THE TAX INSTITUTE

31 May 2012

Committee Secretary
Standing Committee on Economics
PO Box 6021
Parliament House
CANBERRA
ACT 2600

Attn: Mr Stephen Boyd

By email: economics.reps@aph.gov.au

Dear Mr Boyd,

Tax Laws Amendment (2012 Measures No. 2) Bill 2012

The Tax Institute is pleased to have the opportunity to make a submission to the House of Representatives Standing Committee on Economics (**Committee**) in relation to Schedules 2 and 3 of *Tax Laws Amendment (2012 Measures No. 2) Bill 2012* (**Bill**).

Schedule 2 of the Bill contains amendments to the Taxation of Financial Arrangements (**TOFA**) provisions contained in the *Income Tax Assessment Act 1997* (Cth) (**ITAA97**) and the *Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009* (Cth).

Schedule 3 of the Bill contains amendments to the Consolidation provisions contained in the ITAA97.

We do not seek to make any comments in relation to Schedule 1 or Schedule 4 of the Bill.

Summary

Our submission below focuses on the retrospective nature of the amendments contained in Schedules 2 and 3. In particular, we are concerned with:

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- The retrospective application of the changes to the consolidation and rights to future income provisions contained in Schedule 3 as they apply to:

    - the “pre-rules” for the period 1 July 2002 to 11 May 2010;
    - the “interim rules” for the period 12 May 2010 to 30 March 2011; and
    - the “prospective rules” for the period starting 31 March 2011.

- The retrospective nature of the amendments to the consolidation provisions that interact with the TOFA provisions. The primary consequence of these changes is to retrospectively deny a number of taxpayers deductions in relation to certain liabilities while, at the same time, allowing other taxpayers to still obtain deductions in relation to the same liabilities. As the distinction between taxpayers affected and taxpayers not affected is based on whether they made a compliance related election (and they were unaware of these potential consequences when they made the election), we cannot see any basis on which this change should be applied on a retrospective basis.

We consider each aspect in more detail below.

1. Retrospectivity of Tax Law Amendments

a) Principles underpinning tax law amendments

The importance and relevance of tax laws to taxpayer decision making and behaviour cannot be underestimated. As such, The Tax Institute strongly supports working within a framework of guiding principles when introducing tax laws in order to provide taxpayers with greater certainty in relation to their tax liabilities and affairs.

Of these principles, among the most fundamental is that legislative changes should not apply retrospectively except in very specific and limited circumstances and after thorough public consultation. Where the Government considers a deviation from this principle to be warranted, any such deviation should be thoroughly consulted on and explained.

It is our view that the application of this principle should not be dependent on the number, business, investment or tax profile of the taxpayers that may be affected by any specific tax law amendment.

b) Retrospective Legislation

The Tax Institute does not recommend or support retrospective tax law amendments that may be disadvantageous to taxpayers for a number of reasons, including:

- ***Certainty in the law:*** Taxpayers enter into transactions on the basis of the law as it is, not the law as it is rewritten after transactions have occurred. As a result, retrospective changes in tax law that alter a taxpayer's tax liability are likely to disturb the substance of a bargain struck between taxpayers who have made every effort to comply with the prevailing law as at the time of the agreement. In addition, typically taxpayers undertake transactions based on what they considered to be known exposures to tax liabilities. Retrospective amendments could give rise to unexpected joint and several liabilities.

- ***Changes required to financial statements:*** Many entities have prepared and issued financial statements which include the impact of RTFI deductions in tax expense and current tax liability/assets. Subsequent changes to the financial statements as a result of retrospective legislation would have adverse implications for investors and capital markets that have relied on the financial statements.

- ***Uncertainties for investment decisions:*** Taxpayers have committed to investment decisions on the basis of a particular tax profile for an entity. Retrospective amendments to change such a tax profile can materially impact the financial viability of investment decisions and the pricing of those decisions.

- ***Adverse impacts on dividend policies:*** Taxpayers have framed dividend policies based on profit levels which assumed RTFI deductions were available. If the deductions were later not allowed, there would be adverse impacts on dividend policies, including available franking levels.

- ***Flow on consequences of prior M&A transactions:*** Entities have undertaken transactions based on what they considered to be known exposures to tax liabilities. Retrospective amendments could give rise to unexpected joint and severable liabilities.

- ***Redundant advisory costs:*** Taxpayers have incurred significant valuation and advisory fees in relation to the identification and quantification of RTFI deductions. Any retrospective changes could render such advisory costs redundant, as they had delivered little to no ultimate benefit. Boards and shareholders would call into question the basis for incurring such significant, and ultimately unfruitful, costs.

The Tax Institute notes that the Parliament, particularly the Senate, has on various occasions expressed its reluctance to pass retrospective tax laws except in very limited circumstances. The Tax Institute also acknowledges that, in some rare circumstances, retrospective legislation may be appropriate, such as for instance where the amendment corrects an unintended consequence of a provision and taxpayers have applied the law as intended, or in order to address a significant tax avoidance issue.

However, where the Government is of the view that such circumstances exist:

- Thorough consultation should be undertaken with the taxpayer population in relation to the appropriate date of application of the amendments; and

- Should a retrospective date of application be determined to be appropriate following such consultation, the rationale for the retrospectivity should be clearly enunciated and publicised via any relevant press release on introduction of the Bill and via the Explanatory Memorandum to the relevant Bill.

The Tax Institute is of the view that, while the circumstances for retrospective change have been explained for some elements, this is certainly **not** the case for a number of key components of the proposals in the current Bill. In this regard, it would seem that the Government has taken the opportunity to go far beyond those few elements where retrospective change may have been justified; and the outcome will be the cause of significant commercial detriment for a large number of taxpayers.

c) Parliamentary procedures to safeguard against retrospective legislation

We also note that Parliament, especially the Senate, has expressed reluctance to pass retrospective laws except in very limited circumstances. Specifically, Senate Standing Order 24 and the resolution of the Senate of 8 November 1988 set out the Senate's concerns with respect to deliberations regarding retrospective legislation. Relevantly, Senate Standing Order 24 provides as follows:

> *"24. (1)(a)….the Scrutiny of Bills Committee shall be appointed to report, in respect of the clauses of bills introduced into the Senate, and in respect of Acts of the Parliament, whether such Bills or Acts, by express words or otherwise: i) trespass unduly on personal rights and liberties…"*
>
> ….

The following commentary by the Senate Standing Committee for the Scrutiny of Bills is also relevant to Senate Standing Order 24[1]:

> *"2.5 The Committee endorses the traditional view of retrospective legislation. Its approach is to draw attention to Bills which seek to have an impact on a matter which has occurred prior to their enactment. It will comment adversely where such a Bill has a detrimental effect on people. However, it will not comment adversely if:*
>
> - *apart from the Commonwealth itself, the Bill is for the benefit of those affected;*
> - *the Bill does no more than make a technical amendment or correct a drafting error; or*
> - *the Bill implements a tax or revenue measure in respect of which the relevant Minister has published a date from which the measure is to apply and that publication took place prior to that date."*

[1] See "Senate Standing Committee for the Scrutiny of Bills - The Work of the Committee during the 41st Parliament November 2004 to October 2007" issued in September 2008

As we understand it, if retrospective laws are introduced, the Scrutiny of Bills Committee will comment that the provisions breach the principle in Order 24. This is a limitation that the Senate has sought to impose to essentially protect the 'rule of law', and the objectionable nature of retrospective legislation.

2. Schedule 3

a) Pre-rules

The amendments to the rules for the period from 1 July 2002 to 11 May 2010 (**Pre-period**), the "pre-rules", are intended to prevent the retrospective operation of "unintended effects" of and perceived weaknesses in the law. The changes will restore the tax cost setting rules that operated prior to the 2010 amendments (being the original tax cost setting rules) with modifications to limit the deduction for RTFI for unbilled income, ensure a deduction is allowed for the reset tax costs for consumable stores and to treat certain assets as goodwill.

Parliament saw fit to introduce the 2010 amendments to repair the deficient rules that had been in place from 1 July 2002 and thereby provide taxpayers with greater certainty. It seems strange that Parliament is now considering the reinstatement of the former provisions, with their acknowledged technical deficiencies.

It is also relevant to note that the change to clarify the operation of the residual asset rule was announced by the former Government in December 2005 and supported by the current Government in May 2008. During this period, taxpayers have made commercial and investment decisions based on a reasonable expectation the law would be clarified as announced. The reinstatement of the former flawed residual asset provision reverses this Government commitment.

In addition, we are very concerned by the changes for the Pre-period which go far beyond a mere reinstatement of the rules which were in existence prior to the 2010 changes. The changes for the Pre-period will actually introduce a **new** rule (with retrospective effect back to 1 July 2002) which will operate to treat valuable contractual assets as goodwill. We do not believe there to be any valid justification for this unduly harsh retrospective change; and, in any event, the reasons for this particular retrospective element of the Bill have **not** been in any way explained by the Government.

b) Interim Rules

The amendment to the tax cost setting rules for the period from 12 May 2010 to 30 March 2011, the "interim rules", will provide protection to taxpayers who relied on the operation of the rules as they stood prior to the announcement of the Board of Taxation review on 30 March 2011[2]. The purpose of the amendments is to restore the current 2010 residual tax cost setting and RTFI rules, with modifications to treat certain assets

[2] See Press Release No. 45 of 30 March 2011 by the Assistant Treasurer, the Hon Bill Shorten MP (as he then was).

as goodwill, ensure no value is attributed to certain contractual RTFI and ensure the reset tax costs for consumable stores are deductible.

The Tax Institute understands the exclusion that relates to contracts cancellable by customers will, in many cases, operate to eliminate most of the deduction which was clearly available under the 2010 changes, despite the stated objective of the interim rules being to protect taxpayers who relied on the law as it stood at the time they entered transactions.

For the reasons set out above under the heading "Retrospective Legislation", the retrospective amendment of the residual tax cost setting rules as they applied in the interim period will have significant adverse impact on many companies subject to the consolidation regime whose past transactions are affected by these changes, including the absence of an apparent protection for many taxpayers impacted by these changes.

c) Retrospective nature of the "prospective rules"

The proposed provisions introduce "prospective rules" which apply retrospectively from 30 March 2011. These provisions introduce ***significant*** policy changes, in particular:

- by deeming the actual acquisition by the head company of the joining entity's membership interests to be the acquisition of the joining entity's assets as part of the acquisition of a business that is a going concern, and therefore a business that has goodwill, the acquisition of the assets by the head company is likely to be on capital account[3] (which it should be noted was not a model supported by the Board of Taxation); and

- the deemed treatment of *all* rights to future income amounts (other than narrowly defined WIP amount assets) as retained cost base assets, which effectively result in minimal or no cost recognition for these types of assets.

