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Submission on the Tax Consolidation amendments contained in the Exposure Draft to Tax Laws Amendment (2012 Measures No. 2) Bill 2012: Consolidation

Ernst & Young welcomes the opportunity to provide comments to Treasury in response to the Exposure Draft to Tax Laws Amendment (2012 Measures No. 2) Bill 2012: Consolidation (the "ED") released on 18 April 2012.

This submission is brief, as we have already provided input to Treasury, contributed to earlier policy discussions with Treasury and the Government, participated in consultations by the professional bodies in response to the ED, including the professional bodies meeting with Treasury on 29 April 2012, and contributed our detailed comments to the joint professional bodies submissions relating to the RFI and TOFA 3&4 interactions.

Ernst & Young recognises that the ED seeks to give effect to the amendments as proposed and described in Attachments A and B of the then Assistant Treasurer, Mr Bill Shorten's Media Release No. 159 of 25 November 2011 (the "Media Release").

The purpose of this submission is to highlight and support a number of high level policy matters that should be considered by the Government in order to reduce some of the inequities associated with the proposed amendments, but mindful of the revenue savings sought by the Government.

In summary the policy matters considered in this submission are as follows:

Issues relevant to the Exposure Draft

1. For all three periods, rights to future income (RFI) contract tax costs should reflect commercial value. At a minimum, this must occur for capital gains tax purposes. If this measure cannot be implemented in the current Bill it should be considered for later policy refinement.

2. For the pre-period – work-in-progress (WIP), goods and services need further clarification of drafting.

3. Relating to the Taxation of Financial Arrangements (TOFA) interaction measures in Schedule 2 of the ED, we submit that the retrospective commencement of the measures for consolidated groups, with changed consequences for groups which exercised transitional elections, is inequitable policy. It contrasts sharply with the carefully considered transitional arrangements relating to the Schedule 1 RFI measures. We submit that either a deferred start date or the ability for head companies to revoke their transitional elections is required.

Policy issues on which we have previously submitted which should ideally be covered

4. Transitional relief (Interim rules treatment) should be extended to amendment requests, objections and ruling requests lodged before 30 March 2011, which were issued by the Australian Tax Office after that date or are still outstanding.

5. Compensation for compliance costs on adverse retrospective amendments incurred up to 30 March 2011.

Our more detailed comments are below.

RFI contract tax cost should reflect commercial value

We are concerned that under the Government's current policy formulation a "non-deductible right to future income" will be required to be included in goodwill (under the pre rules and interim rules), and RFI other than a WIP amount asset will be treated as a retained cost base asset with a typically negligible tax cost setting amount (under the prospective rules).

Our specific concern with the proposed approach is that notwithstanding that the contracts that include the RFI would otherwise be recognised as separate CGT assets, the effect of those rules is to artificially include the value of the RFI in goodwill (under the pre/interim rules) or reallocate the value of the RFI to other reset cost base assets (under the prospective rules).

This can produce inequitable outcomes if such contracts:

- are separately sold by the consolidated group - the head entity will be fully taxable on the proceeds
- become held by a leaving entity that does not hold the corresponding goodwill (pre/interim rules) or the reallocated value assets (prospective rules) - this would increase the head company's gain on the sale of the leaving entity
- are terminated - the head company will have no capital loss on termination.

Those outcomes are inconsistent with outcomes that would arise under an asset/business acquisition (compared to an entity acquisition with tax cost setting under the consolidation rules).

We recommend that:

a) contracts that include an RFI should be capable of having a tax cost setting amount that properly reflects the commercial value of that particular asset
b) at a minimum, the law should be adjusted to allow consolidated groups to at least be able to recognise the tax cost setting amount of such assets for capital gains tax purposes.

Pre-period – WIP, goods and services

We have previously identified a gap which affects taxpayers such as utilities (e.g., water companies, gas companies, electricity companies) which have made acquisitions in the relevant period. It will also affect companies which have benefits and obligations under part-completed construction contracts.

In Attachment A to the Media Release, the Government confirmed continued deductibility of rights to receive income where the work has been done, or the goods or services have been provided, by the joining entity before the joining time. This included (para 24, second bullet point) situations where:

"▸ the amount can be identified as being in respect of goods or services that have been provided before the joining time by the joining entity to the other entity, where a recoverable debt has not yet arisen in respect of the provision of the goods or services."

