kind, the entry/exit asymmetry may not arise, regardless of the market value of the asset. This will depend on the accounting liability being equivalent to the tax cost allocated to the retained cost base asset. If the asset is a reset cost base asset, the mismatch the Board has identified arises. This suggests that asset characterisation as retained or reset will be an issue for consideration in any proposed remedy.

5.1.2 Asset but no liability

There may be a disparity in the tax and accounting treatments of a trading receivable securitisation.

Under the accounting standards, the basis for not recognising a future obligation as an ‘accounting liability’ may be the lack of a sufficiently reliable estimate of the amount of the future obligation. The Institute agrees with the Board’s proposal that the related (but unrecognised) liability should be recognised for tax cost setting purposes, but the method for valuing the non-accounting liability needs consideration.

Alternatively, the Board should provide guidance as to the nature of ‘unrecognised’ related liabilities that may be recognised under a proposed remedy for tax cost setting (e.g. limited to quantifiable possible obligations but has not yet been confirmed there will be an outflow of resources).

5.1.3 Related Assets

Central to the Board’s preliminary view is how the relevant relationship between assets and liabilities will be drawn. The Institute notes that a like concept is set out in section 705-59, which modifies the general approach for recognising assets and liabilities.

The application of section 705-59 is limited to circumstances where:

- assets and liabilities are required by the accounting standards to be set-off in preparing the entity’s statement of financial position;

- the net amount after the set-off is recognised in those statements; and
- the linked asset is a reset cost base asset.

Possibly excluded from operation of section 705-59 (Draft discussion paper NTLG Consolidation Subcommittee Meeting 23 November 2006) are:

- interest rate swaps
- forward rate agreements
- futures contracts.

Section 705-59 is limited in when it may be applied, and cumbersome when applied. We recommend the Board consider whether any proposed solution to the asset/liability asymmetry problem should include within it the replacement and/or refinement of section 705-59.

While the Institute strongly endorses the Board's proposals on the asymmetry problem, we would be happy to assist in any further exploration of how the relationship between asset/liability is to be drawn.

5.1.4 Finance Leases

We wish to draw to the Board's attention the problems taxpayers encounter when considering the treatment of finance leases created while the leaving entity was a member of a consolidated group and recommend the Board consider this further.

5.1.5 Synthetic TOFA issues

We note that in 2009 the Government announced proposed changes to the law to introduce synthetic financial arrangement rules. The effect would be to give Division 230 financial arrangements recognition based on their economic substance (refer the then Assistant Treasurer Mr Chris Bowen's Media Release No 0.22 of 26 March 2009 Taxation of Financial Arrangements –Synthetic and Complex Arrangements)

If the Government proceeded to introduce these synthetic rules, then the asymmetry between asset and liabilities may not arise in a post TOFA environment.

We recommend the Board consider the potential introduction of consolidation rules dealing with securitisations in the light of a potential introduction of TOFA synthetic rules that may require further amendment to specific consolidation rules.

5.2 Response to specific questions

(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.*

The area identified by the Board is a significant issue for taxpayers. The problem of bifurcated assets, and concomitant liabilities (or vice versa) arises across numerous industries - refer general comments above.

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

The Institute agrees with the Board's preliminary view for resolving this issue, namely that where the asset is tax recognised, so should the accounting liability and where the accounting liability is recognised, and not the related asset, it should be.

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

We have taken the Examples in the Discussion Paper as illustrations of circumstances where the asset and liability relate to each other but their treatments do not coalesce. Example 5.1 is an instance where the entire benefit of the asset is not recognised, and the liability is an obligation to provide the entire benefit of the asset to asset's acquirer. (Presumably the liability needs to be recognised to get the appropriate tax cost setting amount on exit, to the extent it still exists at that time). Example 5.2 is an example where the benefit of the asset has passed but the obligation to pay for the benefit of the asset has not crystallised for accounting purposes.

The appropriate circumstances in which the asset and liability can be said to be related are difficult to precisely specify as much depends on the facts and circumstances, but would include those where:

- the joining entity has dealt with the rights inherent in the asset but to some extent has retained an accounting liability in relation to those rights/asset; and
- the joining entity has acquired the rights inherent in the asset but no accounting liability has yet arisen in respect of them/it.

We note these are not section 705-59 type circumstances, where the linkage is through accounting. Care will be needed to ensure that trusts are not inadvertently caught up in this remedy.