These proposed amendments result in significantly different taxation outcomes under an asset based acquisition as compared with an entity based acquisition. These policy changes were only first announced in the 25 November 2011 Press Release. Therefore, taxpayers entering into transactions between the period 31 March 2011 and 25 November 2011 would have been oblivious to these significant policy changes at the time these transactions were negotiated and/or completed. It is inequitable and unjust to impose such onerous obligations on taxpayers in these circumstances. Therefore, these proposed "prospective rule" changes should apply to transactions which occurred on or after the date of announcement (25 November 2011) rather than to transactions occurring as far back as 30 March 2011.

[3] However, there may be circumstances where the application of the business acquisition approach to a particular asset results in the asset being on revenue account.

3. Schedule 2 - TOFA/Consolidation interaction provisions

The changes made to the consolidation provisions that interact with the TOFA provisions (**TOFA/consolidation interaction provisions**) involve significant retrospective changes in law.

The fundamental consequence of the changes is to reset the tax cost of liabilities assumed as part of a corporate acquisition to the accounting liability at the joining time. At its simplest, prior to the changes a consolidated group (Group A) that acquired an entity with a financial liability (e.g. an out-of-the-money swap) would have obtained a tax deduction when that swap was ultimately discharged (assuming no further movements in the value of the swap and that the liability was otherwise deductible). The changes operate to remove this deduction from the income tax system by resetting the tax cost of the swap at the accounting value of the liability at the joining time.

What taxpayers are aggrieved about in relation to these changes is their retrospective nature. The changes were announced on 25 November 2011 but potentially apply to acquisitions from 2002.

Furthermore, the retrospective nature of the changes do not apply to all taxpayers. Rather, the full extent of the retrospective changes is only felt by taxpayers that elected to un-grandfather their financial arrangements when TOFA started to apply to them (generally, 1 July 2010).

From 1 July 2010, the TOFA provisions operate as the primary code under which the income tax treatment of financial arrangements will be governed. The TOFA provisions represent a fundamental reform to the taxation of financial arrangements. One "compliance" feature of the TOFA provisions is that it allowed taxpayers to un-grandfather their pre-existing financial arrangements such that they were only required to apply one set of provisions to their financial arrangements, that is, they did not have to apply the TOFA provisions to new financial arrangements and the previous law to pre-existing financial arrangements. This ability to un-grandfather existing financial arrangements was simply a compliance measure which allowed taxpayers to apply one set of rules to their financial arrangements. Making the un-grandfathering election was never intended as something that would fundamentally alter tax outcomes in relation to pre-existing financial arrangements.

The effect of the retrospective TOFA/consolidation interaction provisions changes is to change this principle. This arises as a result of the fact that the TOFA/consolidation interaction provisions will only apply to pre-TOFA acquisitions (generally pre-1 July 2010 acquisitions) in relation to taxpayers that elected to un-grandfather their financial arrangements. By way of example, continuing the example set out above in relation to Group A acquiring an entity which held an out-of-the-money swap (and assuming the liability was closed out at this value and was otherwise deductible):

- If Group A did <u>not elect</u> to un-grandfather its TOFA financial arrangements (on 1 July 2010) then Group A would <u>still be entitled to a tax deduction</u> on close out of the swap.

- If Group A elected to un-grandfather its TOFA financial arrangements (on 1 July 2010) then Group A would no longer be entitled to a tax deduction on close out of the swap.

Furthermore, at the time that Group A made the decision to un-grandfather its financial arrangements (in June 2010) Group A was unaware of these potential consequences. This arises from the fact that the provisions did not operate in this way at this time as these changes were only announced (with retrospective effect) on 25 November 2011.

The Tax Institute cannot see on what basis such a retrospective change can be made which has fundamentally different consequences for different taxpayers – why should taxpayers that elected to un-grandfather their TOFA financial arrangements based on the law as it stood at 30 June 2010 be denied tax deductions in relation to financial arrangement liabilities while other taxpayers that did not elect to un-grandfather their TOFA financial arrangements still be entitled to the deductions? In the example above, if Group A had known about the consequences then it may not have made the un-grandfathering election.

Furthermore, in the latest provisions contained in the Bill, the Government has introduced an exception for a limited class of taxpayers that have elected to un-grandfather their TOFA financial arrangements. In summary, the Government has introduced a provision (section 104C contained in the Bill) which provides that taxpayers that received a tax ruling (or written advice under an Annual Compliance Arrangement) in relation to certain assets (e.g. an in-the-money swap) under the pre-TOFA provisions should not have the TOFA/consolidation interaction provisions apply to them retrospectively in relation to both the relevant assets plus also liabilities (e.g. an out-of-the-money swap) which are of the same type as the assets the subject of the ruling/written advice. The relevant ruling/advice that is required is not a ruling/advice in relation to the TOFA provisions or indeed the relevant liabilities.

Although The Tax Institute does not object to the retrospective scope of these provisions being narrowed, The Tax Institute cannot understand on what basis a distinction is now being made between certain taxpayers that have elected to un-grandfather their financial arrangements and other taxpayers that also elected to un-grandfather their financial arrangements. By way of example, why should a taxpayer that simply applied the law as it stood at the time and filed tax returns on that basis be in a worse position than both:

(i) a taxpayer that did not elect to un-grandfather its financial arrangements; and
(ii) a taxpayer that elected to un-grandfather its financial arrangements but received a ruling/agreement in relation to assets that are of the same type as the liabilities that are now the subject of the change.

In our view, this further exception or carve-out (that has been introduced as section 104C) merely reflects the fact that the TOFA/consolidation provisions should not apply retrospectively to taxpayers that un-grandfathered their financial arrangements. This should be a single consistent principle that should apply to all taxpayers.

For the reasons considered above, The Tax Institute believes that the amendments made in Schedule 2 should not have retrospective application. At the very least, the provisions should not apply to pre-TOFA acquisitions (i.e. for taxpayers that elected to un-grandfather their existing TOFA financial arrangements) and ideally they should not apply to any acquisitions that took place prior to 25 November 2011 when the changes were announced.

4. Other

The 2010 amendments made to the consolidation provisions were long-awaited by taxpayers. The amendments were the result of active and detailed consultation between peak bodies, the Treasury and the Australian Taxation Office (**ATO**). A significant number of taxpayers responded to the 2010 amendments by lodging properly drafted and fully considered amendment and objection requests. The Australian Taxation Office has been slow to deal with these issues. Taxpayers who did proper due diligence and made measured requests will be disadvantaged compared to taxpayers who anticipated the changes, as far back as 2005, and lodged returns on an anticipated basis. We understand that many requests, which were lodged appropriately to have the 2010 amendments applied, have not been determined. The requests are to be addressed under this Bill.

Prior Submissions

We also attach for your reference copies of The Tax Institute's prior submissions to The Treasury on these two Schedules as contained in the Exposure Draft issued on 18 April 2012:

- Schedule 2 entitled "Exposure Draft: Tax Laws Amendment (2012) Measures No. 2) Bill 2012 – Schedule 2" jointly prepared with the ICAA, CPA, LCA and CTA dated 2 May 2012 **and** "Operation of the TOFA Rules for consolidated groups" jointly prepared with the ICAA, LCA and CPA dated 12 January 2012; and

- Schedule 3 entitled "Proposed Amendments to the Tax Consolidation Rules – Tax Laws Amendment (2012 Measures No. 2) Bill 2012: Schedule" jointly prepared with the ICAA and CTA dated 3 May 2012.

If you would like to discuss this matter, please contact me or The Tax Institute's Senior Tax Counsel, Robert Jeremenko, on 02 8223 0011.

Yours sincerely

Ken Schurgott
President

2 May 2012

Ms Nan Wang
Manager
Finance Taxation Unit
Business Tax Division
The Treasury
Langton Crescent
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Dear Nan

Exposure draft: Tax Laws Amendment (2012 Measures No. 2) Bill 2012 – Schedule 2

The bodies that are signatories to this letter welcome the opportunity to comment on exposure draft legislation, Tax Laws Amendment (2012 Measures No. 2) Bill 2012 – Schedule 2, containing amendments to the Taxation of Financial Arrangements (TOFA) and Consolidation interaction provisions.

Nevertheless, we believe the consultation timeframe for the exposure draft legislation and accompanying explanatory memorandum was not sufficient given the complexity of the areas of tax law covered by Schedule 2 and in view of the same due date for comments on Schedule 1 dealing with consolidation and rights to future income. Furthermore, as there was little consultation on the measures in Schedule 2 in the lead up to the then Assistant Treasurer's announcement of the measures on 25 November 2011, there should have been a longer consultation period for the exposure draft legislation, especially in view of the retrospective nature of some of the measures.

As outlined in the joint professional bodies' submission to Treasury on the announcement of these measures (attached for your reference), introducing retrospective legislation that adversely affects taxpayers is generally undesirable as it disrupts the stability of our tax system. Furthermore, introducing retrospective legislation without appropriate prior consultation increases uncertainty for those taxpayers who are impacted by the measures.

Even if Treasury decided to retrospectively apply the amendments proposed in Schedule 2 to TOFA liabilities that are subject to the TOFA elective methodologies (where the taxpayer has made a transitional election), the retrospective application of the proposals to TOFA liabilities subject to the accruals and realisation methodologies under TOFA reflects a clear change in policy (from the original TOFA explanatory memorandum) and it seems inappropriate to have these measures apply retrospectively.

The proposed retrospective legislation will adversely affect a range of taxpayers who relied on the existing tax legislation when they were making significant business investment decisions, or deciding whether or not to make a transitional election. Those taxpayers can be divided into two categories:

- head companies of consolidated groups who made a transitional election to ungrandfather their existing financial arrangements at the time that Division 230 started to apply to them, which included financial arrangements that were held at that time as a result of either a formation event for the tax consolidated group or the acquisition of a joining entity; and
- head companies of consolidated groups which have acquired entities with certain financial arrangement liabilities since the time that Division 230 started to apply to them (whether or not they made a transitional election).

First category – taxpayers that made transitional elections

The Australian Taxation Office (ATO) TOFA election and lodgement statistics (based on lodged tax return data) which were referred to in the minutes of the last NTLG TOFA Working Group meeting on 20 March 2012, confirmed that a total of 1,233 taxpayers have lodged TOFA returns and out of those taxpayers, 424 have made transitional elections. At the meeting, the ATO did not have the number of tax consolidated group taxpayers reflected in their data, but were working on identifying statistics for consolidated groups. We note that the Large Business & International taxpayers and Small & Medium Enterprise taxpayers who made transitional elections totalled 365.

