The Institute of Chartered Accountants in Australia

17 October 2008

The Manager
Finance and Strategy Unit
Business Tax Division
The Treasury
Langton Crescent
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By email: tofa@treasury.gov.au

Dear Sir

TOFA 3&4 - Exposure Draft Legislation and Explanatory Material

The Institute of Chartered Accountants in Australia welcomes the opportunity to provide comments to Treasury on the Exposure Draft of *Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008* (ED Bill) and accompanying Explanatory Material (EM).

Our submission, which incorporates comments on a number of consolidation interaction issues which we have already raised and which we undertook to elaborate upon in our meeting of 2 October 2008, is set out under the following headings (not necessarily in order of importance):

1	**Issues other than tax consolidation interaction**	
	1.1	Accruals method is excessively complex and needs financial statement shortcuts
	1.2	Scope of measures
	1.3	Transitional provisions
	1.4	Application provisions
	1.5	Outstanding issues from prior submissions
	1.6	Miscellaneous issues
2	**Consolidation interaction issues**	
	2.1	TOFA liabilities and the tax consolidation provisions
	2.2	Which financial accounts for elective methods
	2.3	Hedging election

We are mindful that the Bill is expected to be introduced into Parliament before the end of the Parliamentary Spring sittings on 4 December 2008. In these circumstances, certain complex issues may not be adequately addressed in the Bill, e.g. the interaction of the hedging election and tax consolidation (refer 2.3 below). However, we understand that Treasury is amenable to these issues being addressed prior to the optional start date of 1 July 2009 and we would welcome an opportunity to progress these outstanding issues with Treasury. We expect that there will be other issues, as yet unidentified, which will also need to be dealt with in subsequent amending bills.

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We also understand that, where existing consolidation issues are exacerbated by the proposed TOFA regime, Treasury will consider replacing any “fix” provided in the proposed legislation for TOFA assets or liabilities with a more general rule for consolidated or MEC groups generally. Again, we would also welcome an opportunity to work with Treasury on any proposed amendments

1. Issues other than tax consolidation interaction

1.1 Accruals method is excessively complex and needs financial statements shortcuts

Accruals method - Introducing a commercially realistic optional method instead of the complex accruals method

The formulation of the accruals method requires a unique methodology to be adopted for tax purposes which may differ from the methodology used in the financial statements of a taxpayer. This is the case even if the financial statements have been accepted for audit purposes and even if the entity is publicly listed.

We strongly submit that this prescriptive approach and its outcomes are uncommercial, particularly in situations where taxpayers have prepared financial statements, and even more so where the financial statements are audited. In our view, this is an unacceptable outcome under the draft legislation.

Discussion

We welcome the fact that, after many years of input from banks and the commercial sector, Treasury has introduced various optional methods which are based on audited financial statements. These methods have the potential to substantially enhance the compliance task of businesses in dealing with the TOFA 3&4 rules.

However, there is no compliance simplification in relation to the compounding accruals method, which is the core, mandatory mechanism to spread gains and losses over multiple years, where a financial arrangement has an outcome which is sufficiently certain.

In such circumstances a taxpayer is required to spread the gain or loss using either:

- the compounding accruals method (paragraph (a) of subsection 230-135(2); or
- a method whose results approximate those obtained using the compounding accruals method, having regard to the length of the period over which the gain or loss is to be spread (paragraph (b) of subsection 230-135(2)).

The gain or loss is spread over uniform intervals not exceeding 12 months as specified in subsection 230-135(3) with various complex rules provided at subsections 230-135(3A) - (5). These include the highly uncommercial rule in subsection 230-135(4) that "the gain or loss is to be spread assuming that you will continue to have the financial arrangement for the rest of its life."

The EM notes (at paragraphs 4.143 to 4.148) that the gain or loss worked out under the compounding accruals method will generally be the same as the amounts calculated under the "effective interest rate" method in AASB 139. However this accounting standard will not necessarily apply to all of a taxpayer's financial arrangements that are subject to the compounding accruals method. As a result, the apparent compliance savings may be quite limited.

The amount of the gain or loss itself may also need to be re-estimated from time to time, pursuant to section 230-160 and subsection 230-120(4) where the financial arrangement features, say, a variable interest rate and that rate changes. A very common commercial example is a borrowing with a floating interest rate. The combined interaction of these

sections seems to require that the "sufficiently certain gain or loss" be re-estimated every time the variable rate changes materially, even if this changes on a weekly or even daily basis. This would appear to introduce an enormous compliance obligation for taxpayers.