6. Capping the tax cost setting amount of assets

6.1 Comments

The Board's preliminary view is that capping the tax cost setting amount of all reset cost base assets – and not just 'revenue type' assets - to the greater of their market value and terminating value may result in greater neutrality, in most circumstances, between consolidated groups that acquire an entity and entities that acquire a business directly. The Discussion Paper suggests that any excess allocable cost amount could be deemed to be allocated to goodwill (where that exists) or result in a capital loss (where no goodwill exists).

Circumstances identified in the Discussion Paper where it is asserted that greater neutrality may not be achieved are where:

- for commercial reasons, a purchaser of a business is prepared to pay more than what might otherwise be regarded as market value for all or some of the assets of the business (paragraph 6.8); or
- in progressive acquisition cases, the market value of an asset at the joining time does not reflect the price effectively paid for the asset by the acquirer (paragraph 6.9).

Considering the two scenarios above:

- in the first scenario an unrelated purchaser has identified a strategic value for one or more assets that can represent the market value of the asset; and
- in a progressive acquisition case it is inevitable that the assets' market values might change from commencement of the progressive acquisition to the end – just as it might rise or fall in an earnout arrangement in relation to a business pursuant to an asset purchase contract.

The spreading of allocable cost base under tax consolidation is already heavily regulated to minimise consequences which are adverse to the revenue. In particular:

- consolidation allocable cost amounts can only be allocated to assets as defined and not to all commercial benefits in the joining entity;
- right to future income assets are retained cost base assets (typically with no tax cost);
- reset cost base assets which are 'revenue type assets' are subject to tax cost setting capping to the greater of their terminating value or market value; and
- the existing rules cause identified goodwill assets to be allocated some of the cost base of the joining entity.

As a result the Institute does not consider that the existing spreading mechanism causes inappropriate distortion of the tax outcomes.

The Discussion Paper does not in our view explain sufficiently why inflating the tax cost setting amount of goodwill, effectively for allocable cost amount anomalies, is more appropriate than spreading it across all capital assets acquired (other than 'revenue type' assets).

In particular, the Institute notes that the resulting excessive allocation to goodwill would in practice mean that there would be no recognition for the relevant allocation unless and until the consolidated group disposes of much or all of its business. For that reason a cap on reset cost base assets accompanied by an allocation to goodwill would represent incorrect policy in the Institute's view.

In the event that the Board recommends, despite our view, that the tax cost setting amount of all reset cost base assets is to be capped then the excess allocable cost amount should be treated as an immediate capital loss akin to CGT Events L4 or L8.

6.2 Response to specific questions

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

No. As indicated above, we do not consider that the Discussion Paper provides sufficient justification to warrant extending the capping rules to all reset cost base assets.

(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?*

The Institute does not consider that capping the tax cost setting amount for all assets will result in greater neutrality relative to a business acquisition. In particular, tax consolidation limits on tax cost setting for various assets do not precisely replicate the outcomes if the assets had been acquired under asset transactions.

As a result the Institute does not consider that the spreading mechanism causes inappropriate distortion of the tax outcomes.

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

Special rules would need to be developed to deal with creeping acquisitions. In a creeping acquisition it is inevitable that the perception of assets' market values might change from commencement of the progressive acquisition to the end. The value might fall or it might rise – just as it might rise or fall in a deferred purchase arrangement in relation to a single asset pursuant to an asset purchase contract. So a 'market value cap determined at joining time' rule could operate inequitably in our view.

(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?*

If the Board recommends that the tax cost setting amount allocated to all reset cost base assets (other than goodwill) be capped then any excess allocable cost amount should be treated as a capital loss akin to CGT Event L4 or L8..

Otherwise, a resulting excessive allocation to goodwill arising from this proposal would in practice mean that there would be no recognition for the relevant tax cost unless and until the consolidated group disposes of much or all of its business. The Institute considers this proposal could result in consolidated groups, selling off segments of the joining companies' assets, being denied an appropriate recognition for the relevant cost base allocated to goodwill because those goodwill disposal rules are quite restrictive.

Special rules would need to be developed to deal with creeping acquisitions to allow for the implicit market value at the time of commencement of the acquisitions to be used.

(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?*

See response to (d).

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

Yes, in the case of creeping acquisitions where the price effectively paid for assets may not reflect their market value at the joining time.

