PITCHER PARTNERS

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

Submission

24 October 2012

PITCHER PARTNERS
ADVISORS PROPRIETARY LIMITED

Level 19
15 William Street
Melbourne
Victoria 3000

Postal Address:
GPO Box 5193
Melbourne Vic 3001
Australia

Tel: 03 8610 5000
Fax: 03 8610 5999

www.pitcher.com.au
info@pitcher.com.au

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24 October 2012

Ms Terresa Yiu
Board of Taxation Secretariat
C/- The Treasury
Langton Crescent
PARKES ACT 2600
AUSTRALIA

Email: taxboard@treasury.gov.au

Dear Terresa

POST IMPLEMENTATION REVIEW OF CERTAIN ASPECTS OF THE CONSOLIDATION TAX COST SETTING PROCESS

Thank you for the opportunity to make a submission in relation to the Board of Taxation's (**the Board**) discussion paper titled "Post Implementation Review of Certain Aspects of the Consolidation Tax Cost Setting Process" (**the Discussion Paper**).

Pitcher Partners comprises 5 independent firms operating in Adelaide, Brisbane, Melbourne, Perth and Sydney. Collectively we would be regarded as one of the largest accounting associations outside the Big Four. Our specialisation is advising smaller public companies, large family businesses and small to medium enterprises – which we refer to as the middle market in this submission.

Our focus in making this submission on the Discussion Paper is therefore on the implications of the recommendations contained in this Discussion Paper on the middle market.

Attachment 1 contains a summary of our responses to each of the questions raised in the Discussion Paper. Attachment 2 contains our detailed responses to each of those questions. We have also included detailed examples in Appendix A to E.

We would be happy to discuss any aspects of this submission with the Board of provide further details or commentary if required. If you have any queries, please contact me at any time on 03 8610 5170.

Yours sincerely

A M KOKKINOS
Executive Director

an independent member of
BAKER TILLY
INTERNATIONAL

ATTACHMENT 1
SUMMARY OF RESPONSES TO THE BOARD'S QUESTIONS

Question 2.1(a): Do stakeholders agree with the Board's analysis in this chapter? Why, or why not?

In general we agree with the analysis with respect to Example 2.1 to 2.3 where an entity that is part of a tax consolidated group is acquired by another tax consolidated group. However, we note that the same issue does not appear to arise to the extent that the joining entity has been owned, or partly owned, by the tax consolidated group. Furthermore, we note that double taxation may occur (from a systemic basis) where the joining entity was not formally part of a tax consolidated group. We therefore highlight these cases for further consideration by the Board, in determining whether appropriate exceptions should be taken into account in the final recommendation by the Board.

Question 2.1(b): Do stakeholders agree with the Board's preferred solution to the issues? Why, or why not?

While Option 1 provides an appropriate outcome in the examples contained in the Discussion Paper, we refer to our problem raised with Question 2.1(a) on the "owned" component of a liability. If the "assumed liability" rule were to properly cater for the "owned" problem, then Option 1 would be administratively difficult to cater for (i.e. as it would require a net profit or loss to be determined on the acquired portion). To balance the integrity of the provisions with compliance costs, we believe that Option 2 should be re-considered by the Board, as this could more easily be adapted where the assumed liability rule caters for "owned" components of the deduction. We agree that liabilities settled on a net profit basis (e.g. under Division 775) is likely to require a special rule.

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?

As unrealised profits may be covered by the proposal (i.e. forex gains), the Board should consider whether liabilities that represent "unearned income" amounts should be excluded from the proposed rules. We are concerned that the proposed rule may result in a second taxing point when the liability is later recorded as profit.

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.

Please refer to our response to Question 2.1(b) regarding owned and acquired components of a liability. Additional compliance tracking options should be considered for current and non-current liabilities, to the extent to which the assumed liability rule will apply to those liabilities.

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?

Please refer to our response to Question 2.1(a) and Question 2.1(b). We believe that the Board should consider the double taxation issues that may arise on a systemic basis where the vendor is not a member of a tax consolidated group.

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?

We believe that the Board should consider how the rule will interact with both the entry calculations (e.g. with section 705-80) as well as the exit calculations. Furthermore, the Board should consider whether the application date should cater for a case where the majority of an entity has been acquired or owned prior to that date.

Question 3.1(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 highlight that we believe that a DTL is required to the extent to which an unrealised gain on a liability is an "owned" amount. We have not identified further scenarios where this may be the case and thus note that this should be explored further by the Board.

Question 3.1(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?

Provided that the Board accepts our Chapter 2 proposition, being that the "assumed liability" rule should not apply to owned liabilities, then section 705-80 may provide the correct outcome where DTLs are removed in these cases without the need for further amendments.

Question 3.1(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.

Refer to our response to Question 3.1(a) and (b).

Question 3.1(d): What alternatives, if any, are there for reducing the complexity introduced by deferred tax liabilities?

Refer to our response to Question 3.1(a) and (b).

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?

We do not agree that section 705-70(1A) was intended to be applied only to DTLs. We note that it is may be possible to change the value of a liability under AASB 3, when the joining entity becomes a member of the tax consolidated group. Section 705-70(1A) seems to be warranted where (at the very least) the head company has factored the change in liability into the purchase price of the entity. However, whether section 705-70(1A) is to be removed or retained would require the Board to appropriately consider the policy of the provision, the compliance costs associated with applying the provision and whether the provision would result in a reduction of the integrity of the system.

Question 4.1(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?

Please refer to our response to Question 4.1(a).

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?

We agree with the proposition to remove section 705-80 for acquired cases. We also note that, based on our limited testing of section 705-80, there is a case for turning off section 705-80 to the extent that a liability is acquired and one is required to apply an "assumed liability" rule to the liability.

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.

Yes, there are many other examples that may result in the same problem, whereby (for example) a risks and rewards test may either recognise or derecognise assets for accounting purposes on a basis other than legal ownership.

Question 5.1(b): Do you agree with Board's preliminary view for resolving this issue? If not, are there other approaches that should be considered?

We agree with the Board's preliminary view for resolving this issue. However, we believe that the Board and Treasury will need to workshop and test various examples to ensure that they work appropriately (as demonstrated by the examples provided). Transitional issues will need to be considered where an entity has already joined a tax consolidated group under the current law and then subsequently leaves applying the proposed new rules.

Question 5.1(c): What are the appropriate circumstances in which assets and liabilities can be said to be related?

At a high level, we believe that the principle requires consideration of the broader assets and liabilities recognised by the entity under the relevant transaction. Accordingly, the "related" test may only apply appropriately if it has regard to this broader concept. We believe that the Board and Treasury should test this suggestion with appropriate examples when developing the solution or legislation.

Question 6.1(a): Do you consider that rules should be introduced to cap the tax cost of all assets?

We are not convinced that a capping rule will provide an appropriate outcome, especially in a creeping acquisition case.

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?

In a creeping acquisition, the proposed capping rule would result in less neutrality as between an asset acquisition as compared to the results under tax consolidation.

Question 6.1(c): What difficulties, if any, could arise if the tax cost setting amount for all assets was capped?

In a creeping acquisition, the proposed capping rule could result in significantly lower tax costs for CGT assets than would otherwise be appropriate. This could give rise to higher tax risks for purchasers that wish to acquire assets under a tax consolidation regime over a period of time (i.e. under a creeping acquisition).

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?

If a capping rule is introduced, then the amount of ACA that is allocated to goodwill should also be capped to its market value. Accordingly, if the company does not have goodwill, no amount would be allocated to the asset.

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?

Any alternative recognition is likely to have revenue implications and therefore (other than retaining the current rules), we are sceptical as to whether the Government would accept an alternative treatment (even where the alternative is more appropriate). Accordingly, if a capping rule is introduced, the Board should accept that (at the very least) a weighted average market value can be used for CGT assets (as an alternative to using the market

value at joining time). Such a rule will likely increase compliance costs significantly and therefore we question whether the capping rule should be introduced in the first place.

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?

Please refer to our response to Question 6.1(a).

Question 7.1(a): Do you agree with the CGT rollover interaction issues that are outlined in this chapter?

Yes, in general, we agree with the CGT rollover interaction issues outlined in Chapter 7 and believe that it is important for the Board and Government to address these issues for large SME groups wishing to consolidate for tax purposes. We believe that addressing these issues is likely to have a positive contribution to the revenue, as it will encourage larger groups to move into a corporate tax system rather than a trust system. We also believe that these suggestions are likely to reduce compliance costs for SME groups significantly.

Question 7.1(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.