It is our view that a commencement date for the final legislation should be 25 November 2011, so that taxpayers who relied on the tax legislation introduced by the Government, and made significant decisions and elections based on that law, are protected. We consider that taxpayers that had made the transitional election, i.e. the TOFA “ungrandfathering election”, based on the law prior to 25 November 2011, should not be subject to any adverse outcomes (i.e. in relation to the calculation of their transitional balancing adjustment amounts and any gains/losses recognised under the Subdivision 230-G balancing adjustment mechanism) as a result of the proposed measures. They should continue to be able to calculate their transitional balancing adjustment amounts and Subdivision 230-G balancing adjustment amounts on the basis of the law as it stood prior to 25 November 2011.

If, however, the Government proceeds with a commencement date of 26 March 2009 then, as submitted in our previous submission, at the very least, the first category of taxpayers should be given the opportunity to reconsider TOFA transitional elections which were made prior to the announcement of these measures and on the basis of the law as it then stood (and which is now being retrospectively amended). The following example illustrates how the retrospective nature of these amendments will impact taxpayers inequitably.

<u>Example – pre-TOFA acquisition</u>

Company A acquired Company B in 2007. As a result of the acquisition, Company A (as head company) assumed various financial liabilities. When Company A acquired Company B it priced the acquisition on the basis that it would be entitled to deductions on close-out of the financial liabilities assumed. On 1 July 2010, the TOFA provisions applied on a mandatory basis to Company A. At this time, Company A had to decide whether to make the ungrandfathering election and apply the TOFA provisions to all of its existing financial arrangements (including those acquired from Company B in 2007 - assuming that they are still on foot). When Company A made this decision in 2010, it did so on the basis that its tax cost in the financial liabilities assumed from Company B would not be reset to their accounting value at the joining time. As such, Company A thought that it would still be able to claim tax deductions when the financial liabilities were closed out. Company A made the ungrandfathering election.

The effect of the new provisions is that Company A will lose the benefit of the tax deductions that it was expecting in relation to the financial liabilities assumed when it acquired Company B. This arises from the fact that the proposed provisions will operate to retrospectively adjust Company A’s tax cost in the liabilities assumed to the accounting value of the liabilities at the time that Company A acquired Company B. This will have the effect of permanently wiping these deductions out of the tax system (the amount of the deductions wiped out will be equal to the accounting value of the liability at the joining time).

In this example, Company A made two significant decisions based on the law as it stood at the relevant time - (i) to acquire Company B and to calculate the price it would pay for Company B and (ii) to elect to ungrandfather its existing TOFA financial arrangements. When it made both decisions, Company A believed that it would be entitled to tax deductions equal to the amount of the financial liabilities assumed (assuming they were otherwise deductible).

The proposed changes reverse this position and retrospectively deny these deductions. Furthermore, as can be seen from the example above, a taxpayer that has chosen to ungrandfather its TOFA financial arrangements is now in a significantly worse position than a taxpayer that chose not to ungrandfather (a taxpayer in exactly the same position who chose not to ungrandfather its financial arrangements in 2010 would still be entitled to the deductions).

It is not apparent how such a retrospective change can be justified.

The explanatory memorandum seeks to justify this policy change at paragraph 2.33 as being purportedly to avoid "loss duplication". Presumably, this refers to the possibility of the joining entity having claimed a tax deduction pre-joining for the mark-to-market movement in the financial liability, and then the head company claiming a deduction for any actual outgoings when the liability is finally settled. However, in the case of a pre-TOFA joining time, there should not be any loss duplication as between the joining entity and the head company. The joining entity, by definition, could not have been subject to the TOFA rules and so would not have been able to utilise any of the accounting methods or the accruals method. The joining entity would not have been entitled to a pre-joining deduction for the mark to market value of the liability, under any tax method then available. Accordingly, there is no basis to create a retrospective permanent difference between taxpayers who have chosen to "ungrandfather" their pre-TOFA liabilities, and those taxpayers who have made a different choice.

Furthermore, the ungrandfathering election is simply a compliance measure designed in order to allow taxpayers not to have to apply two sets of tax provisions to their financial arrangements. As a compliance concession provided to taxpayers, it was never intended that the making of the ungrandfathering election would create significant tax distortions by treating taxpayers differently – i.e. eliminating tax deductions for those that made the ungrandfathering election but not for taxpayers that did not ungrandfather.

Finally, should the retrospectivity of the measures remain, there is a significant flow-on issue in relation to financial liabilities. This arises from the fact that if the deduction is denied (by virtue of resetting the tax cost of the liability at the accounting value of the liability assumed at the joining time) in relation to financial arrangements acquired as a result of pre-TOFA acquisitions, then the historic Allocable Cost Amount (ACA) calculation that was undertaken in relation to that acquisition will be incorrect – as the Step 2 amount should have been 100% of the liability rather than 70% as would have been the case (as at the time of acquisition, it would have been assumed that the liability would have been deductible). If this does occur then the provisions should clearly allow purchaser groups to amend their historic ACA calculations if they have the systems that allow them to do this (and monitor the ongoing consequences). This position should be clarified otherwise there will be ambiguity in relation to whether this is possible under Subdivision 705-E (even if purchaser groups have the systems to allow them to do this). If purchaser groups do not have the systems to allow them to amend the historic ACA calculations, or if they prefer not to, then they should be able to obtain an immediate capital loss in relation to the lost ACA. This could be provided under CGT event L6, but extended to cover both reset and retained cost base assets (CGT event L6 currently only covers reset cost base assets).

Second category – taxpayers that made post-TOFA acquisitions

A consolidated group that is subject to the TOFA rules may have acquired entities with financial arrangement liabilities since the time that Division 230 started to apply to the group. This time could have been as early as 1 July 2009 if an election to early adopt the TOFA rules was made. As noted in the example above, the purchaser group may have priced acquisitions on the basis that they would be entitled to deductions on the settlement of certain financial arrangement liabilities assumed from the joining entities. If the proposed changes apply retrospectively, this may mean that acquisitions since 1 July 2009 (almost 3 years ago) may have been incorrectly priced to the extent of the tax benefit of any deduction that was anticipated.

Again, it is our view that a commencement date for the final legislation should be 25 November 2011, so that taxpayers who relied on the tax legislation introduced by the Government, and made significant decisions and elections based on that law, are protected.

Our previous submission provides more comprehensive examples of the adverse consequences of the retrospective nature of the new measures.

Additional clarification required for accruals and realisation taxpayers

Additional clarification is required for accruals and realisation taxpayers in relation to item 3 of Schedule 2, to explain how they are to deal with the liability and the deemed payment received. Example 2.7 of the explanatory material explains how the gain is to be dealt with under the Subdivision 230-G balancing adjustment. However it then states that the negative liability “is used to work out the gain or loss and the spreading of that gain or loss on an on-going basis”. This ongoing working out and spreading needs more clarification in the law or explanatory material, to avoid a fresh source of uncertainty for affected head companies.

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We would be pleased to discuss any aspect of this submission with you. If you have any queries please contact, at first instance, Karen Liew of the Institute of Chartered Accountants in Australia on 02 9290 5750.

Yours sincerely

Yasser El-Ansary
General Manager – Leadership & Quality
The Institute of Chartered Accountants in Australia

Ken Schurgott
President
The Tax Institute

Margery Nicoll
Acting Secretary-General and Director, International
Law Council of Australia

Paul Drum
Head - Business and Investment Policy
CPA Australia

Frank Drenth
Executive Director
Corporate Tax Association

Attachment: Joint submission on the operation of the TOFA rules for consolidated groups dated 12 January 2012

3 May 2012

Tony Regan
Manager - Company Tax Unit
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The Treasury
Langton Crescent
PARKES ACT 2600

Dear Tony

PROPOSED AMENDMENTS TO THE TAX CONSOLIDATION RULES - TAX LAWS AMENDMENT (2012 MEASURES NO. 2) BILL 2012: SCHEDULE 1

The Institute of Chartered Accountants in Australia, The Tax Institute and the Corporate Tax Association (collectively the **Joint Bodies**) welcome the opportunity to comment on the proposed consolidation amendments contained in Schedule 1 of the Exposure Draft (**ED**) legislation above in respect of the rights to future income (**RTFI**) and residual tax cost setting rules (**the proposed amendments**) and the related Exposure Draft Explanatory Material (**EDEM**).

The proposed amendments implement the government's policy decisions outlined in Media Release of 25 November 2011[1] (**the November release**) by the then Assistant Treasurer the Hon Bill Shorten MP.

We thank Treasury and the Australian Taxation Office (**ATO**) for meeting with us on 26 April to discuss the proposed amendments.

Our detailed submission is in tabular form in the Appendix. We highlight some key points:

1. The ED was released by the Government on 18 April 2012, with submissions on the ED due within two weeks. Given the importance of these proposed measures, it is disappointing that more time was not provided to enable a thorough review and greater consideration of these proposed measures.
2. We request an opportunity for a review of the updated draft law (even if by a small group) before a Bill is presented to parliament. This is because the Appendix outlines a significant number of areas where the ED does not properly implement the November release. We also want to ensure that, to the extent possible given the time constraints, the modifications work effectively in real taxpayer circumstances.
3. The rationale for these amendments is a sensitive issue for government, Treasury and all stakeholders. The proposed measures rectify unforeseen issues which arose from the drafting of the 2010 amendments to the consolidation law and also unforeseen costing

[1] Assistant Treasurer's press release no.159 of 2011

issues affecting revenue. However, they also change the policy to reduce tax revenue cost. This is not a mere integrity measure to counter inappropriate behaviour by certain corporates.

Therefore the EDEM comments concerning the rationale for the changes (paragraphs 1.27 and 1.30 referring to companies acting inappropriately to claim inappropriate benefits) should be reworded to align to the November media release at paragraphs 1.7 to 1.12. That formulation was discussed at length with the office of the previous Assistant Treasurer.

4. In the "pre period", the original formulation of s.701-55(6) is to be reinstated, with clarification only for work in progress and consumables. This will require further clarification by the ATO, as the gaps in s.701-55(6) led to significant controversy involving the ATO and taxpayers: For example, the proposed measures do not deal clearly with a joining entity having incomplete construction contracts.

5. Treasury and the Office of Parliamentary Counsel should confirm with tax publishers that, after the proposed amendments are made, the Income Tax Assessment Act 1997 will show the fully amended prospective period changes (consolidating the three rounds of amendments set out in the complex proposed Schedule 1). This is important to ensure that the law is clearly presented for taxpayers in the future.