Additionally, as identified earlier, there are various commercial benefits or assets where the tax cost setting process does not properly allocate costs to those assets. This proposal would result in such unallocable costs being deferred or wasted, particularly if they were allocated to goodwill.

7. CGT issues

7.1 Comments

Refer to specific comments below.

7.2 Response to specific questions

Question 7.1

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

The Institute agrees with the CGT rollover interaction issues identified in paragraph 7.4 of the Discussion Paper.

In addition, Issue 1 notes that when an entity is rolled over into a consolidated group, the rollover may inappropriately result in the 'owned profits' of the group being considered 'acquired profits' of the consolidated group. We note a similar issue could arise in relation to 'owned losses' for the purposes of Step 5 of the entry ACA, where a rollover could result in an owned loss to become an acquired loss. Step 6 of entry ACA for acquired losses will also need to be reviewed.

(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.*

Conceptually, a systemic rule to deal with the CGT rollover of entities into consolidated groups would appear to be a simple solution.

However, if a systemic solution is proposed to apply to all 'restructures' including those that are subject to Subdivision 126-B rollovers, it is important to ensure various scenarios are tested to ensure the systemic solution does not give rise to inappropriate outcomes.

For example, whether the tax cost base of assets should be retained in certain restructures particularly in the context of proposals in relation to CGT Event J1 also set out in Chapter 7 (refer discussion on CGT Event J1).

(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?*

Refer (b) above.

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

Refer comments on the interaction on these proposals with CGT Event J1 in relation to Subdivision 126-B rollovers.

Question 7.2

(a) Do you have any suggestions as to how the difficulties that arise with CGT event 1 can be addressed? If so, what do you suggest?

This section highlights the issues in relation to the interaction of CGT Event J1 and the tax consolidation provisions. These issues were also discussed at the Board's workshop on CGT Event J1 held on 15 October 2012.

The Institute acknowledges the initiative of the Board in organising the workshop to discuss CGT Event J1. Regrettably only a few people participated in the workshop but it identified very well the complex issues involved in this policy consideration.

The comments below identify the issues for further analysis. However, we submit that these issues need further analysis. This further analysis might be undertaken by the Board in this post implementation review, or alternatively might form the subject of further policy development by Treasury.

Our comments are set out in three parts as follows:

- Part 1: Eligible tier 1 company leaves a MEC group
- Part 2: Subsidiary member leaves a MEC group
- Part 3: Head company of a consolidated group leaves the group.

Part 1: Eligible tier 1 company leaves a MEC group

Paragraph 7.56 indicates that concerns have been expressed that the capital gain or loss on the rolled over asset may not be brought to account appropriately in all cases when an eligible tier-1 company leaves a MEC group.

Specifically, the example provided illustrates that a capital gain could be duplicated because of the operation of CGT Event J1 and the cost bases used in determining the capital gain on the disposal of an eligible tier-1 company.

Example 1 attached illustrates that CGT Event J1 applies because the exiting eligible tier-1 company (eligible tier-1 company A), being the recipient company under section 104-175(1), holds an asset that was subject to a Subdivision 126-B rollover; and eligible tier-1 company A stops being a 100% owned subsidiary of the ultimate holding company, TopCo, when TopCo disposes of the membership interests in eligible tier-1 company A.

In addition, when TopCo disposes of membership interests in eligible tier-1 company A, the MEC pooling rules are triggered. Generally, the effect of the MEC pooling rules (in Subdivision 719-K) is to reallocate the cost base of each membership interest in an eligible tier-1 company based on its market value. As the example illustrates, the existing cost base of the membership interests in the eligible tier-1 company that is disposed of may have been reallocated to other membership interests and hence the full gain or loss may not be duplicated at the break-up time. However, if membership interests in other eligible tier-1 companies of the MEC group are disposed of, the full gain or loss may be duplicated.

In any event, double recognition of a capital gain or loss is inappropriate.

Potential solutions

It should be noted that any solution should achieve two objectives:

- prevent the double recognition of the same gain or loss for tax purposes; and
- be simple to implement.

Firstly, we note the policy surrounding the introduction of CGT Event J1. CGT Event J1 was first introduced by *Taxation Laws Amendment Bill 1993* as a general anti-avoidance measure relating to the effective disposal of rolled-over assets outside a company group. A company holding an asset which has been the subject of a CGT rollover under the old section 160ZZO will be deemed to have disposed of and reacquired the asset for its market value if the companies subsequently leave the control of the company which was the ultimate holding company of the group at the time of the first rollover. Tax consolidation would not appear to change this underlying policy principle. However, tax consolidation may change how the capital gain or loss under CGT Event J1 should be calculated and whether an adjustment needs to be made to prevent a gain or loss from being recognised twice in the tax system.