Yes, in general, we believe that systemic rules should apply to ensure that appropriate results for both taxpayers and the revenue are achieved following a rollover into a tax consolidated group.

Question 7.1(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?

In principle, if Rule 1, 3 and 4 were implemented, these rules would address the majority of concerns by SME groups in rolling entities into a tax consolidated group. We acknowledge that Rule 1 may require some modification to appropriately address the rollovers that should be subject to such rules. Rule 2 may seem unnecessary if Rule 4 is otherwise implemented.

Question 7.1(d): Are there any consequential issues which arise if the Board's suggested rules for dealing with CGT rollovers into consolidated groups are adopted?

Yes, we believe that there may be a number of consequential issues that would need to be considered on implementation of the Chapter 7 rules – however, the amount of consequential issues would be reduced if the Board recommended the use of existing rules that apply the proposed rules contained in Rule 1, 3, and 4.

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?

Noting that the issues with CGT event J1 are complicated and difficult to resolve, we believe the Board should consider whether it is better to simply make suggestions to resolve "some" of the issues with CGT event J1 (being those that are able to be corrected) rather than trying to resolve all of the issues.

ATTACHMENT 2
DETAILED RESPONSES TO THE BOARD'S QUESTIONS

Chapter 2: Liabilities held by an entity that joins a consolidated group

2.1 Question 2.1(a): Do stakeholders agree with the Board's analysis in this chapter? Why, or why not?

Overview

2.1.1 Chapter 2 highlights the outcomes that occur when an entity (that is part of one consolidated group) is acquired by a tax consolidated group. We agree with the Board's analysis with respect to that transaction.

2.1.2 However, we note that this example deals with a 100% acquisition case between two consolidated groups. Accordingly, we are unsure whether the same outcomes occur where this fact pattern does not exist. Per our discussion below, we would recommend further consideration of these additional scenarios.

2.1.3 When testing these other scenarios, we believe that the comparison of economic outcomes versus tax outcomes needs to be slightly adjusted to take into account "owned / taxed profits" of the acquirer (as a relevant economic cash flow). In a 100% acquisition case, as this amount is nil, this is not a relevant factor for the acquirer.

2.1.4 We believe that the following cases should be considered further by the Board in order to determine whether an appropriate outcome occurs under the proposed amendments. While we understand that these examples may have already been tested, it is important to consider this group of additional case studies so that the package of reforms will provide an appropriate outcome in more than just the vanilla acquisition case.

a) Case 1: an entity joins the tax consolidated group when they were 100% owned by the head company (directly or indirectly) prior to recognising the liability as an accounting liability.

b) Case 2: an entity joins the tax consolidated group when they were partly owned by the head company (directly or indirectly) prior to recognising the liability as an accounting liability.

c) Case 3: the entity that joins the tax consolidated group was not part of a tax consolidated group prior to the acquisition.

2.1.5 We note that the list of examples above is not intended to be an exhaustive list of cases that should be further considered by the Board. Accordingly, we highlight these examples so that the Board can consider whether it may be appropriate to adjust the proposed recommendations for certain cases.

Case 1: The owned entity example

2.1.6 This first case involves the situation where an entity is already wholly owned by the head company prior to the recognition of the liability that will eventually give rise to a

tax deduction. The most common situation where this would arise is in a formation case (but may also occur in other cases – for example, a migration case where a 100% owned subsidiary entity was previously a non-resident and thus not part of the tax consolidated group).

2.1.7 Using the same facts as those contained in Example 2.1 of the Board's Discussion Paper, assume that the example was adjusted so that Company A was incorporated by Purchaser Co so that Purchaser Co owned 100% of the shares since incorporation. Assume that Purchaser Co subsequently chooses to form a tax consolidated group (once the liability is recorded in the financial statements of Company A).

2.1.8 Our calculations for this example are contained in Appendix A, which contain what we understand to be the economic and tax outcomes in this example. It is important to note that the tax and economic outcomes in this situation match – that is, there is no mismatch that occurs when a deduction is provided to Purchaser Co. The following table outlines the "economic profit" that we believe would occur after Company A joins the tax consolidated group.

	Economic profit
Proceeds from the sale of asset	$700
Cash at bank	$240
Total proceeds	**$940**
Less: Cost of shares	($200)
Less: Taxed (owned) profits	($140)
Less: Deduction for provision	($200)
Total costs	**($540)**
Economic taxable profit to be taxed to Purchaser Co	**$400**

2.1.9 The economic profit of $400 matches the taxable profit for Purchaser Co after the formation of the tax consolidated group. That is, there is a taxable gain on the disposal of the land equal to $600 and a deduction available on the settlement of the provision equal to $200.

2.1.10 Accordingly, the example demonstrates that in a formation case, where Step 1 has been determined without taking into account the liability amount, the "assumed liability" rule is not required.

2.1.11 We highlight that this example is critically important for the purpose of testing Case 2 below, which relies on the same principal.

Case 2: The partly owned entity example

2.1.12 This second case develops further on the situation covered by Case 1. It involves a case where the entity is already partly owned by a tax consolidated group prior to

entity becoming wholly owned. Such an entity then subsequently joins the tax consolidated group when 100% of the shares are acquired.

2.1.13 Using the same facts as those contained in Example 2.1 of the Board's Discussion Paper, assume that the example was adjusted so that Company A was incorporated by Purchaser Co and Vendor Co, so that Purchaser Co owned 99% of the shares and Vendor Co owned 1% of the shares. Assume that Purchaser Co subsequently only acquired the remaining 1% of shares from Vendor Co for their market value of $6 (i.e. 1% x $600).

2.1.14 In this example, the facts have been set so that it is relatively simple to determine that Purchaser Co has only acquired 1% of the liability – that is, the purchase price for the acquisition of the 1% of shares in Company A were adjusted for the provision / liability of Company A.

2.1.15 Our calculations for this example are contained in Appendix B. The following table outlines the "economic profit" that we believe would occur after Company A joins the tax consolidated group.

	Economic profit
Proceeds from the sale of asset	$700.00
Cash at bank	$240.00
Total proceeds	**$940.00**
Less: Cost of shares	($204.00)
Less: Taxed (owned) profits	($138.60)
Less: Deduction for provision	($200.00)
Total costs	**($542.60)**
Economic taxable profit to be taxed to Purchaser Co	**$397.40**

2.1.1 In this example, we believe the economic profit is equal to $397.40. We also believe that the taxable profit to the tax consolidated group, however, is equal to $396.00. The difference is equal to $1.40. It is important to note that this effectively equates to 1% of the $140 duplication demonstrated by Example 2.1 in the Board's Discussion Paper.

2.1.2 We have tested the above example with different owned / acquired percentages. The examples all seem to demonstrate the same limitation regarding the duplication of deductions. That is, to the extent that the "acquisition" did not include a portion of the liability (and thus is not reflected in the purchase price recorded at Step 1), there appears to be no duplication. In other words, in the example above, there should be no reason to deny 99% of the deduction for the liability to Purchaser Co.

2.1.3 Accordingly, we believe that the correct taxation outcome would not occur if a consolidated group is required to apply the "assumed liability" rule to the extent to which it is not an acquired (deductible) liability.

2.1.4 We acknowledge that the reverse is also true. That is, a formation case may also involve a subsidiary that has recently been acquired. Accordingly, the same principles as contained would apply in those cases in determining the extent to which a duplication / mismatch occurs.

Case 3: Disposal by a non-consolidated group

2.1.5 This third case involves the disposal of an entity by a non-consolidated group to a tax consolidated group. For example, using the same facts as Example 2.1, assume that Company A was owned by Trust X and therefore did not form part of a tax consolidated group.

2.1.6 Our calculations for this example are contained in Appendix C. The following tables summarise the outcome that we believe would occur both before and after the proposed change to introduce an assumption of liability rule.

Case 3A: Current law	Vendor	Purchaser	Total
Taxable profit	400[1]	0[2]	400
Economic profit[3]	260	140	400
Over / (under) taxed	**140**	**(140)**	**0**

Case 3B: After possible legislative change	Vendor	Purchaser	Total
Taxable profit	340[4]	200[5]	540
Economic profit[6]	200	200	400
Over / (under) taxed	**140**	**0**	**140**

2.1.7 As demonstrated, a duplication of the loss / deduction is unlikely to occur on a systemic basis where both the Vendor and the Purchaser are Australian resident taxpayers. However, we acknowledge that a mismatch of tax obligations can still occur as demonstrated by the table (i.e. over-taxation of the vendor and under-taxation of the purchaser). We also acknowledge that due to various reasons, the vendor may not be taxable on sale of shares (e.g. where a non-resident taxpayer sells non-TAP assets).