6. The Joint Bodies were involved in the earlier confidential consultation on this package, following the announcement by previous Assistant Treasurer the Hon Bill Shorten MP on 30 March 2011 and (after the review by the Board of Taxation) government policy discussions between 30 June and 24 November 2011. We do not expansively discuss issues raised in that process but restate, for the record, two significant concerns raised by the Joint Bodies:

   a) We are concerned about the retrospective nature of the changes and the limited protection given (particularly in the pre period) to consolidated groups, limited in essence to assessments and private rulings obtained. As explained in the confidential consultations, this has disadvantaged those groups which transparently sought guidance from the ATO in relation to the impact of the law prior to amending or lodging their relevant tax returns and incurred significant expenses in preparing amendments not lodged by the 30 March 2011 announcement. This transitional approach has operated to the benefit of groups which took positions and filed their amended tax returns with, in many cases, no discussion about uncertain tax issues with the ATO. This highlights the difficulties with retrospective laws of this nature.

   b) Additionally, while the objective of these rules is "making the tax outcomes for consolidated groups more consistent with the tax outcomes that arise when assets are acquired by entities outside the consolidation regime"[2] the proposed measures will result in some adverse taxation outcomes compared with asset acquisitions outside consolidation. In particular, acquired rights to future income which have a commercial value will, outside consolidation, be recognised at their purchase price

[2] Refer paragraph 1.63 of the Explanatory Memorandum to the ED

for income tax and capital gains tax purposes: in consolidation those assets will be retained cost base assets with, in many cases, no tax value. In our view this outcome is inappropriate and places taxpayers at a disadvantage as compared to the outcome that would have arisen had those assets been acquired outside consolidation.

We will be writing to the Assistant Treasurer separately to restate our concerns with the broad impact of these proposed amendments.

To discuss any of these items, please contact at first instance Susan Cantamessa on 02 9290 5625 or Peter Murray on 03 9288 6677.

Yours Sincerely

Yasser El-Ansary
General Manager – Leadership & Quality
The Institute of Chartered Accountants in Australia

Ken Schurgott
President
The Tax Institute

Frank Drenth
Executive Director
Corporate Tax Association

cc: The Hon David Bradbury MP, Assistant Treasurer and Minister Assisting for Deregulation

APPENDIX

#	ED ref (schedule, part, item)	Section	Comment	Recommendation
1.	-,-,4	170	• The extended amendment period is inconsistent with Attachment A. • Paragraphs 31 to 33 of Attachment A specified that the normal (generally four year) amendment period would continue to apply in relation to "ATO activated amendments" but the additional two year amendment period would apply to specific taxpayer that activated amendments under the pre rules.	• Consistent with Attachment A, the proposed extended period of amendment should only be available to taxpayers that are under the pre rules and that choose to amend.
PRE RULES				
2.	S1, P1, 2	701-55(5C)	• The provision only applies to WIP amounts assets that are in relation to "work but not goods". This is inconsistent with paragraph 24 of Attachment A.	• Treasury should amend the definition of a WIP amount asset in section 701-63(5) to include goods or services.
3.	S1, P1, 2	701-55(5C)	• The provision is more restrictive than Attachment A. For example, work for a particular stage of a contact could be complete but a recoverable debt may not have arisen as a result of the terms of the contact rather than simply as a result of the work being incomplete.	• Treasury should amend the definition of a WIP amount asset in section 701-63(5) to also include completed work, goods and services where a recoverable debt has not arisen. • Treasury and ATO should develop an example for the EM of a joining entity engaged in a part-complete construction contract, to ensure clarity for this conventional and very common scenario affecting various sectors. Draft TD 2004/D85 (withdrawn in contemplation of the 2010 amendments) illustrates the issues involved.

#	ED ref (schedule, part, item)	Section	Comment	Recommendation
4.	S1, P1, 2	701-55(5C)	• Section 25-95 provides for a deduction over 2 years (at worst). Therefore, the provision may bring forward the deductions as compared to the “original 2010 rules”.	• We assume that the impact of bringing forward deductions for WIP amount assets has been taken into consideration.
5.	S1, P1, 3	701-55(6)	• Section 701-55(3) was amended specifically to allow section 701-55(6) the ability to deal with Subdivision 70-E items (i.e. Land carrying trees and rights to fell trees). • However, section 70-120(2) requires one to “have paid to acquire land carrying trees” for the provision to operate.	• A specific provision is required to ensure that section 70-120 operates appropriately with section 701-55.
6.	S1, P1, 7	701-63(1)	• The treatment of goodwill as a single asset will be problematic in practice where the joining entity carries on multiple businesses with multiple goodwill assets.	• An adjustment to the single goodwill rule is required.
7.	S1, P1, 7	701-63(1)	• The provision is framed as an “avoidance of doubt” provision. However, it includes items that are clearly not goodwill under (1)(b) – i.e. RTFI assets.	• The provision is a deeming provision and therefore should not be labelled as an avoidance of doubt provision.
8.	S1, P1, 7	701-63(1)	• The provision refers to an “entity”, rather than the joining entity.	• Treasury should amend paragraph 701-63(1) to clarify that it refers to the joining entity.

#	ED ref (schedule, part, item)	Section	Comment	Recommendation
9.	S1, P1, 7	701-63(1)	• The provision states it only applies for the purposes of Part 3-90. It is understood that this is intended to ensure that a subsequent disposal of the asset will still be treated as a separate asset for tax purposes, however without an ACA amount.	• Treasury should clarify (in the EM) the reason for the use of the words "for the purposes of this Part" and the consequences thereon. • Further, if the consequences are that a subsequent disposal of the asset will not have any cost base, the inappropriateness of this outcome should be considered further (given that outside of consolidation the cost of the asset would be reflected on disposal of the asset).
10.	S1, P1, 7	701-63(2)	• The provision is inconsistent with Attachment A as it does not exclude mine site improvements.	• For completeness, Treasury should mention (in the EM) the current status of the mine site improvements issue.
11.	S1, P1, 7	701-63(2)(b)	• The current definition of accounting intangibles would include mining information. • Mining information in respect of exploration activities is specifically dealt with under subsection 701-55(2) and is deductible under section 40-80. To also include the value of this intangible asset in goodwill is clearly an unintended outcome.	• Treasury should modify para (b) to exclude mining information. This amendment should carry through all relevant periods.
12.	S1, P1, 7	701-63(2)(b)	• The current definition of accounting intangibles may include deferred tax assets. Whilst the outcome is inconsequential for non-excluded assets, this will result in excluded assets being allocated ACA. This is clearly inappropriate.	• Treasury should modify para (b) to also exclude deferred tax assets.

#	ED ref (schedule, part, item)	Section	Comment	Recommendation
13.	S1, P1, 7	701-63(2)(b)	• Clarity is required that the deemed definition of goodwill would not include assets such as copyright.	• Treasury should clarify (in the EM) that an intangible that constitutes a CGT asset, a Division 40 asset, or an asset otherwise recognised for tax purposes will not fall within the deemed goodwill definition. • This would also eliminate the need to separately mention mine site improvements and mining information which are otherwise dealt with under subsection 701-55(2) and Division 40.
14.	S1, P1, 7	701-63(2)(b)	• Clarity is required regarding the terms “customer relationship asset” and “know how asset”.	• Treasury should clarify (in the EM) that these terms are based on their accounting meaning. A summary of their accounting meanings may also be useful.
15.	S1, P1, 7	701-63(4)	• The term “right to future income” is defined without including a limitation for rights that constitute recoverable debts. • This drafting would inadvertently include trade and service receivables that have already been assessed to the joining entity.	• Treasury should amend the definition of a right to future income to exclude rights that constitute a recoverable debt.
16.	S1, P1, 7	701-63(4)(c)	• The use of the term “Division 230 financial arrangement” can create some ambiguity given that Division 230 could generally only apply from 1 July 2010 however, as a result of the proposed TOFA interaction provisions, in undertaking a number of associated TOFA calculations, Division 230 would be deemed to apply back to an earlier joining time.	• Treasury should clarify these ambiguities by confirming that if, because of an ungrandfathering election, Division 230 subsequently applies to an asset of the joining entity that joined the consolidated group or multiple entry consolidated group at an earlier time then, in respect of that earlier joining time, the asset should be regarded under para (4)(c) as a Division 230 financial arrangement.

#	ED ref (schedule, part, item)	Section	Comment	Recommendation
17.	S1, P1, 7	701-63(5)	• The definition of WIP does not include a separate asset type rule, similar to section 701-90. • Arguably, an asset that includes a component of WIP could be treated as a WIP asset in totality (or alternatively may not be considered a WIP asset).	• Treasury should consider whether a WIP asset is treated as a separate asset (from the contract) for Part 3-90 purposes. • Consideration of this issue should also involve consideration of valuation issues. • This issue is similar for all periods, where WIP is defined as the asset, but is not separated from the contract.
18.	S1, P1, 7	701-63(5)	• As outlined earlier, the definition of a WIP amount asset is inconsistent with the definition contained in para 24 of Attachment A. The attachment extended to goods or services.	• Treasury should amend the definition of WIP amount asset in section 701-63(5) to include goods or services.
INTERIM RULES				
19.	S1, P2, 23	701-63(3)(b)	• The EM examples 1.1 – 1.5 use terminology which is inconsistent with the provisions. Given the potential breadth of its application, the provision needs to be given useful examples in the EM based upon the Press Release and Draft Legislation. In particular example 1.3 in the EM suggests that a contract which can be unilaterally cancelled by the payment of a compensation amount will be a non-deductible RTFI yet it is not within the terms of the provision as proposed.	• Treasury to amend the examples contained in the EM to achieve the recommended consistency and usefulness.

#	ED ref (schedule, part, item)	Section	Comment	Recommendation
20.	S1, P2, 23	701-63(3)	• Under subsection 701-63(3) a non-deductible RTFI is one to the extent that the value of the right is contingent on contract renewal, a renewal contingency. Subsection 701-63(3)(a) specifically includes a contingent right to an amount. The EM in various places suggests that the only deductible RTFI is to the extent the future income is 'guaranteed'. Example 1.3 is not supported in the legislation. • In addition, the "to the extent rule" raises a concern where fixed term contracts are cancellable, compensation may be paid, but the compensation does not reflect the cancelled remainder of the contract. The question is whether it is appropriate to treat these types of fixed term contracts as goodwill.	• Contingent, non-guaranteed RTFI under existing contracts should be eligible for deductibility. This should be specifically acknowledged and confirmed in the EM. Paragraph 1.53 in particular should be amended to reflect this. It is not correct that the joining entity's RTFI is uncertain if the other party is able to unilaterally cancel the contract without compensation. There are numerous examples of consumer contracts (eg. funds management and telecommunications) where fees are charged according to the level of services provided, rather than being a guaranteed amount, which, nonetheless, should be RTFI. • Guidance in the EM on how taxpayers are expected to value that part of the contract that may be cancelled without compensation would be useful.
21.	S1, P2, 23	701-63(3)(a) and (b)	• Whether the expression "to the extent" will operate as intended, which is to apportion the value of the right as between the non-contingent and the contingent (paragraph (a)) and to characterise the right as a non-deductible RTFI, as between unilateral cancellation without compensation and with compensation.	• Treasury should confirm with the drafter that this is effective and that the expression "to the extent" in paragraph (a) in particular does not operate to make the whole of the right a non-deductible RTFI merely because to some extent there is a renewal contingency. Simple clear examples in the EM illustrating that "to the extent "is not to be interpreted as "ïf" or some similar expression.
22.	S1,P2, 23 (and 7 in Pre-rules)	701-63	• See comments in respect of item 7 and section 701-63 for the pre-rules comments in respect of the goodwill asset. These apply equally here.	• Treasury to reconsider approach to the deemed goodwill asset to ensure that the problems identified are resolved.