As the policy for introducing CGT Event J1 would still seem to be valid, it seems appropriate for CGT Event J1 to continue to apply.

Possible Alternative 1 – adjust reset cost base

To avoid duplicating a capital gain or loss at the membership interest level, a solution might be to increase (or decrease) the reset cost base of the membership interests in the eligible tier-1 company by the amount of the capital gain (or capital loss) under CGT Event J1.

The adjustment to the cost base due to a capital gain under CGT Event J1 would be allocated based on the market value of the membership interests in the similar manner to how the current MEC pooling rules operate under Subdivision 719-K.

Example 1 illustrates how this solution might be implemented.

This proposal potentially precludes the same gain or loss from being recognised twice. As the MEC pooling rules already operate when membership interests are disposed of, the CGT Event J1 capital gain or loss could increase or decrease the pooled cost amount under Subdivision 719-K and a reset cost base allocated across membership interests in eligible tier-1 companies based on their market value.

We have not tested this solution across all possible scenarios. We recommend that the Board gives further consideration to the range of potential scenarios to see if the proposed solution is workable and engage in further consultation on these developed examples.

Possible Alternative 2 – 'turn off J1'

Under existing law, CGT Event J1 does not happen in certain circumstances. If section 104-182 were modified so that it covers MEC groups as well as consolidated groups (see discussion on 'Subsidiary member leaves a MEC group'), CGT Event J1 would not happen where a recipient company ceases to be a subsidiary member, thus avoiding the double recognition of the same capital gain or capital loss. A subsidiary member of a MEC group includes an eligible tier-1 company (section 719-25(2)). A capital gain would be recognised when the membership interests in the eligible tier-1 company is disposed of.

However, the disadvantage of this approach is that a full capital gain arising from CGT Event J1 event because of an effective disposal may not be fully reflected at the time the membership interests in the eligible tier-1 company are sold, as the cost base of these membership interests may have been reallocated to other membership interest under the MEC pooling rules and the full capital gain might not be recaptured until these other membership interests are sold.

Other relevant issues in identifying a solution

Other issues that need to considered in finding an appropriate solution include:

- If CGT Event J1 is to be retained in this scenario where an eligible tier-1 company leaves a MEC group then careful consideration needs to be given to the drafting of the proposed amendment to section 104-182 to cover MEC groups. This is because the term ‘subsidiary members’ of a MEC group can include eligible tier-1 companies. If CGT Event J1 is to be retained in this scenario then the amendment to section 104-182 might need to be limited to subsidiary members of MEC groups that are not eligible tier-1 companies.
- It should be noted that an eligible tier-1 company of a MEC group can arise where the membership interests are partly held by the foreign top company and another eligible tier-1 company of the MEC group. For example, the foreign top company owns 30 percent of the membership interests in the eligible tier-1 company and the remaining 70 percent of the membership interests is owned another eligible tier-1 company. This example should be considered in the context of any solution proposed by the Board.

Part 2: Subsidiary member leaves a MEC group

Paragraph 7.58 provides that a capital gain or loss on an asset subject to Subdivision 126-B rollover relief may be included in taxable income twice. This is because a capital gain or loss on the disposal of membership interests is calculated using the tax cost setting rules that apply when an entity leaves a group. In addition, CGT Event J1 may also apply to include a capital gain or loss made on the rolled over asset. This result is shown in Example 2 attached where a capital gain of $200 is duplicated.

The problem arises because of the wording of section 104-182. As currently drafted, CGT Event J1 does not happen in relation to a company in receipt of a rollover asset which leaves a consolidated group. The primary reason for this is that Division 711 uses the cost base of the existing subsidiary’s assets in working out the capital gain or loss at the membership level and hence, CGT Event J1 is switched off to avoid the duplication of the same gain or loss.

As noted, the section 184-182 exclusion does not technically apply to MEC groups as only consolidated groups are referred to and the definition of consolidated group in section 995-1(1) does not include MEC groups. As a result CGT event J1 will occur for subsidiary members of MEC groups, not for subsidiary members of consolidated groups.

Potential solution

On the face of it section 104-182 could be modified so that CGT Event J1 does not happen to a subsidiary member of a MEC group at the break up time.