[1] Proceeds on the sale of shares ($600) less the cost base of shares ($200) = $400
[2] See conclusions to Example 2.2 of the Board's Discussion Paper for the Purchaser
[3] See conclusions to Example 2.2 of the Board's Discussion Paper
[4] It is assumed the proceeds on the sale of shares would be adjusted to $540 for the reduced DTA
[5] See conclusions to Example 2.2 of the Board's Discussion Paper for the Purchaser
[6] See conclusions to Example 2.3 of the Board's Discussion Paper

2.1.8 However, in the SME sector, the scenario above is likely to occur more often than not. That is, where a non-consolidated "taxable" entity disposes of its shares in an entity to a consolidated "taxable" entity. In many cases, such transactions occur between family members. Accordingly, from an overall revenue and system perspective, we highlight that an assumption of liability rule could result in many SME groups being effectively overtaxed in cases that may be considered inappropriate. We also note that, subject to concessions allowing SME groups to enter tax consolidation, there is a significant compliance impediment for SME groups to enter tax consolidation in order to avoid this duplication issue.

2.1.9 Accordingly, we request that the Board consider this example in determining whether an exception should be provided where the shares held in the joining entity have not been subject to Division 711 and resulted in a taxable gain to the vendor.

Response to Question 2.1(a)
In general we agree with the analysis with respect to Example 2.1 to 2.3 where an entity that is part of a tax consolidated group is acquired by another tax consolidated group. However, we note that the same issue does not appear to arise to the extent that the joining entity has been owned, or partly owned, by the tax consolidated group. Furthermore, we note that double taxation may occur (from a systemic basis) where the joining entity was not formally part of a tax consolidated group. We therefore highlight these cases for further consideration by the Board, in determining whether appropriate exceptions should be taken into account in the final recommendation by the Board.

2.2 Question 2.1(b): Do stakeholders agree with the Board's preferred solution to the issues? Why, or why not?

2.2.1 We understand that Option 1 has been chosen by the Board as it appears to provide the correct tax outcome for the consolidated group in the example contained in the Discussion Paper.

2.2.2 However, it is difficult to respond to this question until one understands whether the Board accepts the exceptions contained in Section 2.1 of this submission. This is because Option 1 would be difficult to implement if the Board were to agree that an "assumed liability" rule is not appropriate to the extent that the joining entity is an owned entity (or has been acquired from a non-tax consolidated group).

2.2.3 This is because Option 1 would then only be applied to the extent of the acquired portion of the liability, rather than the whole of the liability, making it difficult if not impossible to apply. This is because Option 1 would mandate a "net profit" calculation to be applied only to the "acquired" portion of the liability. It is again noted that this complication arises if the Board accepts the propositions outlined in Section 2.1. While one solution to this problem may be ignore our suggestions in Section 2.1, we do not believe that it would be an appropriate solution.

2.2.4 Where this is the case, we highlight that there the Board must consider whether there should be balance struck between compliance and integrity. Accordingly, we

highlight that Option 2 should be reconsidered as an option that may give rise to a more appropriate balance between compliance and integrity.

2.2.5 That is, to the extent that a liability is an acquired accounting liability, a deduction would be denied after the joining time to that extent under Option 2. Accordingly, in our Case Study 1, no deduction would be denied (as the case involved a 100% owned entity). In our Case Study 2, a deduction of $2 would be denied, equal to 1% of $200. The deduction could be denied on a FIFO basis. On this approach, Option 2 would appear to be a relatively simple solution to the problem.

2.2.6 We acknowledge that Option 2 is not a perfectly scientific approach to addressing the issue. However, we believe that this alternative would strike an appropriate balance between integrity and compliance and therefore request that the Board reconsider this alternative.

2.2.7 We further note that should an entity exit the tax consolidated group, Option 1 would require one to determine the exact amount of the liability remaining that had been there at entry time (i.e. in accordance with section 711-45(8)). Alternatively, Option 2 would seem to simply require one to determine the extent to which a deduction has not been denied for the purpose of the operation of the provision (thus in our view reducing compliance requirements for the operation of the provision).

2.2.8 We also note that this would not deal with liabilities that are subject to “net” provisions, such as Division 775. We believe that such provisions should be examined separately and should have their own interaction rule with tax consolidation (taking into account the above issues).

Response to Question 2.1(b)
While Option 1 provides an appropriate outcome in the examples contained in the Discussion Paper, we refer to our problem raised with Question 2.1(a) on the “owned” component of a liability. If the “assumed liability” rule were to properly cater for the “owned” problem, then Option 1 would be administratively difficult to cater for (i.e. as it would require a net profit or loss to be determined on the acquired portion). To balance the integrity of the provisions with compliance costs, we believe that Option 2 should be re-considered by the Board, as this could more easily be adapted where the assumed liability rule caters for “owned” components of the deduction. We agree that liabilities settled on a net profit basis (e.g. under Division 775) is likely to require a special rule.

2.3 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?

2.3.1 It is unclear whether the proposed rule would extend to liabilities such as “unearned income” liabilities, which become assessable after the joining time. That is, while the chapter deals with “deductible liabilities”, it is unclear whether this extends to

unrealised profits simply because Chapter 2 seems to indicate that unrealised gains on forex loans would also fall within the assumed liability rule.

2.3.2 As unearned income amount can become taxable in the future (i.e. when the income is earned), or may consist of an amount that has already been taxed in the past for tax purposes. We therefore believe that it may be inappropriate to include such liabilities within the proposed liability assumption rule (i.e. which could result in a second duplicated gain when the liability is settled for nil (as the case has already been received)). We note that calculations would need to be conducted to determine the correct policy position for such arrangements.

2.3.3 Accordingly, we believe that the Board should consider whether such liabilities need to be specifically excluded from the proposed rule.

Response to Question 2.1(c)
As unrealised profits may be covered by the proposal (i.e. forex gains), the Board should consider whether liabilities that represent "unearned income" amounts should be excluded from the proposed rules. We are concerned that the proposed rule may result in a second taxing point when the liability is later recorded as profit.

2.4 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.

2.4.1 In addition to our preference to use Option 2 for gross liabilities, we note that there will still be compliance issues associated with tracking the deductions of liabilities over time. We request the Board to consider proposing compliance alternatives, similar to section 711-45(8).

2.4.2 The reason for this is due to the fact that deductible liabilities are predominantly calculated using actuarial calculations and therefore bear little correlation to the actual amount that is otherwise paid or deducted at a later stage. For example, a provision for long service leave requires probability and present value estimation (reference is made to AASB 119). However, such amounts would never equate to the deduction claimed, which would be performed on a nominal basis as amounts are paid at a later date.

2.4.3 One type of option that could be considered by the Board would be to allow a straight line write-off of the amount over a period of time, depending on whether the liability would be a current or non-current liability in accordance with the accounting standards. For example, where a liability is a current liability, taxpayers could be provided with a choice to "assume" that the amount is to be deducted over two years on a straight line basis. Where the liability is a non-current liability, a five year option could be provided. This type of option could otherwise avoid the need to require taxpayers to track the exact amounts of each of the liabilities that would be subject to this provision.

2.4.4 Furthermore, if the Board accepts this write-off rule, this would also ensure that compliance costs are kept to a minimum when there is an owned element. For example, assume there is an annual leave provision of $100,000, whereby only 50% is acquired. The assumed liability provision under Option 2 would deny a deduction for $50,000. This amount would be denied over two years for leave deductions (by simply requiring one to add an amount back to assessable income during that period). In our view, applying this option using this compliance saving method may provide a simpler mechanism to implementing the assumed liability rule.

Response to Question 2.1(d)
Please refer to our response to Question 2.1(b) regarding owned and acquired components of a liability. Additional compliance tracking options should be considered for current and non-current liabilities, to the extent to which the assumed liability rule will apply to those liabilities.

2.5 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?

Response to Question 2.1(e)
Please refer to our response to Question 2.1(a) and Question 2.1(b). We believe that the Board should consider the double taxation issues that may arise on a systemic basis where the vendor is not a member of a tax consolidated group.

2.6 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?

2.6.1 There are a number of interactions that should be considered when implementing the Board's proposed solution. For example, the Board should ensure that appropriate interactions occur between aspects of the entry tax cost setting provisions (e.g. section 705-80 interacts appropriately with the proposals) and with the exit tax cost setting provisions (e.g. that section 711-45(8) interacts appropriately with the proposal). Further discussion of section 705-80 interaction issues is discussed at Section 4.3 of this submission.