It is also unclear on what basis a taxpayer's income tax return is to be lodged, and on what basis running balance adjustments under section 230-145 are to be calculated, if the sufficiently certain gain or loss is constantly changing. Is the sufficiently certain gain or loss calculated at the year-end date (30 June for many taxpayers), at the return lodgment date (the succeeding 15 January) or some other date? Similar issues arise in relation to quarterly PAYG instalment tax payments.

So the formulation in the ED Bill requires a unique methodology to be adopted for tax purposes, which may differ from the methodology used in the financial statements of a taxpayer, even if the financial statements have been accepted for audit purposes and even for listed public entities.

We strongly submit that this prescriptive approach and its outcomes are uncommercial, particularly in situations where taxpayers have prepared financial statements. This is all the more so where the financial statements are audited. This is an unacceptable outcome under the draft legislation.

Proposed paragraph (b) of section 230-135(2) authorises an alternative method but only one "whose results approximate those obtained using the [compounding accruals] method". This subjects the alternative method to some searching scrutiny, and requires significant compliance efforts to test whether the method used by the company or business in its financial statements aligns with the compounding accruals methodology.

This formulation will lead to significant compliance costs and uncertainty, and will doubtless lead to disputes between taxpayers and the ATO as to the extent to which the business uses a method "whose results approximate" those obtained using the compounding accruals method. This outcome is all the more likely because there is no materiality requirement expressed in this rule.

Recommendations

(a) The accruals method urgently needs a compliance short cut

We can understand the concern on the part of Treasury that taxpayers might be tempted to adopt accruals methods which are uncommercial and which defer gains or bring forward losses.

However, there is clearly sufficient integrity around amounts which are reported by taxpayers in their financial statements. This is particularly so when those financial statements are audited, and all the more so where the relevant entities are listed or public entities with widely held investors.

We therefore recommend that subsection 230-135(2) be augmented by a new paragraph (c) which provides that a taxpayer can adopt the accruals calculations used in its financial statements, where those financial statements are produced in accordance with accounting standards and are audited. The preparation of financial statements in accordance with accounting standards, where the financial statements are audited, provides more than enough integrity for the present purpose.

(b) The re-estimation rules require clarification

The re-estimation rules in section 230-145 (and other sections) require clarification for tax return lodgment and PAYG instalment calculation purposes, to specify the "cut-off" date for changes in variable rates that trigger a re-estimation of the "sufficiently certain gain or loss". We submit that the tax return be able to be lodged based on the variable rate that applies on

the final day of the income year (regardless of subsequent movements). As well, when quarterly PAYG Instalments are to be calculated, a quarterly cut-off date might be appropriate.

1.2 Scope of measures

Since we first saw proposals for Division 230 to apply to financial arrangements, the following developments have occurred which may require additional consideration as recently emerging issues:

- ***Interaction with proposed Carbon Emissions Trading Scheme (ETS)*** - although we believe that the existing Division 230 framework should adequately cover derivative-type arrangements which are likely to emerge under an ETS[1] as proposed in the Carbon Pollution Reduction Scheme (CPRS) (Green Paper), to the extent that new derivatives/instruments arise from the ETS which for various reasons may not qualify as financial arrangements under Division 230, we consider that they should be specifically scoped into Division 230.

  In addition, we point out that in some circumstances, emissions permits under the CPRS may constitute financial arrangements that fall within the ambit of Division 230.

  If the Government proceeds with a discrete set of rules for the tax treatment of emissions permits (such as those proposed in chapter 11 of the Green Paper), we recommend that the default position be that such permits be excluded from Division 230 (however, further consultation is required to ascertain whether some taxpayers might be allowed to elect to have all or some gains on losses on permits recognised under Division 230).

  As it is proposed that Australia's ETS will not apply until 2010, we acknowledge that there is additional time to fully address the associated Division 230 interactions once the proposed ETS legislative measures and systems become certain.

- ***Appropriateness of current exclusion for certain "earnout" arrangements (subsection 230-410(13)*** - the ATO's Draft Taxation Ruling, TR 2007/D10, proposes a change in the tax treatment applicable to earnout arrangements to that which has been accepted for many years (Taxation Ruling TR 93/15 was withdrawn with effect from 17 October 2007). The proposed treatment set out by the current draft ruling may mean that further consideration of the basis upon which earnouts were first excluded from the application of Division 230 may need to be revisited.