However, consideration needs to be given to the following:

- situations where the assets are membership interests in an eligible tier-1 company of a MEC group; and
- where the rollover assets are membership interests in an eligible tier-1 company, whether the right outcome is achieved having regard to the tax value of the assets of the rolled down eligible tier-1 company . Although we appreciate MEC group ‘transfer down’ issues are outside the scope of this review, any amendment to section 104-182 for MEC groups may potentially impact a transfer down reorganization. An amendment to section 104-182 for MEC groups requires clarification of existing technical issues for transfer down cases in a MEC group. We also note that proposals to retain the tax value of assets for a ‘restructure’ as proposed in Rule 4 of the Board’s Discussion Paper appear to apply in the case of MEC transfer down cases. This also needs to be

considered in tandem with a proposed solution to address these issues – refer example 2A.

Part 3: Head company of a consolidated group leaves the group

We agree with the comments made in Discussion Paper that there are uncertainties where assets, being membership interests, are rolled to the head company of a consolidated group that is owned by a foreign resident and the head company subsequently leaves the group.

Example 3 identifies issues raised in a scenario where the rolled over assets are membership interests in a subsidiary of the foreign company.

Assume TopCo holds a 100% interest in two Australian resident entities, SubCo and HeadCo. Assume SubCo holds a TARP asset with a cost base of $100. The following events occur:

- The membership interests in SubCo are transferred to HeadCo under a Subdivision 126-B rollover. Assume the market value of the membership interests is $600 (being the net asset value of SubCo).
- TopCo sells the membership interests in HeadCo to a third party for market value of $600 (assume this event occurs shortly after the rollover so the market value of the membership interests at the rollover time and the break up time is the same).

Rollover of membership interests

When the membership interests in SubCo are transferred to HeadCo, SubCo becomes a subsidiary member of the HeadCo consolidated group and therefore an ACA calculation needs to be performed at the joining time.

As the cost base of the membership interests in SubCo are inherited by HeadCo, Step 1 of the entry ACA is $100 and Step 2 liabilities are $400. Total ACA to allocate to SubCo's assets is $400. Based on the market values, $450 is allocated to the TARP asset and $50 to the depreciable asset.

Break up time

When TopCo sells the membership interests in HeadCo, a technical question arises as to whether CGT Event J1 applies. In particular, section 104-175(1)(b) sets out one of the conditions for CGT Event J1 to apply: 'the company (the recipient company) that *owns the roll-over asset* just after the roll-over stops being a 100% subsidiary' (emphasis added).

The issue that arises is whether HeadCo can be said to 'own the rollover asset just after the roll-over' despite the single entity rule. As noted at the Board's meeting on CGT Event J1 on 15 October 2012, any solution proposed by the Board to address the issues in this example could result in an inference drawn on how the ATO might interpret CGT Event J1 in light of the single entity rule. The Board should be mindful of this.

Potential solution

Conceptually HeadCo, that owns the rolled over asset, has left the TopCo group and hence there is an effective disposal of rolled-over assets outside a company group. Hence, it seems that the policy for CGT Event J1 as set out above should apply in this scenario.

If it is assumed CGT Event J1 applies, there are 3 possible options to calculate the cost of the membership interests for the purposes of working out a CGT Event J1 capital gain.

- Option 1: Historic cost
- Option 2: Deem an exit ACA calculation at the break up time for the membership interests
- Option 3: Nil cost base because the membership interests in SubCo are not recognised in the consolidated group

If the historic cost or deemed exit ACA calculation is used, a capital gain of $500 would arise under CGT Event J1. However, if a nil cost base is used for the membership interests, a capital gain of $600 would be used. The economic (and deferred) gain in relation to the rolled over asset is $500 (it is assumed there is no gain or loss on the sale of the shares in HeadCo).

Thus, the application of CGT Event J1 based on either the historic cost base of the shares or a deemed ACA calculation at the break up time would appear to give the economic outcome in this example.

However, the disadvantage of this approach is the requirement to retain records in relation to the historic cost base of the shares for a rollover that may have been done many years ago. The disadvantage of a deemed exit ACA calculation in relation to membership interests in Sub-Co is that it increases complexity for taxpayers of having to perform this calculation where there has not been an exit of SubCo.

An alternative approach was discussed at the Board's workshop on 15 October under which a CGT Event J1 capital gain is determined by reference to the cost of the underlying assets of the rolled over entity. In this example, the CGT Event J1 capital gain would be worked out by reference to assets other than depreciable assets and revenue assets.