2.6.2 As the proposal will apply more broadly to almost all joining entities, it is critical that the proposal apply on a prospective basis. However, as many purchasers may have currently factored in the DTA into the price paid for the shares in an entity, this may provide some anomalous outcomes for a purchaser involved in a creeping acquisition that commenced prior to the introduction of the assumed liability rule. Accordingly, we request the Board to consider an appropriate application rule that takes into account the fact that an entity may join after the proposed application date, whereby the majority of shares in the entity had been acquired prior to that date.

Response to Question 2.1(f)
We believe that the Board should consider how the rule will interact with both the entry calculations (e.g. with section 705-80) as well as the exit calculations. Furthermore, the Board should consider whether the application date should cater for a case where the majority of an entity has been acquired or owned prior to that date.

Chapter 3: Deferred tax liabilities

3.1 Question 3.1(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.

3.1.1 We have outlined two examples where we believe that a DTL should be allowed. Both of these cases involve a DTL relating to a liability, whereby the unrealised gain on the liability is an "owned" amount. We have determined that, in these cases, a DTL is justified to the extent of the "owned" amount of the unrealised gain.

3.1.2 The calculations for these two examples are provided in Appendix D. We highlight also that an important aspect of the calculations is determining by way of an application of section 705-80.

Response to Question 3.1(a)
We highlight that we believe that a DTL is required to the extent to which an unrealised gain on a liability is an "owned" amount. We have not identified further scenarios where this may be the case and thus note that this should be explored further by the Board.

3.2 Question 3.1(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?

3.2.1 We believe that there may be other ways in which the correct result, as outlined by Appendix D, could be achieved other than by using a DTL. That is, if it is determined that the DTL is only required in an "owned" case where a liability results in an unrealised gain, it would be possible to formulate an adjustment to Step 2 for this amount.

3.2.2 However, if section 705-80 is retained, then the "owned" component of a DTL would simply revert to an income tax payable (ITP) amount under that provision and thus this would alleviate the need for any further adjustments. That is, section 705-80 would seem to do the work to obtain the correct result for the owned component.

3.2.3 However, that being said, under the current proposal contained in Chapter 2, section 705-80 would only provide a solution in a formation case and would not provide a solution in a creeping acquisition case. This is because the "assumed liability" rule currently proposed in Chapter 2 does not seem to distinguish between an "owned" acquisition case and a 100% acquisition case. Therefore, section 705-80 would not result in the "owned" DTLs turning into an appropriate ITP amount.

3.2.4 However, if the Board accepts our proposition contained in Chapter 2, being that the assumed liability rule should not be applied to "owned" liabilities, then section 705-80

would seem to apply appropriately in lieu of providing DTLs in the limited testing that we have conducted.

3.2.5 That being said, section 705-80 (however) may not work appropriately where the DTL relates to an asset. Thus, section 705-80 may require further refinement to ensure that it provides the correct outcome in the correct cases.

Response to Question 3.1(b)
Provided that the Board accepts our Chapter 2 proposition, being that the "assumed liability" rule should not apply to owned liabilities, then section 705-80 may provide the correct outcome where DTLs are removed in these cases without the need for further amendments.

3.3 Question 3.1(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.

Response to Question 3.1(c)
Refer to our response to Question 3.1(a) and (b).

3.4 Question 3.1(d): What alternatives, if any, are there for reducing the complexity introduced by deferred tax liabilities?

Response to Question 3.1(d)
Refer to our response to Question 3.1(a) and (b).

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

4.1 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?

4.1.1 It is difficult to determine whether section 705-70(1A) was intended to be limited to deferred tax liabilities. That is, the words to the provisions are unambiguous in terms that they would apply to any liability of the joining entity.

4.1.2 Furthermore, in our view, it is difficult to suggest that the Explanatory Memorandum to the introduction of section 705-70(1A) was written in a way to suggest that the provision was intended to be limited to DTLs.

> 1.42 In working out the amount of liabilities to be added under step 2 in working out the allocable cost amount, it is the value of the liability to the joined group and not the value of the liability to the entity becoming a subsidiary member that is the relevant amount [Schedule 2, item 25, subsection 705-70(1A)] . This ensures that the liabilities are correctly valued in working out the cost to the consolidated group of acquiring the entity.

4.1.3 That is, the Explanatory Memorandum stated that the provision ensured that "liabilities " (in plural) would be correctly valued in working out the cost to the consolidated group of acquiring the entity by applying section 705-70(1A).

4.1.4 Accordingly, if the group believed that the liability was undervalued when determining the purchase price of the joining entity, the Step 2 liability would be appropriately adjusted to reflect the correct value of the liability to the consolidated group under section 705-70(1A).

4.1.5 In effect, the accounting standard AASB 3: *Business Combinations* generally applies when an entity joins a tax consolidated group. AASB 3 requires the acquirer to effectively apply their accounting standards and principles to the liabilities of the joining entity (refer to paragraph 15 of the standard). In many cases, this may give rise to new accounting liabilities being recognised (or liabilities not being recognised) by the head company under the application of AASB 3. Furthermore, Australian Accounting Standards provide for different accounting depending on how an entity classifies or designates a particular asset or liability. Examples of such are provided at paragraph 16 of the standard.

4.1.6 Where the head company of the group has factored the change in value of the accounting liability into the purchase price, it would seem that section 705-70(1A) could provide a more correct / appropriate outcome for determining the tax cost setting amount of assets to the head company. It is worth noting that such an adjustment may not only result in liabilities being recorded, but liabilities being de-recognised (and thus reducing the ACA of the joining entity).

4.1.7 Accordingly, whether the Board believes that section 705-70(1A) should be retained would need to have regard to the policy of the provisions, compliance costs, and the integrity of the system.

Response to Question 4.1(a)
We do not agree that section 705-70(1A) was intended to be applied only to DTLs. We note that it is may be possible to change the value of a liability under AASB 3, when the joining entity becomes a member of the tax consolidated group. Section 705-70(1A) seems to be warranted where (at the very least) the head company has factored the change in liability into the purchase price of the entity. However, whether section 705-70(1A) is to be removed or retained would require the Board to appropriately consider the policy of the provision, the compliance costs associated with applying the provision and whether the provision would result in a reduction of the integrity of the system.

4.2 Question 4.1(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?

Response to Question 4.1(b)
Please refer to our response to Question 4.1(a).

4.3 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?

4.3.1 We agree with the proposition that section 705-80 is generally unnecessary in the case where there is a 100% acquisition. We note, however, that section 705-80 may result in unintended consequences when applied together with an "assumed liability" rule.

4.3.2 That is, assume that Company A has one single asset valued at ($110) and a provision account (valued at $100), which was not yet been deducted by Company A (i.e. which current results in a DTA to Company A). Assume that the head company pays $10 to acquire the shares – however, the acquisition is not performed as a 100% acquisition (i.e. it occurs over two tranches spanning 2 months).

4.3.3 In this example, section 705-75 would not apply to the ACA calculation performed by the head company. This is because the provision would no longer be deductible to the head company.

4.3.4 However, the current operation of section 705-80 would result in an adjustment being made for 30% of the value of the liability. This is because it requires Company A to assume it had already deducted the liability before the joining time. Thus a Step 2 adjustment (being a reduced ITP) or a step 6 adjustment (being an acquired loss)

would occur for 30% of the liability value. This would (inadvertently) reinstate the section 705-75 adjustment for the head company.

4.3.5 The above highlights that, to the extent that the liability is "acquired", section 705-80 is not required. The same rule seems to also apply with respect of DTLs and the examples provided in Appendix D. That is, to the extent that the unrealised gain relating to the liability was "acquired", section 705-80 does not seem to be required. However, to the extent that the unrealised gain relating to the liability was "owned", section 705-80 seems to be required to provide the correct result.

Response to Question 4.2(a)
We agree with the proposition to remove section 705-80 for acquired cases. We also note that, based on our limited testing of section 705-80, there is a case for turning off section 705-80 to the extent that a liability is acquired and one is required to apply an "assumed liability" rule to the liability.

Chapter 5: Assets and liabilities recognised on different basis

5.1 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.

5.1.1 There are a number of cases that give rise to the same problem. The problem generally occurs when (for accounting purposes) a "risks and rewards" rule is applied to recognise an asset for accounting purposes that is not owned or held by the entity for tax purposes. The reverse is also true (i.e. de-recognise an asset that is owned by the entity for tax purposes).