#	ED ref (schedule, part, item)	Section	Comment	Recommendation
23.	S1,P2, 23 (and 7 in Pre-rules)	701-63	• An issue arises in relation to the treatment of RTFIs which relate to passive income, e.g. income under a lease contract. The RTFI definition in the pre rules is per the 2010 amendments. The EM commented that leasing contracts did not fit within the RTFI definition.	• Treasury should ensure that the treatment of potentially passive income generating assets is clarified.
24.	S1,P2, 23 (and 7 in Pre-rules)	701-63	• Double counting of accrued income that is assessable and amount treated as goodwill is inappropriate	• Accrued income should be treated as a retained cost base asset instead.
25.	S1, P2, 26	701-90	• The removal of subsection 701-90(1) in this period may cause unnecessary enquiries being made to publishers as to what happened to it.	• Appropriate acknowledgement in the text to minimise concerns or possible renumbering.
26.	S1, P2, 28	705-56A(2)	• It would appear that this provision goes further than is intended. • The implication of paragraph (1)(b) is that the encumbrance is one created by the “contract” that includes the right to future income. • However, the reference to encumbrance in subsection (2) is not limited. Therefore, an encumbrance not created under the contract could inappropriately reduce the value of the RTFI asset.	• Subsection (2) should be amended to ensure that an encumbrance is in relation to the contract giving rise to the right covered by paragraph (1)(b)

#	ED ref (schedule, part, item)	Section	Comment	Recommendation
PROSPECTIVE RULES				
27.	S1, P3, 36	701-56	• It is unclear as to what the proposed words "business of the joining entity as a going concern" achieve. • The words are not consistent with the approach recommended by the Board of Taxation, as contained in para 59 of Attachment A. • For example, if a target entity was a passive investment company with a single asset, the proposed provision may deem an outcome which is inconsistent with the actual factual situation. • As well, the phrase 'going concern' invites comparison with the GST rules which may add uncertainty.	• Proposed section 701-56 be modified so that it is more consistent with the proposal made by the Board of Taxation and cited at para 59 of Attachment A. For example, reference could be made to the head company acquiring all of the assets of the joining entity as part of a business acquisition. • To assist in taxpayer and judicial consideration of this provision, the section or EM might note the assumed underlying policy of aligning the tax consequences to the treatment of a business acquisition outside tax consolidation. For example paras 61 and 62 of Attachment A and para 6.14 of the Board of Taxation's report state that the "modifications (are) to ensure that the outcomes under the rule are closer to those that arise outside consolidation under a business acquisition approach. (62) Under a business acquisition approach, the head company will be treated as having acquired the assets of the joining entity as if they were acquired directly, as part of a business acquisition. The revenue or capital character of the assets will then be determined based on the character of the asset in the hands of the head company, rather than the joining entity."

#	ED ref (schedule, part, item)	Section	Comment	Recommendation
28.	S1, P3, 42	701-67	• Part 3-90 will be limited to CGT assets. • This is inconsistent with the comment in para 55 of Attachment A, which refers to assets that are recognised for taxation purposes. In fact, para 56 specifically notes that assets that are recognised for taxation purposes are "primarily" CGT assets, which envisages that CGT assets are not the only kinds of assets that can be included. • This is also inconsistent with TR 2004/13, "Income tax: the meaning of an asset for the purposes of Part 3-90 ..." of which para 11 states that "Assets recognised under the [ITAA 1936 and 1997] would come within the ordinary commercial or business meaning of an asset for Part 3-90 ... Assets within these categories would include items of trading stock, revenue assets, traditional and qualifying securities, depreciating assets and CGT assets." They would include assets held by the taxpayer under arrangements that are not their CGT assets (e.g. trading stock under a consignment agreement). • Mining information may be inappropriately excluded as a reset cost base asset under the proposed approach (as it may not be a CGT asset)	• Treasury should consider changing the words used to be consistent with para 11 of TR 2004/13. The section should also contain a note listing the various specific tax-recognised assets. • RTFI and WIP amount assets should also be expressly referred to in s.701-67 to remove potential uncertainty raised in next submission point. • It is highlighted that the risk of anticipated revenue implications is managed by the Item 37 amendment to 701-56(3)(d) that would ensure that blackhole assets are excluded from Part 3-90. • Mining information should be specifically included as an asset for the purposes of Part 3-90.

#	ED ref (schedule, part, item)	Section	Comment	Recommendation
29.	S1, P3, 44	705-25(5)(d)	• The definition of "RTFI assets" includes any right to income, even if the income has been assessed. Accordingly, a foreign currency trade receivable would be treated as a retained cost base asset under the proposed rule if the asset were a majority owned asset. • The recognition of RTFI needs to interact precisely with proposed s.701-67 - RTFI might be incapable of recognition by current drafting of s.701-67. Amendment of s.701-67 as above will reduce this risk,	• In line with our recommendation made on S1, P1, Item 7, the definition of RTFI should not include income amounts that already constitute recoverable debts. • As noted, s.701-67 and this item should ensure that a RTFI asset can be recognised as a separate asset for the purpose of Part 3-90.
30.	S1,P3,51	701-63(5)	• Same issue as for RTFI assets given current drafting of s.701-67. "WIP amount asset" will be defined in s.701-63(5). However, with the proposed repeal of s.701-90, it is unclear whether WIP amount asset can be recognised as a separate asset in view of s.701-67.	• As noted, s.701-67 and this item should ensure that a WIP amount asset can be recognised as a separate asset for the purpose of Part 3-90.
TRANSITIONAL RULES				
31.	S1, P4, 52		• The cumulative mechanics of Part 4 do not seem to achieve the required outcomes	• Treasury to reconsider. For example, the definition of prospective rules should be "... means Part 3-90 of the Income Tax Assessment Act 1997 as amended by Parts 1 of this Schedule and then by Part 2 of this Schedule and then by Part 3 of this Schedule".

#	ED ref (schedule, part, item)	Section	Comment	Recommendation
32.	S1, P4, 53	(1)	• The EM does not provide guidance on how the provisions would operate where there is a tail. The current wording of the provisions would seem to provide protection for tail deductions.	• Treasury should consider providing an example in the EM that outlines how the application rules operate to a pre-12 May 2010 joining time, where a deduction spans the original 2002 rules, the interim rules, and has a remaining undeducted amount post 30 March 2011.
33.	S1, P4, 53	(3)	• The protection of assessments issued between 12 May 2010 and 30 March 2011 may not operate as intended. Refer to attached examples 1, 2, 3 attached to this submission.	• Treasury is asked to reconsider the wording of this protection provision or to provide clear guidance on what is meant by "assessment ... that relates to the application of subsection 701-55(5C) or (6) of the original 2010 rules".
34.	S1, P4, 53	(5)	• The protection of assessments issued pre 12 May 2010 may not operate as intended. Refer to attached example 4 attached to this submission.	• Treasury is asked to reconsider the wording of this protection provision or to provide clear guidance on what is meant by "assessment ... that relates to the application of subsection 701-55(6) of the original 2002 rules".
35.	S1, P4, 53	(6)	• Attachment A allowed an amendment to be made if a taxpayer were to seek a deduction for WIP or consumables (para 33). This is not currently reflected in Item 53(6).	• Item 53(6) should be updated to ensure that a taxpayer can make an amendment for WIP and consumables in line with para 33 of Attachment A. [WSP comment – I think this provision does work to allow a deduction for WIP and consumables as those deductions would not be sought through the application of s701-55(6) of the original rules, but through new subsections (5C) and (5D).]
36.	S1, P4, 54	(3)	• The current drafting of the provision does not allow a taxpayer to amend their return to be consistent with the ruling.	• Item 54(3) should be removed.

ATTACHMENT – EXAMPLES PROVIDED

1.0 Application

We make the following comments in relation to Schedule 1 Part 4 of the ED.

1.1 Cumulative "mechanics" of the Application provisions

We note that item 52 defines the pre, interim and prospective rules as follows:

> **interim rules** means Part 3-90 of the Income Tax Assessment Act 1997 7 as amended by Part 2 of this Schedule.
>
> **pre rules** means Part 3-90 of the Income Tax Assessment Act 1997 as amended by Part 1 of this Schedule.
>
> **prospective rules** means Part 3-90 of the Income Tax Assessment Act 1997 as amended by Part 3 of this Schedule.

We note that the appropriate application of the interim rules requires that the ITAA 97 is first amended by Part 1 of Schedule 1 before it is amended by Part 2 of Schedule 1. Similarly, the appropriate application of the prospective rules requires that the ITAA 97 is first amended by Part 1 of Schedule 1 and then by Part 2 of Schedule 1 before it is amended by Part 3 of Schedule 1.

It does not seem clear that the mere sequential placement of Parts 1, 2 and 3 will necessarily achieve the necessary cumulative outcomes required. We would have thought that the relevant definitions should be amended as follows:

> **interim rules** means Part 3-90 of the Income Tax Assessment Act 1997 7 as amended by Part 1 of this Schedule and then by Part 2 of this Schedule.
>
> **pre rules** means Part 3-90 of the Income Tax Assessment Act 1997 as amended by Part 1 of this Schedule.
>
> **prospective rules** means Part 3-90 of the Income Tax Assessment Act 1997 as amended by Part 1 of this Schedule and then by Part 2 of this Schedule and then by Part 3 of this Schedule.

1.2 Assessments subject to the interim rules

An assessment will be subject to the interim rules where:

- Under Item 53(3)(a) – "the joining time is before 12 May 2010" and "the head company's latest notice of assessment, for the income year, that relates to the application of subsection 701-55(5C) or (6) of the original 2010 rules in respect of the joining entity, was served on the head company by the Commissioner on or after 12 May 2010 and on or before 30 March 2011; or

- Under Item 55(3)(b) – "the joining time is on or after 12 May 2010" and "the arrangement under which the joining entity joined the group commenced (see item 55) on or after 10 February 2010 and on or before 30 March 2011".