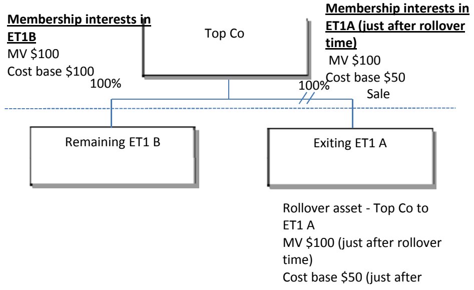
Thus, the CGT Event J1 capital gain under this approach would be:

- $600 (difference between the market value of $900 and $300, assuming the cost of the assets are retained because of Rule 4 of the Board's proposal for 'restructures'); or
- $450 (difference between the market value of $900 and $450, assuming the reset cost base at the joining time is used).

The Institute highlights that the issues raised here are interdependent with the proposal in Rule 4 to retain the tax value of assets and should be considered in tandem when the Board considers its recommendation.

If the alternative approach as discussed in the workshop is considered, it will also be important to consider the appropriate cost base of the assets that were used in taking into account in working out the CGT Event J1 capital gain. Prima facie, it would seem appropriate for the cost base of these assets to be reset to their market value just after the breakup-time to avoid double recognition of a gain (or loss) in the future.

Example 1: ET1 leaves a MEC group



ET1 A's balance sheet (just after rollover time)

ASSETS	Tax cost	Market value	LIABILITIES	Tax cost	Market value
TARP asset (rolled over asset)	50	100	Equity	50	100
Total assets	50	100	**Equity**	50	100

ET1 B's balance sheet

ASSETS	Tax cost	Market value	LIABILITIES	Tax cost	Market value
Cash	100	100	Equity	100	100
Total assets	100	100	**Equity**	100	100

MEC pooling

BEFORE Membership interests in	Tax cost	Market value	AFTER EVENT	Tax cost	Market value
ET1 A	50	100	ET1 A	75	100
ET1 B	100	100	ET1 B	75	100
Total	150	200	**Total**	150	200

CGT Event J1

Capital gain breakup time	Tax cost	Market value shares	Capital gain
TARP asset			
Historic cost	50	100	50

Sale of ET1 A

Capital gain	Tax cost	Market value shares	Capital gain
Membership interests in ET1 A	75	100	25

Total taxable gain

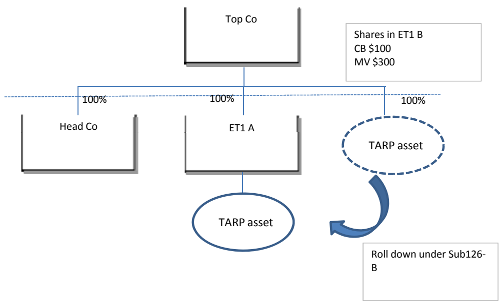
Capital gain	Tax cost	Market value shares	Capital gain	Economic outcome
Membership interests in ET1 A	75	100	25	
CGT Event J1	50	100	50	
Total			75	50

Note: Economic outcome is $50 (difference between $150 less $100).
Duplication of $25 occurs when ET1 A is sold off. If ET1 B is also sold off there will be a duplication of full $50 capital gain.

Proposed solution:

Capital gain	Capital gain	Increase cost base	New cost base	Capital gain	Economic outcome
CGT Event J1	50			50	50
Membership interests in ET1 A		25	100	0	
Membership interests in ET1 B		25	100	0	

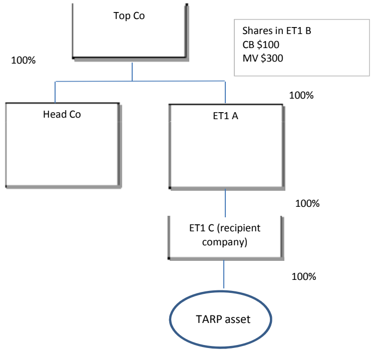
Example 2: Subsidiary member leaves a MEC group