5.1.2 When this occurs, the accounting balance sheet is often balanced by either recognising or de-recognising a liability. As the tax consolidation provisions use accounting liabilities, this can then result in a distortion of the ACA on entry or exit of an entity.

5.1.3 It is noted that the consolidation provisions deal specifically with leases that effectively fall into this same category of problem. That is, a leased asset may not be legally owned by the entity, but may require a lease liability to be recognised on the balance sheet. However, due to the prescriptive nature of the amendments contained in Part 3-90 to deal with leases, the current solution contained in Part 3-90 has not resolved all of the problems for leases in the ACA entry and exit calculation.

5.1.4 Other examples where this problem seems to occur can include repo arrangements, stock securitisation arrangements, etc, where a risks and rewards test is applied to legally owned assets.

Response to Question 5.1(a)
Yes, there are many other examples that may result in the same problem, whereby (for example) a risks and rewards test may either recognise or derecognise assets for accounting purposes on a basis other than legal ownership.

5.2 Question 5.1(b): Do you agree with Board's preliminary view for resolving this issue? If not, are there other approaches that should be considered?

5.2.1 In our view, the proposal put forward by the Board appears to provide a systemic solution to this problem. We do not believe that an alternative is required to resolve this issue.

5.2.2 However, we believe the Board should appropriately recommend that Treasury consider examples from the perspective of the two entities involved in the relevant transactions giving rise to the issue outlined in the Discussion Paper. For example, we

have included an example in Appendix E to outline the considerations that would need to be taken into account when developing this proposal.

5.2.3 We also note that transitional issues may need to be considered when implementing this proposal. That is, depending on whether a liability was recognised on entry would also likely determine whether the proposal should be applied subsequently on exit.

Response to Question 5.1(b)
We agree with the Board's preliminary view for resolving this issue. However, we believe that the Board and Treasury will need to workshop and test various examples to ensure that they work appropriately (as demonstrated by the examples provided). Transitional issues will need to be considered where an entity has already joined a tax consolidated group under the current law and then subsequently leaves applying the proposed new rules.

5.3 Question 5.1(c): What are the appropriate circumstances in which assets and liabilities can be said to be related?

5.3.1 The Board's preliminary view requires two separate rules. The first would effectively require the recognition of a liability where the asset is recognised for tax purposes but not for accounting. The second would effectively require the de-recognition of a liability where the asset is not recognised for tax purposes but is otherwise recognised for accounting purposes.

5.3.2 As outlined above, we agree with these two broad principles. However, we note that formulation of these into the legislation would require appropriate testing of examples to formulate this correctly. Furthermore, the application of both of these proposed rules would require one to consider whether: (a) they should apply; and (b) the value to which they should apply. The following demonstrates this.

Rule 1: Recognition of a liability in certain cases

5.3.3 Reference is made to the example in Appendix E, in particular Company B in that example. In that example, it may be the case that an asset is recognised for tax purposes (i.e. Asset X) but not accounting purposes.

5.3.4 In that example, it would seem only appropriate to recognise a liability on entry or exit if Asset X is not replaced by another accounting asset that does not have a corresponding a corresponding tax asset. That is, in the example in Appendix E, if Asset X is simply replaced by an accounting asset (a receivable) that is not a corresponding tax asset, then no adjustment is required. Alternatively, if Company B recognises the receivable for both accounting and tax purposes, then a liability would be required to be recognised for entry and exit calculations. The liability recognised is effectively the legal obligation to return Asset X to Company A.

5.3.5 Accordingly, when determining whether a liability is required to recognised, we believe that one would be required to have regard to the broader accounting and tax assets recognised under the relevant arrangement or transaction to effectively determine a "net position".

5.3.6 Where a liability is required to be recognised to provide the correct ACA result, it would appear (from very limited testing) that the amount of the liability that should be used would be equal to the tax cost of Asset X just before the joining or leaving time. This would likely ensure that the correct ACA is allocated to the assets (on entry) or to the membership interests (on exit). While this seems to provide an appropriate result in the example contained in Appendix E, such a proposition would also need to be tested further.

5.3.7 As highlighted above, recognising the liability is not a simple matter of identifying a "related asset". There are further inter-relationships with other assets and liabilities that may need to be considered in order to determine the appropriate principle.

Rule 2: De-recognition of a liability in certain cases

5.3.8 The reverse also seems to apply in the second case. That is, a liability should only be de-recognised if the accounting asset is also not replaced with another tax asset (where that other tax asset also does not have a corresponding accounting asset).

5.3.9 To demonstrate, in the example in Appendix E, arguably Company A recognises Asset X without a corresponding tax asset. However, alternatively, one could argue that Company A is required to recognise a tax receivable equal to $200 (i.e. the cash to be returned to Company A at the end of the repurchase arrangement). The receivable is not recognised for accounting purposes.

5.3.10 If Company A is required to recognise the receivable as a tax asset (but not an accounting asset), the ACA would then provide the correct outcome in this case without the requirement for a special rule. However, if Company A is not required to recognise the receivable as a tax asset, the accounting liability will overstate the ACA amount. Furthermore, while the "receivable" may be a retained cost base asset in this example, the relevant "other asset" may very well be a reset cost base asset and provide different outcomes under different situations.

5.3.11 Accordingly, when determining whether a liability is related to an asset, and whether the corresponding liability should be recognised, we believe that the rule would be required to have regard to the broader accounting and tax assets recognised under the relevant transaction.

Response to Question 5.1(c)
At a high level, we believe that the principle requires consideration of the broader assets and liabilities recognised by the entity under the relevant transaction. Accordingly, the "related" test may only apply appropriately if it has regard to this broader concept. We believe that the Board and Treasury should test this suggestion with appropriate examples when developing the solution or legislation.

Chapter 6: Capping the tax cost setting amount of assets

6.1 Question 6.1(a): Do you consider that rules should be introduced to cap the tax cost of all assets?

6.1.1 It is hard to understand the requirement or the basis of a capping rule in relation to any asset in a 100% acquisition case, other than in respect of cases where amounts are allocated to an asset due to ACA anomalies.

6.1.2 That is, assume that 100% of the shares are acquired in a single transaction. In such a case, if the ACA results in a value greater than the market value, then such an amount would typically be due to an ACA anomaly. However, it would be rare that such a circumstance would occur.

6.1.3 Alternatively, assume that there has been a creeping acquisition of shares, whereby the entity only owns only underlying CGT asset. Assumes that 80% of the shares in the entity are acquired when the asset is worth $1 million (i.e. $800,000 is paid for the shares) and 20% of the shares are acquired when the asset is worth $100,000 (i.e. $20,000 is paid for the shares).

6.1.4 In that example, the CGT capping rule would only allow $100,000 to be allocated to the CGT asset, and would require $720,000 to be allocated to either goodwill or to a CGT event. However, in this example the allocation to the asset would not be due to a ACA anomalies. That is, the amount otherwise allocated to the asset (i.e. $820,000) would fully reflect the market value of the asset over the time the asset was acquired.

6.1.5 Accordingly, other than where ACA is over and above the market value of the asset due to ACA anomalies, it is hard to accept that the capping rule provides an appropriate outcome.

Response to Question 6.1(a)
We are not convinced that a capping rule will provide an appropriate outcome, especially in a creeping acquisition case.

6.2 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?

6.2.1 No. In a creeping acquisition case, the capping rule would result in a greater diversity of results.

6.2.2 Reference is made to the earlier example. In a business acquisition, the asset would be provided with a cost base of $820,000. However, under a capping rule, the asset would be provided with a cost base of $100,000, with $720,000 being allocated to goodwill or a CGT event.

Response to Question 6.1(b)
In a creeping acquisition, the proposed capping rule would result in less neutrality as between an asset acquisition as compared to the results under tax consolidation.

6.3 Question 6.1(c): What difficulties, if any, could arise if the tax cost setting amount for all assets was capped?

6.3.1 In our view, higher tax risks would be associated with acquiring CGT assets through a creeping acquisition under tax consolidation as compared to a 100% acquisition, due to the skewing that would result in a capping a the time of purchase the last remaining shares in the joining entity.

Response to Question 6.1(c)
In a creeping acquisition, the proposed capping rule could result in significantly lower tax costs for CGT assets than would otherwise be appropriate. This could give rise to higher tax risks for purchasers that wish to acquire assets under a tax consolidation regime over a period of time (i.e. under a creeping acquisition).

6.4 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?

6.4.1 In our view, applying the amount to goodwill (over and above the market value of goodwill) is an inappropriate allocation of ACA. If capping should occur, goodwill should also be provided with no more ACA than is its market value. It is difficult for us to understand a justification to allocating ACA to goodwill that exceeds its market value, especially where a capping rule is introduced for CGT assets.