Treasury is asked to provide further guidance or examples on what is meant by "relates to the application of subsection 701-55(5C) or (6) of the original 2010 rules". We provide the following examples to illustrate some of the potential unintended outcomes:

<u>Example 1</u>

A head company may have lodged, in December 2010, a 2010 income tax return which covered a company joining the group in January 2010. A first year RTFI deduction is claimed in that tax return pursuant to sections 701-55(5C) and 716-405. The same head entity may then have lodged a 2011 income tax return in December 2011 containing the second year deduction for the same RTFI asset that was reflected in the 2010 income tax return. Please confirm that the claiming of a second year RTFI deduction under section 716-405 in the 2011 tax return lodged in December 2011 should not be treated as giving rise to a notice of assessment that "relates to the application of subsection 701-55(5C) or (6) of the original 2010 rules" (and should therefore not operate to remove the application of the interim rules to the 2010 assessment).

<u>Example 2</u>

The same facts as above, except that the head company does not include an RTFI deduction in the relevant 2010 tax return when lodged (in December 2010). But the head company does claim a deduction for the reset tax cost of consumable stores in that tax return – pursuant to the application of section 701-55(6) and section 8-1. The head company subsequently (in February 2011) lodges an application for amendment in respect of the 2010 income tax return to claim the RTFI deductions. It would seem that, if the ATO process this application after 30 March 2011 and issue an amended assessment, the head company would have a notice of assessment that “relates to the application of subsection 701-55(5C) or (6) of the original 2010 rules” issued post 30 March 2011 and the head company would thereby lose the protected application of the interim rules to the original 2010 assessment (and any subsequent assessment).

However, if the head company withdraws the application for amended 2010 assessment before it is processed and makes no subsequent request for 2010 amended assessment, the original 2010 assessment would seem to be covered by the interim rules. Accordingly, the tax cost of the RTFI assets of the joining entity are reset under the interim rules (even if the head company did not make an actual RTFI claim in the 2010 year). And there would then seem to be nothing to preclude that head company from claiming RTFI deductions under s716-405 under the interim rules in subsequent years.

<u>Example 3</u>

Same facts as above, except that an RTFI deduction (but not a deduction for consumable stores) is claimed in the relevant 2010 tax return when lodged by the head company (in December 2010).

In May 2012 (prior to the enactment of the provisions contained in the ED), the head company lodges a request for amendment of the 2010 assessment to claim a deduction for consumable stores. The ATO issue an amended assessment allowing this deduction in June 2012 (also prior to the enactment of the provisions contained in the ED). The issue of this amended assessment would then seem to represent a notice of assessment that “relates to the application of subsection 701-55(5C) or (6) of the original 2010 rules” issued post 30 March 2011 and the head company would thereby lose the protected application of the interim rules to the original 2010 assessment (and any subsequent assessment).

1.3 Protected tail deductions

Treasury is asked to confirm whether RTFI "tail deductions" are intended to be protected if the relevant assessment covering the joining time is subject to the interim rules. As they stand, the provisions in Item 53 seem to protect tail deductions claimed in subsequent years.

Subitem 53(1) provides as follows:

> "The provisions specified in subitem (2), (3), (4) or (5) apply to an assessment of the head company of a consolidated group or MEC group for an income year in respect of an entity (the joining entity) that becomes a member of the group at a time (the joining time)."

It is noted that there is nothing in subitem 53(1) that limits the relevant assessment to be the one for the income year in which the relevant joining time has occurred. On the contrary, the use of the terms "an assessment" in the first line and "a time" in the last line of this provision would suggest such a limitation is not imposed.

1.4 Protected application of the original 2002 rules

Subitems 53(5) and (6) provide protected application of the original 2002 rules in the following circumstances:

> (5) Despite subitems (2), (3) and (4), those provisions are the original 2002 rules if the head company's latest notice of assessment, for the income year, that relates to the application of subsection 701-55(6) of the original 2002 rules in respect of the joining entity, was served on the head company by the Commissioner before 12 May 2010.
>
> (6) Subitem (5) does not apply if:
> (a) the head company of the group requests an amendment of the assessment and the amendment relates to the application of subsection 701-55(6) of the original 2002 rules in respect of the joining entity; or
> (b) the amendment of the assessment:
> (i) would relate to an asset of a kind mentioned in paragraph 701-63(2)(b) of the pre rules; and
> (ii) would not be consistent with the outcome that arises under the pre rules for assets of that kind.

Treasury is asked to provide further guidance or examples on what is meant by "relates to the application of subsection 701-55(6) of the original 2002 rules". We provide the following examples to illustrate some of the potential unintended outcomes:

<u>Example 4</u>

A head company may have lodged, in December 2008, a 2008 income tax return which covered a company joining the group in January 2008. The joining company has a number of RTFI assets.

Aware of the various Government statements relating to clarification of section 701-55(6), the company decided to not claim any deduction for assets potentially reset under s701-55(6) in the relevant tax return. Neither did it claim a capital loss in that year for the reset CGT cost base of any RTFI contracts that expired in that same year post joining time.

Similarly, in its 2009 tax return, lodged in December 2009, the company claimed no RTFI deduction or capital loss in respect of expired RTFI contracts.

In November 2010 (ie. after the enactment of TLAA (2010 No.1)) the head company lodged an application to amend the 2008 and 2009 tax returns to claim RTFI deductions. These applications have still not been processed by the ATO.

It would seem that, unless the head company had any other asset in respect of which it applied s701-55(6) in the 2008 tax return as lodged, it is not protected by subitem 53(5).

Whereas, if, for example, the head company returned a profit on close out of a hedge contract in its 2008 tax return, the tax cost of which had been reset under s701-55(6), subitem 53(5) would apply. And, it is suggested that the subsequent request for amendment to claim RTFI deductions lodged in November 2010 would not trigger the exclusion in subitem 53(6)(a) because the amendment relates to the application of sections 701-55(5C) and s716-405 (rather than to s701-55(6)). On this basis, the original 2002 rules would apply. The important outcome of the application of these rules is that the RTFI assets would retain a separate CGT cost base (rather than losing that cost base through the application of s701-63).

While this protection mechanism is welcomed, it should not be based on a requirement that the head company actually applied section 701-55(6) in respect of an assessment issued pre 12 May 2010. Given the relevant Government announcements, many companies at that time prudently refrained from applying this provision in the expectation that they would subsequently amend the relevant assessment once the law was clarified.

1.5 Protection for private rulings

It is noted that sub-item (3) of item 54 would render ineffective the protection otherwise provided by a private ruling where, (as would be usual subsequent to the issue of the ruling) a taxpayer lodges a request for amendment to give effect to a positive private ruling. The relevant protection should not be removed in these circumstances.

12 January 2012

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Dear Christine

Operation of the TOFA rules for consolidated groups
Media Release No. 159 - Changes to the income tax law affecting consolidated groups

As you will be aware, on 25 November 2011, the then Assistant Treasurer announced a number of changes to the income tax law affecting consolidated groups. The changes contained in Attachment A of the 25 November 2011 media release number 159 ('the media release") were the subject of extensive consultation. Unfortunately the changes contained in Attachment B of the media release were not subject to any consultation.

The professional bodies that are signatories to this letter are of the view that significant consultation regarding the implementation of these proposals must be undertaken. In particular, extensive consultation is required regarding the retrospective nature of the proposals that will adversely affect taxpayers who relied on the existing tax legislation when they were making significant business investment decisions.

The attached submission discusses the following issues:

- Part A – the need for greater consultation;
- Part B – a summary of our understanding of the proposed changes in Attachment B; and
- Part C – examples demonstrating how the proposals will impact taxpayers inequitably (together with a discussion of some aspects of the proposals).

Although a number of issues are raised in the Attachment B media release this submission is primarily directed at the transitional balancing adjustment amendments set out in paragraphs 7 to 11 of Attachment B. This arises from the fact that these amendments largely reflect the retrospective nature of the proposals. Although this submission does indirectly discuss some issues relating to "liabilities" assumed when an entity joins a tax consolidated group (i.e. the changes set out in paragraphs 4 to 6 of Attachment B), this submission does not consider these issues in any detail and does not consider the appropriate way to deal with such liabilities under the income tax system. This will form the basis of a separate submission that we will provide in early 2012.

We would be pleased to discuss any aspect of this submission with you. If you have any queries please contact, at first instance, Susan Franks of the Institute of Chartered Accountants in Australia on 02 9290 5750.

Yours sincerely

[redacted]

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Part A – the need for extensive consultation

Introducing retrospective legislation that adversely affects taxpayers is generally undesirable as it disrupts the stability of our tax system. However, unexpectedly introducing retrospective legislation without appropriate prior consultation increases uncertainty for those taxpayers who are impacted by the measures.

The difficulties of introducing retrospective legislation were recognised by the former Assistant Treasurer in relation to the announcements contained in Attachment A of media release 159. To overcome these difficulties, the then Assistant Treasurer held extensive consultations which included:

a) Announcing publicly on 30 March 2011 that the Government was concerned about certain consolidations law issues and that the Board of Taxation would commence an urgent review into those matters.
b) A public review by the Board of Taxation involving a public issues paper and public invitation for submissions.
c) Board of Taxation discussions with a range of experts, and subsequent Board of Taxation report to the Government.
d) After the Board's report, an extensive consultation process commenced on 30 June 2011. The consultation process was led by the Government, and also included Treasury, the ATO and selected representatives from the business community and tax profession. A number of meetings were held in relation to the key issues and likely way forward for the Government.
e) Discussing successive drafts of Attachment A which contained a comprehensive analysis of the precise issues at stake, with section references, legislative history and treatment of transitional issues, as appropriate given the significant amendments with retrospective effect.
f) Protection of various assessments and amended assessments lodged by consolidated groups relying on the law in force.

In contrast, there has been no consultation in relation to Attachment B of media release 159. It is understood that the extent of consultation before the issue of Attachment B only extended to showing the proposed Attachment B measures in draft form on 24 November 2011, one day before their release on 25 November 2011, to the representatives involved in and focusing on the Attachment A issues.

Whilst the changes made by Attachment A (and the transitional rules in respect of these) remain the subject of much concern for businesses, the policy changes contained in Attachment B should at least be subject to a similar level of consultation to that given to those contained in Attachment A of media release 159.

On the face of Attachment B, the proposals apply retrospectively, without any regard to the fact that taxpayers will have made tax elective choices and decisions, with significant financial implications, and without any apparent regard for the need to achieve a degree of equity amongst taxpayers.