ET1 A's balance sheet

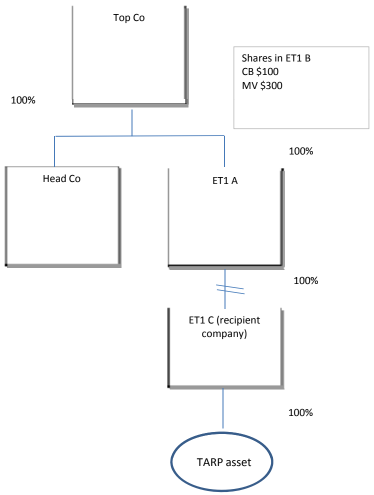
ASSETS	Tax cost	Market value	LIABILITIES	Tax cost
TARP asset	100	300	Equity	100
Total assets	100	300	**Liability & Equity**	100

Step 1: Shares in ET1 B rolled over under Sub 126-B from Top Co to ET1 C



Deferred capital gain to Top Co	Tax cost	Market value	Capital gain	Economic outcome
126-B	100	300	200	200

Step 2: ET1 C leaves the MEC group



ET1 C leaves MEC group

	Tax cost	Market value shares	Potential capital gain on sale	Economic outcome
TARP asset	100	300	200	200

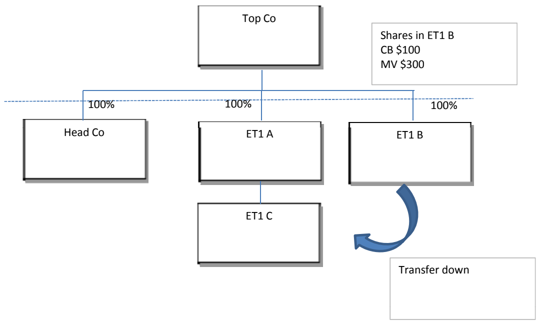
Assume ET1 C incorporated for nominal value & has no other assets or liabilities.

Taxable gain	Potential capital gain on sale	Economic outcome
Shares in ET1C	200	
CGT Event J1	200	
Total	400	200

Observations:

(1) If CGT Event J1 happens when ET1 C leaves the MEC group, capital gain of $200 will arise.
(2) This same gain of $200 has been recognised when TARP asset has been disposed of.
(3) Result: Double recognition of the same gain.

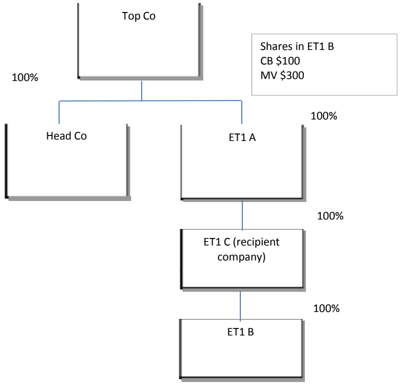
Example 2A: Subsidiary member leaves a MEC group



ET1 B's balance sheet

ASSETS	Tax cost	Market value	LIABILITIES	Tax cost
TARP asset	100	300	Liabilities	0
			Total liabilities	0
			Equity	100
Total assets	100	300	**Liability & Equity**	100

Step 1: Shares in ET1 B rolled over under Sub 126-B from Top Co to ET1 C



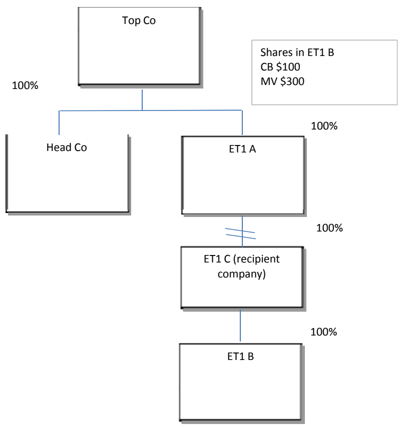
Deferred capital gain to Top Co	Tax cost	Market value shares	Capital gain	Economic outcome
126-B				
Shares in ET1 B	100	300	200	20

Tax cost of TARP asset after ET1 B is rolled down

Asset	Tax cost	Market value shares	Potential capital gain on sale	Economic outcome
TARP asset	100	300	200	200

Tax cost of $100 assumes ET1B's assets are not reset on roll down because ET1 does not 'become' subsidiary member of MEC group.
Reference: NTLG Consolidation Discussion paper - 26 November 2006
Technical clarification required.