6.4.2 Accordingly, in our view, one should determine the value of goodwill at the time of entry and should only allocate ACA to goodwill that reflects its true market value. Any excess of ACA over and above this amount should be provided with an alternative recognition that is appropriate for the purchaser. This does not mean that no recognition should occur for the ACA. In our view, it means that an appropriate result should occur with respect to the treatment of that ACA reflecting the actual cost of the assets to the head company.

Response to Question 6.1(d)
If a capping rule is introduced, then the amount of ACA that is allocated to goodwill should also be capped to its market value. Accordingly, if the company does not have goodwill, no amount would be allocated to the asset.

6.5 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?

6.5.1 There are limited alternatives that could be provided for the excess. The first is an instant recognition of the amount as a capital loss. The second is the recognition of the loss over a period of time (e.g. 10 years). The third is a redistribution of the excess over all non-revenue assets (which is effectively what occurs under the non-capping rule). As the first two would likely have revenue costs, the third option appears to be the more appropriate option.

6.5.2 However, taking the third option would simply mean that the capping rule would not be introduced. While we maintain that this is the best solution to the problem, we are not confident that the Board will accept this proposal.

6.5.3 Accordingly, in any event, if the Board chooses to introduce a capping rule, it should provide taxpayers with the ability to calculate the weighted average value of the relevant CGT asset (for the purpose of capping). In the example provided earlier, this would mean that the value would be equal to $820,000, being the weighted average market value of the asset calculated at the time when interests were acquired in the joining entity (i.e. reflecting the actual cost of the asset to the head company).

6.5.4 We note that this is likely to increase compliance costs significantly, as it would require multiple valuations of assets over a period of time under a creeping acquisition. Accordingly, we maintain our position that the simplest option is that CGT assets are not capped under the tax consolidation regime.

Response to Question 6.1(e)
Any alternative recognition is likely to have revenue implications and therefore (other than retaining the current rules), we are sceptical as to whether the Government would accept an alternative treatment (even where the alternative is more appropriate). Accordingly, if a capping rule is introduced, the Board should accept that (at the very least) a weighted average market value can be used for CGT assets (as an alternative to using the market value at joining time). Such a rule will likely increase compliance costs significantly and therefore we question whether the capping rule should be introduced in the first place.

6.6 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?

Response to Question 6.1(f)
Please refer to our response to Question 6.1(a).

Chapter 7: CGT issues

7.1 Question 7.1(a): Do you agree with the CGT rollover interaction issues that are outlined in this chapter?

7.1.1 In principal, we agree with the CGT rollover interaction issues that are outlined in this chapter. We highlight that many of the issues identified in this chapter, including the loss of "taxed" profits, the "head company interposition" issue, and the skewing issues result in many SME groups not choosing to consolidate for tax purposes.

7.1.2 While this is unlikely to be a problem for smaller groups, we believe that this is rather unfortunate given that many larger SME groups have been looking to corporatise in recent times, simply due to the complexities with trusts and the use of corporate beneficiaries.

7.1.3 From a tax perspective, we believe that allowing these larger SME groups to consolidate for tax purposes is more likely to result in greater revenue, rather than integrity risks for the revenue. This is because the proposed solutions to the problems involve a "stick" in relation to tax costs, thus not giving rise to any tax "uplifts" in assets. Furthermore, it would assist in moving trust structures to corporate structures, thus ensuring that the relevant activities are within the corporate tax net. While one may argue that losses can be grouped under tax consolidation, we note that losses are effectively grouped already under the family trust election regime of Schedule 2F.

7.1.4 In general, we believe that tax consolidation should not result in taxing points where there has been a rollover and there has been no change to the economic underlying ownership of the asset being rolled over.

7.1.5 We also believe that tax consolidation should not produce different results where the tax consolidated group utilises one rollover as opposed to another rollover (when the commercial outcomes are identical). We believe that this gives rise to taxation anomalies and this complex tax planning.

7.1.6 Accordingly, we believe that this is an important issue for the Board to address in seeking to ensure that larger SME groups are provided with an opportunity to consolidate for tax purposes. Furthermore, we believe that the use of these alternatives would greatly simplify how tax consolidation interacts with the tax cost setting process for SME groups.

Response to Question 7.1(a)
Yes, in general, we agree with the CGT rollover interaction issues outlined in Chapter 7 and believe that it is important for the Board and Government to address these issues for large SME groups wishing to consolidate for tax purposes. We believe that addressing these issues is likely to have a positive contribution to the revenue, as it will encourage larger groups to move into a corporate tax system rather than a trust system. We also believe that these suggestions are likely to reduce compliance costs for SME groups significantly.

7.2 Question 7.1(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.

7.2.1 In an SME context, rollovers invariably result in little or no change in the underlying economic ownership of the relevant entity and its assets. However, the tax consequences of each rollover can change quite significant, depending on the rollover chosen and the time that the rollover is implemented.

7.2.2 In essence, inappropriate tax outcomes can be avoided with appropriate tax planning. For example, a rollover may result in owned taxed profits becoming acquired profits. However, the payment of a pre-rollover dividend can be used to eliminate this issue.

7.2.3 What this means is that taxpayers that have appropriate advice and conduct their affairs with appropriate tax planning will obtain appropriate outcomes, while other taxpayers who (commercially) undertake the same transaction will often find themselves faced with an inappropriate application of certain provisions.

7.2.4 For example, a taxpayer that utilises a Subdivision 122-A rollover may lose all Step 3 profits (as they become acquired). However, if a Subdivision 124-G rollover is instead utilised, the Step 3 profits are embedded into the cost base of the shares. While these two rollovers can achieve the same economic outcome (i.e. interposition of a new head company), they have significantly different tax consolidation outcomes. Furthermore, if such an interposition occurs after the formation of a consolidated group, it is only the latter rollover that has no tax consequence. There appears to be no logical reason for this difference.

7.2.5 We agree that the implementation of systemic rules for rollovers and their interaction with the tax consolidation regime will help to ensure that tax considerations and tax planning is not required to achieve an appropriate result when moving into a tax consolidated group.

7.2.6 Finally, we note the previous Government had announced systemic rules to be implemented for all rollovers into consolidated groups, similar to those contained in Chapter 7. That is, the previous Government announced that:

> "The changes will ensure that the tax cost setting rules do not apply to uplift the tax costs of the assets of an entity that joins a consolidated group or

> multiple entry consolidated group (MEC group) following a CGT rollover affecting the membership interests of the joining entity."

7.2.7 We understand that these proposals were to ensure that tax uplifts were not inappropriately obtained in certain cases. Accordingly, we highlight that should the proposals in Chapter 7 be implemented, the proposals would also help to increase the integrity of the tax consolidation provisions and their interactions with the tax consolidation regime.

Response to Question 7.1(b)
Yes, in general, we believe that systemic rules should apply to ensure that appropriate results for both taxpayers and the revenue are achieved following a rollover into a tax consolidated group.

7.3 Question 7.1(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?

Rule 1: Identifying a restructure

7.3.1 The proposed rule would consider all rollovers being treated as a "restructure". We have considered this rule in detail and believe that this is justified where (effectively) the entity continues to be owned by the same underlying owners both before and after the rollover.

7.3.2 In general, this would always be the case where is a Subdivision 122-A, Subdivision 122-B, Subdivision 124-G, Subdivision 124-H and Subdivision 126-B rollover. However, this is not always going to be the case where a Subdivision 124-M rollover occurs.

7.3.3 In the latter case, where there is a Subdivision 124-M rollover, we believe that it would be appropriate to regard the arrangement as a "restructure" when either the "common stakeholder" test is satisfied, or where all of the entities that own shares in the underlying entity (either directly or indirectly) are part of the same family group for Schedule 2F purposes (family trust provisions). Both of these cases demonstrate a scenario where there is no or little change to the economic ownership of the underlying assets.

Rule 2: Cost base of membership interests

7.3.4 We believe that Rule 2 is important where a stick option is not provided under Rule 4 where a rollover has occurred. This is because the cost base rules currently result in a Step 3 (acquired profit) issue that would not otherwise be addressed. We are uncertain whether the Board will accept a stick option under Rule 4 where (for example) the rollover does not result in the entity joining the tax consolidated group immediately.