The ED does not implement this proposal currently. It is important for a broad range of companies including utility companies which have supplied their products but do not have (under government regulations) recoverable debts until they issue their bills on their monthly or periodic cycles.

Additionally, we are concerned that the drafting for the pre-period does not adequately deal with part-completed construction contracts, where the joining entity has income entitlements and deduction obligations. Specifically, the definition of WIP amount asset does not adequately cover the mix of partly completed and completed contracts for work and goods and services. Some further refinement and ideally an example in the EM are desirable.

TOFA and consolidation measures

The ED also implements the comments in the Media Release relating to the interaction of tax consolidation with the TOFA rules contained in Division 230. TOFA applied to eligible taxpayers from income years starting on or after 1 July 2010, or (at the taxpayer's option) for income years starting on or after 1 July 2009.

The Government decided, as announced in the Media Release, to amend the law effective from the commencement of Division 230. Also, the ED proposes retrospective commencement of changes relating to the treatment of liabilities for taxpayers which made transitional elections on the basis that this was signalled in earlier materials relating to the fair value, foreign exchange retranslation and financial accounts methods (see para 2.29 of the draft explanatory materials). However, the ED goes further to propose retrospective commencement in relation to interaction with the default realisation and accruals methods, which was not signalled in earlier materials.

However, in our view, the amendments raise equity issues when considering the irrevocable elections which some taxpayers exercised to bring their previous "pre-TOFA" financial arrangements into Division 230. The affected groups:

a) made decisions on whether to take transitional elections based on the extant law
b) now find that the tax consequences are different
c) have no capacity to revoke their irrevocable elections. Some groups might never have exercised their elections if the new rules had applied.

Our key submissions are that the Government should consider either:

a) a deferred start date for these measures; or
b) at a minimum, the ability for affected consolidated head companies to amend their transitional elections.

Transitional relief (interim rules treatment) should be extended

This is an issue on which we submitted in the earlier policy development phase. We are aware of a number of cases where consolidated groups sought amendments, objections or private binding rulings in relation to the RFI and residual asset tax consolidation rules, after the enactment of *Tax Laws Amendment (2010 Measures No 1) Act 2010* but before 30 March 2011. If those amendments, objections or rulings were not issued or allowed by the Australian Tax Office by 30 March 2011, then those claims will not be eligible for the application of the interim rules, based on the current drafting of the application rules in the ED (this was also the position in the Media Release).

We request that the Government reconsider its policy position on this matter. In our view, the interim rules provide the Government with the necessary integrity protections to eliminate claims that may be considered inappropriate from a policy perspective, or present an excessive cost to the revenue.

We submit that groups, that had lodged claims before 30 March 2011, should have the ability to have their claims considered, albeit under the more limited interim rules.

Compensation for compliance costs incurred up to 30 March 2011

Many consolidated groups have incurred significant legal, tax, valuation and accounting costs in respect of the implementation of the RFI and residual asset tax consolidation rules contained in *Tax Laws Amendment (2010 Measures No 1) Act 2010*.

We recommend that, in the absence of extending transitional relief for groups that had acted on the changes before 30 March 2011 (as outlined above), in relation to the adverse affect of retrospective changes, consolidated groups should be compensated for compliance costs that were incurred in implementing the previously enacted law, at least up to 30 March 2011 (being the date of the Government announcement of The Board of Taxation review of the RFI and residual asset rules).

Such compensation would be fair and reasonable given that many of the retrospective proposed changes are simply based on revenue savings rather than policy considerations (the treatment of RFI outlined in item 1 above is a clear example of this). Groups with assets that were clearly contemplated when the law was enacted, are particularly aggrieved.

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We would welcome the opportunity to discuss this submission further with Treasury. To discuss any aspect of this submission, please contact Jonathan Rintoul (02 9276 9256), Andrew Woollard (03 8650 7511), Tony Stolarek (03 8650 7654) or Richard Czerwik (03 9288 8408) in the first instance.

Yours faithfully

Tony Stolarek
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