Step 2: ET1 C leaves the MEC group



ET1 C leaves MEC group

	Tax cost	Market value shares	Potential capital gain on sale	Economic outcome
Shares in ET1 C	100	300	200	200

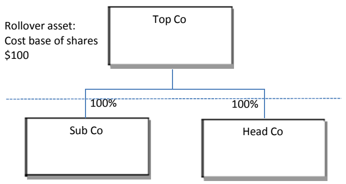
Exit ACA produces tax cost of $100 for shares in ET1C (based on tax cost of shares in ET1 B of $100
Assume ET1 C incorporated for nominal valu & has no other assets or liabilities.

Observations:

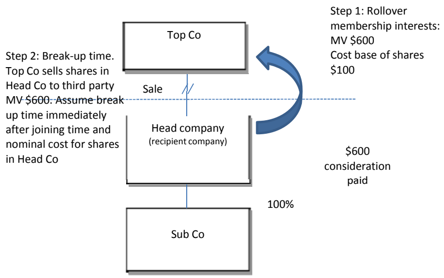
(1) If CGT Event J1 happens when ET1 C leaves the MEC group, capital gain of $100 will arise.
(2) This same gain has been recognised when shares in ET1C has been disposed of.
(3) Result: Double recognition of the same gain.

(4) If the rolled over asset are shares in an ET1 that is rolled down, need technical clarification that assets are not reset.
Alternatively, if assets are reset in a transfer down case, then potentially there is no gain duplication.

Example 3 - Tax consolidation and J1 example



Assumed facts: Sub Co was incorporated with equity of $100. Subsequently, Sub Co purchased assets for $500 using $100 of equity capital and $400 borrowings. No MEC group formed.



SubCo's balance sheet

ASSETS	Tax cost	Market value	LIABILITIES	Tax cost
TARP asset	300	900	Liabilities	400
Depreciable asset	200	100		
			Total liabilities	400
			Equity	100
Total assets	500	1000	**Liability & Equity**	500

Step 1: Rollover of membership interests

Head Co - Acquisition cost of shares	Tax cost	Market value	Economic outcome
Membership interests (assume net asset value 1000 less 400 at joining)		600	600
If ACA allocation based on Step 1 $100:			
- TARP asset	450	900	900
- Depreciable asset	50	100	100
Deferred gain in membership interests s126-60 ITAA 97	100	600	500

Note: ACA is worked out using Step 1 of $100 (original cost of shares) and Step 2 $400 of liabilities.
Top Co has deferred a gain of $500 from the disposal of membership interests in Sub Co to Head Co.

Step 2: Break-up time

Capital gain breakup time	Tax cost	Market value shares	Capital gain (Head Co)	Economic outcome (Top Co)
CGT Event J1 membership interests				
(1) Historic cost	100	600	500	500
(2) Push down/Push up	100	600	500	500
(3) Nil cost base	0	600	600	500

Note: Exit ACA for membership interests in (2) is determined using the terminating value of assets ($500) less $400 liabilities (Step 4).
Option 3 of nil cost base is based on the technical argument the shares don't exist at the joining time.
Economic gain to Top Co for the disposal of membership interests in Sub Co is $500 ($600 less $100 cost).

J1 capital gain based on $100 cost of shares appears to give the economic result (although Head Co will be taxed)

Alternative proposal to work out J1 capital gain

Proposal: Deem J1 for assets held at joining and break-up time			Capital gain	Economic outcome
TARP asset	300	900	600	500
Depreciable asset	200	100	0	0
Total	500	1000	600	500

Note: Proposed solution results in amount different to economic outcome because:
(a) only TARP asset used to work out deemed capital gain (and other assets are reflected in the market value of the shares
(b) The assets were acquired by Sub Co after the company was incorporated, so the cost base of shares do not reflect cost base of assets.

CGT Event J1 capital gain under this approach would be $600 (difference between the market value of $900 and $300, assuming the cost of the assets are retained because of Rule 4 of the 2012 BoT proposals for 'restructures') or $450 (difference between the market value of $900 and $450, assuming the reset cost base at the joining time is used).

Step 3: Acquisition cost for shares & assets after J1

Head Co - New acquisition cost for assets?	Tax cost	Market value	Capital gain	Economic outcome
If tax cost retained:				
- TARP asset	450	900	450	0
- Depreciable asset	50	100	50	0
Total			500	
If tax cost reset:				
- TARP asset	900	900	0	0
- Depreciable asset	100	100	0	0
Total			0	

Note: If the tax cost of assets are retained and J1 continues to apply, then there is potentially duplicate recognition fo the same economic gain (J1 and when the assets are disposed of after the break up time).
If the tax cost of assets are reset, there is no double recognition of the same gain.