We are of the opinion that, proper implementation of Attachment B requires a commencement date of 25 November 2011 so that taxpayers which relied on the tax legislation introduced by the Government and made significant decisions, and elections, based on that law are protected. To be clear, we consider that taxpayers that had made elections (the TOFA "un-grandfathering election") based on the law prior to 25 November 2011 should not be subject to any adverse outcomes in relation to the calculation of their transitional balancing adjustment amounts as a result of the changes proposed by Attachment B – i.e. they should continue to be able to calculate their transitional balancing adjustment amounts on the basis of the law as it stood prior to 25 November 2011.

In the alternative, if the Government proceeds with making the Attachment B measures retrospective then, at the very least, taxpayers should be given the opportunity to reconsider TOFA transitional elections which were made prior to the announcement of Attachment B and on the basis of the law of Australia as it then stood (and which is now being retrospectively amended by Attachment B). We have included within Appendix C to this submission an example of how the retrospective nature of these amendments may impact taxpayers inequitably.

We believe that the Government must use the consultation process and the issues emerging from it to develop an appropriate package of measures in relation to Attachment B dealing with:

- date of commencement of the measures; and
- protection for taxpayers who relied on the law and made elections based on the law.

Part B – intended scope and operation of the measures

Although dealing with an extremely complicated area of the income tax law, Attachment B is extraordinarily brief. Indeed, it contains no references to legislative provisions and does not discuss/explain the context of the proposed changes or what the changes are intended to achieve. As such, we have set out below what we understand the measures set out in Attachment B apply to and also what we understand the Attachment B measures do. We have summarised these in a simple example (below) and we seek your confirmation that both our understanding and the example are correct.

We understand the Attachment B measures apply to:

1. financial arrangements (within the meaning of Division 230 ITAA 1997) held on or after the time Division 230 ITAA 1997 starts to apply;

2. by the head company of a tax consolidated group;

3. financial arrangements held as a consequence of either a formation event for the tax consolidated group or an entity joining the tax consolidated group after the commencement of Division 230 ITAA 1997 (in the case of a pre-TOFA acquisition the measures will only apply, via the calculation of a transitional balancing adjustment amount, to taxpayers that have elected to un-grandfather their existing financial arrangements at the time that Division 230 starts to apply to them and they hold financial arrangements previously acquired as a result of a pre-TOFA acquisition).

We seek your confirmation that our understanding is correct.

Furthermore, we understand that the measures:

1. deem the head company of the relevant tax consolidated group to have acquired/assumed financial arrangements (whether assets or liabilities) from the joining entity at the joining time;

2. deem financial arrangement liabilities subject to fair value, retranslation or financial reports tax timing methods to have been assumed by the head company at their accounting value at the joining time (that is, the head company is deemed to have received the accounting value as consideration);

3. deem financial arrangement liabilities which are not subject to fair value, retranslation or financial reports tax timing methods to have been assumed by the head company at their accounting value at the joining time;

4. allow the head company to use only the primary method (long-form method) for working out TOFA transitional balancing adjustments; and

5. in calculating their transitional balancing adjustment amounts, require the head company to apply the TOFA/consolidation interaction provisions (including, rules 1, 2 and 3 above) in relation to historic corporate acquisitions. For completeness, we note that although not stated in Attachment B we assume that the TOFA/consolidation interaction provisions are intended to be s.701-55(5A), s.701-55(5B), s.701-61 and s.715-375.

Although not stated in Attachment B we understand that the intent or "policy" behind rules 2 and 3 is to deny a consolidated group that assumes liabilities on acquisition of a company any deductions in relation to that assumed liability up to the amount of the accounting value of the liability at the time that the consolidated group acquired the company.

We seek your confirmation that our understanding is correct.

Although there may be disagreement between Treasury and industry in relation to the scope of these changes, we understand that at a minimum Treasury accepts that:

- some of these changes (particularly, rule 3 above) reflect a change in policy; and
- the position in relation to a number of the other changes was not clear prior to Attachment B.

In particular, we believe that it was clear (prior to the release of Attachment B) that taxpayers that had elected to un-grandfather their existing financial arrangements did not have to apply the TOFA/consolidation interaction provisions in relation to historic corporate acquisitions (i.e. rule 5 above did not apply). This is considered in further detail in Part C below.

The above points are summarised below in an example and we seek your confirmation that you agree with this calculation.

Example

Facts

- Company B is an Australian resident company and a member of the Company A tax consolidated group;
- The shares in Company B are sold to Company C (an Australian resident company and head company of the Company C tax consolidated group) for $121 (net assets) either before or after the start of the TOFA law and, as a consequence, Company B joins the Company C tax consolidated group;
- For completeness, we assume that neither the Company A tax consolidated group nor the Company C tax consolidated group have chosen to apply any of the elective taxation methods under the TOFA law;
- At the acquisition time Company B has assets of $200 funded by borrowings of $100 and share capital of $100;
- The assets comprise only cash at bank denominated in Australian dollars (that is, cash of $200);
- The borrowing is denominated in foreign currency and the exchange rate has changed in such a way that the liability is now only worth $70 (that is, there is an unrealised FX gain of $30);
- Ignoring any interest income earned in respect of the assets, Company B therefore has an accounting profit of $30 and a tax expense (deferred tax liability) of $9 – that is, retained earnings of $21;
- Consequently, Company B's balance sheet is:

Assets	
Cash at bank	200
Liabilities	
Borrowings	70
Deferred tax liability	9
Net assets	**121**
Share capital	100
Retained earnings	21
Shareholders equity	**121**

Analysis

<u>Tax position of the vendor (Exit ACA)</u>
<u>The position of the vendor, the Company A consolidated group, is as follows:</u>

Exit ACA		
Step	**Amount**	**Legislative reference**
1	$200	S711-25
2	$Nil	
3	$Nil	
4	$109	S711-45(5)
Total old group ACA	**$91**	
Gain on disposal		
Sale proceeds	$121	
Capital gain	$30	

Please note that the above exit ACA calculation has been shown on the basis that the step 4 amount has been 'tax effected'. Attachment B is not stated to apply to the exit ACA calculation.

Entry ACA

Under the Attachment B measures:

- Company C (as head company of the tax consolidated group) will be deemed to have acquired the financial liability (the borrowing) at $70 (its accounting value) at the joining time.

- For TOFA purposes, the liability is therefore 'reset' to $70 so that, assuming no further movement in the exchange rate until repayment of the liability, no tax gain or loss is ultimately ever made on extinguishing the liability (refer section 230-25 ITAA 1997).

  In this regard we seek your confirmation that, if the Attachment B changes are introduced, further retrospective changes would be made so that the 'reset' of the liability occurs for all TOFA purposes including, in particular, the balancing adjustment provisions in Subdivision 230-G (as well as the interaction of TOFA and consolidation). The associated consequence of this is that the deferred tax balance (the deferred tax liability) should no longer be recognised.

- The entry ACA calculation in respect of Company B is as follows:

Step	**Amount**	**Legislative reference**
1	$121	S705-65 (note 1)
2	$ 70	S705-70 (1A)
For simplicity, ignore othe steps		
Total ACA	**$191**	
Retained cost base asset	$200	
Shortfall ACA (L3 gain)	$9	

Note 1: Purchase price currently reflects the deferred tax liability of $9 which, pursuant to the operation of Attachment B and subsection 705-70(1A) ITAA 1997, would otherwise not be a liability of the tax consolidated group. It is entirely possible that, following the announcement of Attachment B, the purchase price would be increased to reflect the fact that the liability would be ''reset' for tax purposes (with the effect that the acquiring group (in this example, the Company C tax consolidated group) would not be required to pay the $9 deferred tax in respect of the liability). This is one of the many issues requiring consideration.

Part C – Transitional balancing adjustment amounts in relation to un-grandfathered financial arrangements (plus various examples)

As reflected above, this submission relates specifically to the retrospective nature of the amendments which arise as a result of the proposal to apply certain TOFA/consolidation interaction provisions to the calculation of a taxpayers transitional balancing adjustment (**TBA**) amount (see paragraphs 7 to 11 of Attachment B).

This submission does not consider the appropriateness (or not) of applying the long-form method to the calculation of TBA amounts in relation to financial arrangements acquired as a result of a pre-TOFA acquisition. Although we are not convinced that permanent differences should arise (see paragraph 11 of Attachment B) provided that the Subdivision 230-G balancing adjustment provisions work correctly, we have not addressed the long-form v short-form TBA issues in this submission.

What we do consider to be a fundamental retrospective change in law is the proposed application of the "TOFA/consolidation" interaction provisions (see paragraph 8 of Attachment B) to the calculation of a taxpayer's TBA amount in relation to financial arrangements that it has acquired/assumed as a result of a historic corporate acquisition.

We consider that this proposal represents a retrospective change in law which will lead to inequitable consequences for those taxpayers that have elected to apply the TOFA provisions to their existing financial arrangements (i.e. those taxpayers that have elected to un-grandfather their existing financial arrangements).

In particular, we note that:

- taxpayers have already made elections to un-grandfather their existing TOFA financial arrangements – taxpayers made these decision in good faith based on the TOFA provisions as enacted. If taxpayers had known that the TOFA/consolidation interaction provisions applied when calculating their TBA amounts then they may not have made the decision to un-grandfather their existing TOFA financial arrangements; and

- although there are a number of consequences flowing from the application of the TOFA/consolidation interaction provisions to historic corporate acquisitions perhaps the most fundamental consequence is the denial of deductions in relation to financial arrangement liabilities assumed by a consolidated group when it acquired another entity (as a result of "resetting" the tax cost of the liability assumed to its accounting value at the time of acquisition). Such a retrospective change is inherently inequitable as the transaction will have been originally implemented on the basis that the deductions would be available to the purchasing group. To deny such deductions in relation to historic corporate acquisitions (potentially all the way back to 2002) cannot be justified from a policy perspective.

- In the Attachment A consolidation announcement, certain measures were implemented with effect prospectively from 31 March and various transitional measures apply to taxpayers which had lodged returns or amended returns or entered into transactions relying on the legislation. Attachment B is completely silent on consideration of these issues.

Although these issues are inherently complicated, we have attempted to illustrate our concerns through a simple example.

Example

Facts

- Company B is an Australian resident company and in 2006 was a member of the Company A tax consolidated group;

- Company B had the following assets/liabilities on 31 December 2006:

  - a deposit of $100 (denominated in Australian dollars) (the **Cash**); and
  - a derivative that was ($100) out-of-the-money (the **Derivative**).

- The Derivative was recognised in Company B's accounts with a fair value of ($100). A deferred tax asset of $30 was also recognised in Company B's accounts in relation to the Derivative.