7.3.5 To the extent that a stick option is provided for the joining entity following a rollover, Rule 2 would be unnecessary. As Rule 4 addresses a number of problems, such as skewing and the Step 3 profit issue, we believe that this rule should be provided to

SME groups in lieu of Rule 2. Accordingly, if this is accepted by the Board, we would agree that Rule 2 would then be unnecessary. However, to the extent that Rule 4 is limited in its application, then we request that the Board consider Rule 2 to address the step 3 profit issue.

Rule 3: Interposition of a head company

7.3.6 In our view, this proposition is critical for SMEs. The chapter highlights the significant anomalies that occur by interposing a head company using one rollover as compared to another. It is also noted that the issues can also be avoided by simple tax planning – i.e. rolling down the assets to a subsidiary after consolidating for tax purposes.

7.3.7 We believe that this is one of the easier fixes in the legislation, given that there is already an existing provision that allows for the seamless interposition of a head company – i.e. sections 703-65 to 703-80.

Rule 4: Stick option

7.3.8 As noted earlier, this would remove a number of the issues associated with rollovers – and would also eliminate integrity risks identified by the previous Government. Furthermore, from an SME perspective, a stick option would result in the lowest level of compliance costs for entities joining a tax consolidated group. Accordingly, we believe that Rule 4 is a critical requirement for the current tax consolidation legislation for SME groups looking to consolidate.

Response to Question 7.1(c)
In principle, if Rule 1, 3 and 4 were implemented, these rules would address the majority of concerns by SME groups in rolling entities into a tax consolidated group. We acknowledge that Rule 1 may require some modification to appropriately address the rollovers that should be subject to such rules. Rule 2 may seem unnecessary if Rule 4 is otherwise implemented.

7.4 Question 7.1(d): Are there any consequential issues which arise if the Board's suggested rules for dealing with CGT rollovers into consolidated groups are adopted?

7.4.1 To the extent that the Board can propose the use of existing rules to deal with these proposals, we believe the consequential amendments would be kept to a minimum. For example, if Rule 3 was implemented using section 703-65 to 703-80 (the existing interposition provision), then it would likely result in lower consequential amendments being required.

7.4.2 However, there may be other consequential issues that the Board would still need to consider. For example, the proposals in Chapter 2 would seem unnecessary in a rollover context. This is because the "restructure" would be similar to a formation / owned case, rather than an acquisition. Furthermore, CGT event J1 and its interaction with the proposals would need to be considered further.

Response to Question 7.1(d)
Yes, we believe that there may be a number of consequential issues that would need to be considered on implementation of the Chapter 7 rules – however, the amount of consequential issues would be reduced if the Board recommended the use of existing rules that apply the proposed rules contained in Rule 1, 3, and 4.

7.5 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?

7.5.1 Addressing the issues with CGT event J1 can (in itself) be quite difficult, simply due to the operation of other provisions that interact with the tax consolidation provisions (such as pooling under the MEC provisions).

7.5.2 At a high level, we believe that there are a few issues that have been identified that are easy fixes. That is, to the extent that an entity leaves an MEC group utilising a Division 711 calculation, we believe that the exception contained in section 104-182 should otherwise apply. This is because the "unrealised J1 gain" would otherwise be embedded in a reduction in the cost base of shares in the leaving entity, being the policy behind the current operation of section 104-182.

7.5.3 Another alternative for dealing with future J1 amounts would be to allow companies to utilise Subdivision 124-M rather than Subdivision 126-B for a rollover of membership interests. Currently, Subdivision 124-M is turned off through the application of section 124-795(2)(b) when a Subdivision 126-B rollover is available. As Subdivision 124-M would only apply when the replacement interest is TAP and would provide for a retained cost base in the shares issued to the original shareholder, this would seem to avoid the unnecessary requirement to utilise J1 for capturing the future capital gain.

Response to Question 7.2(a)
Noting that the issues with CGT event J1 are complicated and difficult to resolve, we believe the Board should consider whether it is better to simply make suggestions to resolve "some" of the issues with CGT event J1 (being those that are able to be corrected) rather than trying to resolve all of the issues.

APPENDIX A
OWNED ENTITY AND DEDUCTIBLE LIABILITIES

Background

This example is based on the facts contained in Example 2.1 to 2.3 of the Board's Discussion Paper. However, we have adjusted the facts so that Purchaser Co incorporated Company A and has always owned 100% of Company A since its incorporation.

Determining the tax cost setting amount of assets on formation

The allocable cost amount (ACA) and tax cost setting amount (TCSA) calculation contained at Example 2.1 has been re-performed, taking into account the above change in facts.

Step	Item	Amount
1	Cost of membership interest	
	- Owned (100%)	$200
2	Liabilities	
	- Provision	$200
	- Adjustment for deductible liabilities	($60)
	- Section 705-80 adjustment[7]	$0
8	**Total**	**$340**

In this example, the allocable cost amount of $340 is allocated to cash ($240) and land ($100). Accordingly, the subsequent disposal of land for $700 results in a taxable gain of $600 to Purchaser Co. Purchaser Co also obtains a tax deduction for the provision for leave equal to $200. Accordingly, after forming a tax consolidated group, the total tax position for Purchaser Co would be equal to $400.

Economic v tax position

The following table outlines the "economic profit" that would occur after Company A joins the tax consolidated group. It is noted that (for the purpose of this calculation) the after taxed profits of $140 are identified as a "cost" to the group of reinvesting after tax profits in the company. The after tax amount, rather than the before tax amount, has been used in order to determine the correct economic profit to the tax consolidated group after the formation time.

[7] The section 705-80 calculation results in Step 5 losses of $60 (due to reductions made at section 705-100(2))

Costs and proceeds	Economic profit
Proceeds from the sale of asset	$700
Cash at bank	$240
Total proceeds	**$940**
Less: Cost of shares	($200)
Less: Taxed (owned) profits	($140)
Less: Payment to settle provision	($200)
Total costs	**($540)**
Economic taxable profit to be taxed to Purchaser Co	**$400**

The economic profit of $400 matches the taxable profit for Purchaser Co after the formation of the tax consolidated group. Accordingly, the example seems to demonstrate that a deductible liability does not give rise to duplication or mismatch issues where the liability is effectively an "owned" liability of the tax consolidated group.

APPENDIX B
PARTLY OWNED ENTITY AND DEDUCTIBLE LIABILITIES

Background

This example is same as that contained in Appendix A, however the facts have been adjusted so that Purchaser Co has owned 99% of the shares since incorporation. At the joining time, Purchaser Co acquires the remaining 1% from Vendor Co for its market value.

Determining the allocable cost amount

The following table outlines the calculation of the allocable cost amount for Company A when it joins the tax consolidated group.

Step	Item	Amount
1	Cost of membership interests	
	- Owned (100%)	$198
	- Acquired (1%)	$6
2	Liabilities	
	- Provision	$200
	- Adjustment for deductible liabilities	($60)
	- Section 705-80 adjustment[8]	$0
8	**Total**	**$344**

Determining the tax cost setting amount

In this example, the allocable cost amount of $340 is allocated to cash ($240) and land ($104). Accordingly, the subsequent disposal of land for $700 results in a taxable gain of $596 to Purchaser Co. Purchaser Co also obtains a tax deduction under the current law for the provision for leave equal to $200. Accordingly, after forming a tax consolidated group, the total tax position for Purchaser Co would be equal to $396 under the current law.

Economic v tax position

The following table outlines the "economic profit" that would occur after Company A joins the tax consolidated group. It is noted that (for the purpose of this calculation) the after taxed profits of $138.60[9] are identified as a "cost" to the group of reinvesting after tax profits in the company. The

[8] The section 705-80 calculation results in a Step 5 loss of $59.40 (due to reductions made at section 705-100(2)) and a Step 6 loss of $0.60 (i.e. 1% x $200 x 30%). The total amount is equal to the adjustment made by section 705-75 of $60.
[9] Calculated as $140 x 99% = $138.60

after tax amount, rather than the before tax amount, has been used in order to determine the correct economic profit to the tax consolidated group after the formation time.

Costs and proceeds	**Economic profit**
Proceeds from the sale of asset	$700.00
Cash at bank	$240.00
Total proceeds	**$940.00**
Less: Cost of shares	($204.00)
Less: Taxed (owned) profits	($138.60)
Less: Payment to settle provision	($200.00)
Total costs	**($542.60)**
Economic taxable profit to be taxed to Purchaser Co	**$397.40**

Using the methodology in Example 2.3, there is a mismatch of economic profit ($397.40) to taxable profit ($396) equal to $1.40. This equates to 1% of the duplication / mismatch issue identified in Example 2.3 of the Board's discussion paper.

APPENDIX C
ACQUISITION FROM A NON-CONSOLIDATED GROUP

Background

This example is based on the facts contained in Example 2.1 to 2.3 of the Board's Discussion Paper. However, we have adjusted the facts so that the vendor is a non-tax consolidated group (e.g. a Vendor Trust). Accordingly, the vendor would calculate their taxable position based on their historical cost base of shares in Company A.

Taxable position of Vendor Trust – current law

As Vendor Trust would calculate its taxable position based on its historic cost base, the taxable profit that would have been derived by Vendor Trust would be equal to $400 (i.e. $600 proceeds less $200 cost base). The following table is taken from Example 2.2 of the Board's Discussion Paper, modified for this calculation.

Current law	Vendor	Purchaser	Total
Commercial profit	260	140	400
Taxable profit	400	0	400
Difference	**140**	**(140)**	**0**

The above table highlights that, from a systemic point of view, the total commercial profit and taxable profit equates to $400 in this example. However, there is over-taxation of the vendor and under-taxation of the purchaser.

Taxable position of Vendor Trust – "assumed liability" rule

In Example 2.3, there has been an adjustment to the sales price to reflect that the purchaser would not obtain a deduction for liabilities. The adjustment is equal to 30% of the $200 liability (or $60). Accordingly, Company A is sold for $540.

In this case, as Vendor Trust would calculate its taxable position based on its historic cost base, the taxable profit that would have been derived by Vendor Trust would be equal to $340 (i.e. $540 proceeds less $200 cost base). The following table is taken from Example 2.3 of the Board's Discussion Paper, modified for this calculation.

Current law	Vendor	Purchaser	Total
Commercial profit	200	200	400
Taxable profit	340	200	540
Difference	**140**	**0**	**0**

The above table highlights that, from a systemic point of view, the total commercial profit and taxable profit equates to $540 in this example. Accordingly, there appears to be over-taxation of the vendor (being taxation on the retained earnings value).

APPENDIX D
FOREX AND DTL'S

Background

This example examines the interaction of DTLs in an entry calculation where there is an unrealised gain attributable to a foreign currency amount. Assume that Company A was incorporated with the following balance sheet.

Assets		**Liability and equity**	
Cash	$1	Forex loan (USD)	$110
Land	$110	Share capital	$1
Net assets	$111	Net liabilities and equity	$111

Shortly thereafter, assume that the forex loan value moves to $100, so that there is an unrealised gain of $10. This results in the recognition of a profit amount of $10 and a DTL of $3. The following balance sheet reflects those movements.

Assets		**Liability and equity**	
Cash	$1	Forex loan (USD)	$100
Land	$110	DTL	$3
		Share capital	$1
		Retained earnings	$7
Net assets	$111	Net liabilities and equity	$111

Key interaction issue – section 705-80

It is highlighted that section 705-80 will currently operate to turn a DTL relating to a liability into an income tax payable ("ITP") under section 705-80. While section 705-80 is proposed to be turned off for 100% acquisitions, section 705-80 may continue in other case.

In those cases (where the entity is not joining from another consolidated group), it is therefore inconsequential to turn off DTLs, as the amount would simply be replaced with an ITP of an equivalent amount (thereby rendering the amendment inoperative). However, in many cases, we believe that this may be the appropriate outcome – i.e. either retaining a DTL or keeping the amount provided under section 705-80. These examples are outlined below.

Formation of a tax consolidated group

Assume that Company A subsequently forms part of a tax consolidated group. Assume that the cost base of the shares in Company A is equal to $1. Furthermore, assume that a DTL is able to be recognised as a liability under Step 2. The following outlines the outcome that would occur under the ACA calculations (taking into account section 705-80).

Step	Item	Amount
1	Cost of membership interests	
	- Owned (100%)	$1
2	Liabilities	
	- Loan	$100
	- DTL	$3
	- Section 705-80 adjustment	$7
8	**Total**	**$111**

S	Section 705-80 calculation	Amount
1	Cost of membership interests	
	- Owned (100%)	$1
2	Liabilities	
	- Loan	$100
	- ITP	$3
3	Owned taxed profits	$7
8	**Total**	**$111**

As demonstrated by the above calculation, the total ACA is equal to $111. This would provide an appropriate tax cost setting amount for the cash ($1) and the land ($110) in a formation case. Furthermore, it also acknowledges that the tax consolidated group would also still be required to pay tax on the forex gain after the formation time (i.e. as acknowledged by Chapter 2, a formation would not apply the "assumed liability" rule).

This calculation demonstrates that a DTL should remain in this case. If the DTL were removed, it is noted that the section 705-80 calculation would simply increase by $3 – thereby resulting in a correct ACA calculation once again. If both the DTL and the ITP were removed, then this would inappropriately reduce the ACA by $3, being an amount that the owned group will be liable for to pay tax on in the future relating to owned profits.

50% owned case

Assume that 50% of the shares were acquired on incorporation (i.e. $0.50) and then 50% were acquired when there was a 50% movement in the DTL (i.e. $4.00[10]). Accordingly, assume that the shares in Company A were acquired for a total of $5. Furthermore, assume that that the "assumed liability" rule will apply to $50% of the acquired liability. The following outlines the outcome that would occur under the ACA calculations (taking into account section 705-80).

Step	Item	Amount
1	Cost of membership interests	
	- Owned (100%)	$4.50
2	Liabilities	
	- Loan	$100.00
	- DTL	$1.50
	- Section 705-80 adjustment	$3.50
8	**Total**	**$109.50**

S	Section 705-80 calculation	Amount
1	Cost of membership interests	
	- Owned (100%)	$4.50
2	Liabilities	
	- Loan	$100.00
	- ITP	$1.50
3	Owned taxed profits	$3.50
8	**Total**	**$109.50**

Company A has effectively been acquired by paying for $4.50 (equity), $100.00 (for loans), and $5 of owned profits (whereby at least that amount of profit would remain taxable in the future under the proposed Chapter 2 amendments). Accordingly, the group has paid $109.50 for the underlying assets and therefore an ACA of $109.50 is justified in this example. Accordingly, recognising a DTL or ITP to the extent of the owned component of the liability provides a correct result in this case.

[10] This amount is calculated as 50% x equity of $1 plus 50% x retained earnings of $7.00.

APPENDIX E
ASSETS AND LIABILITIES

Background

This example demonstrates scenarios where the proposed rules contained in Chapter 5 could work effectively for one party, but may not be required for another party to a transaction giving rise to the problems.

Example

In this example, assume that Company A was incorporated with $100 of share capital. Company A acquires an asset worth $100 (Asset X). Company B is also incorporated with $200 and has cash at bank of $200. When Asset X is worth $200, Company A enters into a repurchase agreement with Company B, whereby Company A sells Asset X to Company B for $200, together with a forward agreement to re-acquire the asset in 12 months time for a fixed price of $200. Assume that Company A retains the risks and rewards of Asset X, so that Company A continues to recognise Asset X together with a liability of $200. Company B recognises a loan receivable for accounting purposes of $200. Assume that TOFA does not apply to either of these entities. The following highlights the tax and accounting balance sheets of Company A and B.

Company A			Company B		
	Tax	**Acc**		**Tax**	**Acc**
Cash	$200	$200	Cash	-	-
Asset X	$-	$200	Asset X	$200	-
Receivable	$-	$-	Receivable	$?	$200
Payable	$-	($200)	Payable	$?	$-
ITP	($30)	($30)	ITP	$-	$-
Equity	($100)	($100)	Equity	($200)	($200)
R/E	($70)	($70)	R/E	$-	$-
Total	**$-**	**$-**	**Total**	**$-**	**$-**

Company A – ACA

If Company A joined a tax consolidated group, the ACA process would ordinarily include the $200 payable to Company B. In an entry calculation, this would artificially increase the ACA by $200. However, in an exit scenario, this would artificially reduce the ACA by $200. Accordingly, the proposed rule by the Board would ensure that the $200 liability would neither be recognised during the entry or exit calculation in this example.

Company B – ACA

In this example, Company B has legal ownership of Asset X, but instead records a receivable for accounting purposes. The critical question in this example is whether the system would require Company B to also recognise a tax receivable for $200 in an entry or exit calculation. If a tax asset is required to be recognised, whereby it is not recognised for accounting purposes, then there should also be an appropriate recognition of a liability in both an entry and exit calculation. In this example, the amount of the liability to be recognised would be equal to the tax cost of the asset included in Division 711 or the tax cost of the asset prior to the joining time. If the receivable is not recognised, then there would seem to be no requirement to recognise a liability for ACA purposes in this example.