  The financial statements of Company B were

Assets	
Deposit	100
Deferred tax asset	30
Liabilities	
Derivative	100
Net assets	**30**
Share capital	100
Retained earnings	(70)
Shareholders equity	**30**

- The shares in Company B were sold to Company C (an Australian resident company and head company of the Company C tax consolidated group) on 1 January 2007 for $30 (i.e. net assets). At this time Company B joined the Company C tax consolidated group.

- On 1 July 2010, the Company C tax consolidated group became subject to TOFA. At this time, Company C still held the Cash of $100 and the Derivative. For the purposes of this example, we have assumed that Derivative had not changed in value – i.e. it is still ($100) out-of-the-money on 1 July 2010 and at the time the Derivative is closed out.

- Company C elected to un-grandfather all of its existing financial arrangements (under Item 104(2) of the TOFA Act). As such, Company C is required to calculate a TBA amount in relation to all its un-grandfathered financial arrangements which will include the Cash of $100 and the Derivative. (Note: these facts are only relevant to Scenarios 1 and 3).

- Company C is subject to the default accruals and realisation provisions with Division 230 (i.e. Company C has not elected to apply any of the TOFA elective methods). For completeness, we note that no material differences should arise if Company C has elected to apply the elective methods – the only differences would be timing differences in relation to the recognition of the TOFA gains/losses in relation to the Derivative.

We have set out in the attached spreadsheet a number of scenarios in relation to this example being:

Scenario 1 Current law and un-grandfathering election made by Company C

- Scenario 1 is based on the existing provisions (i.e. without the Attachment B changes) and on the assumption that Company C elected to un-grandfather its existing financial arrangements.

- As reflected in Scenario 1, Company A will incur a capital loss of $70 and Company C will be entitled to a deduction for the $100 loss incurred when the Derivative is closed out.

Scenario 2 Current law and no un-grandfathering election made by Company C

- Scenario 1 is based on the existing provisions (i.e. without the Attachment B changes) and on the assumption that Company C has not elected to un-grandfather its existing financial arrangements.

- As reflected in Scenario 2, Company A will incur a capital loss of $70 and Company C will be entitled to a deduction for the $100 loss incurred when the Derivative is closed out.

Scenario 1 and 2 demonstrate that under the existing TOFA provisions (i.e. without applying the TOFA/Consolidation interaction provisions when calculating a taxpayers TBA) there is no difference between a taxpayer (here, Company C) that has elected to un-grandfather its existing financial arrangements and a taxpayer that has not elected to un-grandfather its existing financial arrangements.

Scenario 3 Attachment B applies and un-grandfathering election made by Company C

- Scenario 3 is based on the changes set out in Attachment B applying retrospectively (i.e. the TOFA/Consolidation interaction provisions applying when a taxpayer calculates its TBA amount) and on the assumption that Company C elected to un-grandfather its existing financial arrangements.

- As reflected in Scenario 3, Company A will incur a capital loss of $70.

- Furthermore, we assume that the "intent" of the Attachment B changes will be that Company C will ultimately be denied any deduction for the $100 loss that is incurred when the Derivative is closed out - as Company C will be deemed to have assumed the liability for its accounting value of ($100) at the time when Company C acquires Company B.

- We say "intent" as this will only occur if Treasury make further changes to the TOFA provisions beyond those set out in Attachment B. Attachment B merely states that the TOFA/Consolidation interaction provisions (relevantly, here s.715-375) will apply for the purposes of calculating a taxpayer's TBA. The calculation of a taxpayer's TBA amount does not include the Subdivision 230-G balancing adjustment provisions which will apply when the Derivative is closed out. In the absence of further changes in law, Company C should still be entitled to a deduction for the $100 loss incurred when the Derivative is closed out.

- Furthermore, in this scenario, the entry ACA Step 2 amount will be incorrect because, when the acquisition took place in 2007 it would have been assumed that the loss on the Derivative would be deductible to Company C - as such, the Step 2 amount would have been reduced to $70. As there does not appear to be any ability to adjust this amount retrospectively, Company C will also have lost $30 of ACA (as well as the $100 deduction).

Scenario 4 Attachment B applies and no un-grandfathering election made by Company C

- Scenario 4 is based on the changes set out in Attachment B applying retrospectively (i.e. the TOFA/Consolidation interaction provisions applying when a taxpayer calculates its TBA amount) and on the assumption that Company C has not elected to un-grandfather its existing financial arrangements.

- As reflected in Scenario 4, Company A will incur a capital loss of $70 and Company C will be entitled to a deduction for the $100 loss incurred when the Derivative is closed out.

A number of significant points are demonstrated by Scenarios 3 and 4 – these include:

- ***When Company C has elected to un-grandfather its existing financial arrangements, it is in a significantly worse position as a result of the changes introduced by Attachment B than it is under the current TOFA provisions. This is inequitable as Company C will have made the decision to un-grandfather its existing financial arrangements on the basis that the $100 loss that will be incurred when the Derivative is closed out would be deductible.***

- ***When Company C elects to un-grandfather its existing financial arrangements, it is in a significantly worse position than a taxpayer that has chosen not to un-grandfather its existing financial arrangements. Again, this is inequitable as why should Company C be denied the benefit of deductions (which it was always expecting to obtain) in relation to the loss incurred on***

close out of the Derivative solely as a result of electing to un-grandfather its existing financial arrangements (again, noting that Company C will have made the decision to un-grandfather its existing financial arrangements on the basis that the loss in relation to the Derivative would be deductible).

At their heart, these changes are retrospectively penalising taxpayers that have

(i) elected to un-grandfather their existing TOFA financial arrangements and
(ii) had historically acquired financial arrangements as a result of a corporate acquisition.

This is inequitable for a number of reasons, including:

- At the time of completing a pre-TOFA acquisition the purchaser (here, Company C) will have implemented the acquisition on the basis that certain liabilities that it assumed (e.g. an out-of-the-money derivative) would be deductible when the liability was ultimately discharged. The deductibility of such liabilities has been a feature of the income tax system since the consolidation provisions were introduced in 2002. It is not appropriate, in our view, to retrospectively deny such deductions in relation to corporate acquisitions which in many cases go as far as 2002.

- Even if there was any policy basis to deny such deductions, why should only a limited class of taxpayers (i.e. taxpayers that have un-grandfathered their TOFA financial arrangements) be denied the deductions? Furthermore, why should the changes only apply to a taxpayer that has un-grandfathered its existing financial arrangements with the changes having no consequences for a taxpayer that has not un-grandfathered its existing financial arrangements? In the example above, why should Company C be denied a deduction in relation to the $100 loss incurred on close out of the Derivative when it has un-grandfathered its financial arrangements (Scenario 3) but remain entitled to the $100 deduction if it had not un-grandfathered its financial arrangements?

- In 2010/11 when taxpayers were evaluating whether to un-grandfather their existing financial arrangements they did so in good faith on the basis of the TOFA provisions as they stood at that time – i.e. they based their decision on the income tax provisions at that time. In our view, it was clear that at this time the TOFA/Consolidation interaction provisions did not apply when calculating a taxpayers TBA. Taxpayers made irrevocable elections to un-grandfather their existing financial arrangements based on this position. Again, the basis upon which a retrospective policy change should be made here is not immediately apparent to us, especially after taking into account that taxpayer will have made irrevocable elections in relation to this.

- We understand that Treasury may argue that the TOFA/Consolidation interaction provisions were always clearly intended to apply when calculating a taxpayers TBA amount and that the change in Attachment B is simply clarifying this. We do not agree with such a proposition. In particular:

  a) in our view the clear reading of the TBA provisions is that the TOFA/consolidation interaction provisions did not apply when calculating a taxpayers TBA amount;

  b) at no stage within the Explanatory Memorandum to the TOFA Act is there any suggestion that the TOFA/Consolidation interaction provisions were intended to apply when calculating a taxpayers TBA amount (i.e. in relation to pre-TOFA corporate acquisitions). As this would have been a fundamental issue relevant to the calculation of a taxpayer’s TBA amount, we cannot believe that if this was intended then this would not have been reflected in the Explanatory Memorandum (which is almost 500 pages long); and

  c) if the TOFA/Consolidation interaction provisions were intended to apply when calculating a taxpayers TBA (in relation to a pre-TOFA acquisition) then other changes would also need to be made to the TOFA provisions in order to make the provisions work. By way of example if the provisions did apply and the tax cost of a TOFA asset was reset under s.701-55(5A) then how would s.701-61 apply in the context of a pre-TOFA acquisition? Further, if the tax cost of either an asset or a liability was reset under the TOFA/Consolidation interaction provisions for the purposes of calculating a taxpayer’s TBA amount then this would also need to flow through into the calculation of a taxpayer’s balancing adjustment calculation (under Subdivision 230-G) when the asset or liability was ultimately terminated/closed out. Again, the fact that none of these issues were addressed within the TOFA provisions clearly indicates that the TOFA/Consolidation interaction provisions were never intended to apply when calculating a taxpayers TBA amount.

- If the TOFA/consolidation interaction provisions did retrospectively apply to the calculation of a taxpayers TBA amount then the effect of Attachment B would be to apply two retrospective changes in law to taxpayers that had (i) un-grandfathered their financial arrangements and (ii) held liabilities that they assumed as part of a pre-TOFA corporate acquisition. In other words, the amendments to the calculation of a TBA amount would involve one retrospective change in law and the amendments to assumed liabilities (also reflected in Attachment B) would involve a second retrospective change in law that would apply by virtue of the TBA provisions.

- Finally, even if fundamental changes were made to apply the TOFA/Consolidation provisions retrospectively through the calculation of a taxpayer's TBA amount there remains a fundamental flaw in relation to liabilities. This arises from the fact that if the deduction is denied (by virtue of resetting the tax cost of the liability at the accounting value of the liability assumed at the joining time) in relation to financial arrangements acquired as a result of pre-TOFA acquisitions then the historic ACA calculation that was undertaken in relation to that acquisition will be incorrect – as the Step 2 amount should have been 100% of the liability rather than 70% as would have been the case (as at the time of the acquisition it would have been assumed that the liability would have been deductible). As the ACA calculation may not be able to be revisited the consequence of the changes are not only to deny the purchaser group deductions in relation to the loss incurred but also to leave the purchaser without the appropriate amount of ACA. This is illustrated in Scenario 3 as Company C will not only be denied a deduction in relation to $100 loss incurred on close out of the Derivative but will also have only received a Step 2 ACA of $70 (in 2007) rather than the $100 which it would have received if the liability assumed was not deductible.

The above example shows the results in the case of a loss on a liability. We acknowledge that the reverse outcomes may arise in the case of a gain on a liability. For example, a favourable fluctuation in exchange rates on a borrowing denominated in a foreign currency.