- We suggest that Treasury consult further with the ATO in relation to the outcomes which can emerge in relation to additional or unpaid amounts in respect of earnout arrangements and whether Division 230 may be appropriate, particularly if the draft ruling is finalised in its current form.

1.3 Transitional provisions

Limitation of use of deferred tax balances

Item 121 of Schedule 1 of the ED Bill, which is concerned with the transitioning of pre-existing financial arrangements into Division 230, proposes (items 121(11) and (12)) a "short-cut" approach to applying the method statement in item 121(10) in the case of financial arrangements that result in deferred tax assets (DTAs) and/or liabilities (DTLs). However, the shortcut only applies where the taxpayer has chosen that the Subdivision 230-F method of relying on financial reports applies.

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[1] Refer the Institute's submission dated 10 September 2008 to the Department of Climate Change on the proposed structure of the Carbon Pollution Reduction Scheme (CPRS).

In the context that the shortcut is designed to reduce the compliance costs of otherwise having to perform individual calculations for all existing financial arrangements (as stated in paragraph 13.38 of the EM of the ED), we submit that consideration should also be given to having a similar approach in respect of financial arrangements to which the other elective methods apply, ie Subdivision 230-C (fair value method) or Subdivision 230-D (general foreign exchange retranslation method).

Use of deferred tax balances

We acknowledge that amendments have appropriately been made to ensure that the adjustments for gross-up deferred tax balances that are made to the step 5 and step 6 amounts of the method statement in item 121(10) are applied correctly.

However, the references in item 121(11) and 121(12) to "attributable assessable amount" and "attributable deductible amount" do not give an appropriate account of the nature of deferred tax balances. Item 121(11) refers to an amount recorded in respect of a DTA account attributable to an existing financial arrangement as the "attributable assessable amount" and item 121(12) refers to an amount recorded in respect of a DTL account attributable to an existing financial arrangement as the "attributable deductible amount".

Although these are "references" only, for the sake of removing any confusion, we submit that the amount to be attributed to the DTA be referred to as the "attributable deductible amount" (which is the nature of a DTA which represents a future deductible amount) and the amount to be attributed to the DTL be referred to as the "attributable assessable amount" (which is the nature of a DTL which represents a future assessable amount).

Transitioning in pre-existing qualifying forex accounts under election

The discussion in the EM (paragraphs 7.63 - 7.66) in respect of a pre-existing qualifying forex account does not appropriately address the appropriate outcome when seeking to apply the rules where the commencement year is also the same year in which the qualifying forex account election
is made.

We would appreciate confirmation of the intention that any previously unrecognised ("unrealised") foreign exchange gain/loss on the account up until the commencement year would be dealt with *only* via the transitional balancing adjustment (in item 121) or is it the intention that the specific balancing adjustment under section 230-235 apply in priority (ie the transitional balancing adjustment would have regard to the amount recognised by section 230-235).

1.4 Application provisions

Qualifying forex accounts - practical impact of time of amendment

Item 22 of Schedule 1 of the ED Bill, which modifies the definition of a "qualifying forex account", is to have effect from 1 July 2003. Although we have no objection to this application time as it coincides with the time at which the definition became relevant to Division 775, we seek confirmation that there will be an ability for the retranslation election available under Subdivision 775-E to be made on a retrospective basis to coincide with the retrospective start date to the modified definition. In addition, retrospectivity in the context of the ability to make the limited balance exemption (Subdivision 775-D) needs to be addressed.

Consideration should also be given to the ability for taxpayers to amend prior year income tax assessments to reflect elections which can be made retrospectively to 1 July 2003, noting that the standard four-year time period to amend may soon be expiring for June balancing taxpayers.

We appreciate that the previous Government's proposals (announced by the then Minister for Revenue on 5 August 2004) to modify the Division 775 rules in relation to the elections relating to qualifying forex accounts (along with other issues in relation to the current Division 775 rules) are yet to be enacted. However, for the sake of completeness, it may be appropriate to incorporate any associated amendments that directly relate to the widening of the definition of a qualifying forex account into the same amending Bill.

The above comments have, as stated, been based on the fact that item 22 of Schedule 1 of the ED is stated in section 2 of the ED to commence on 1 July 2003 (which we support). However, we note that this item will (due to the operation of item 120 of Schedule 1 of the ED, and the inclusion of item 22 within the definition of '*financial arrangement amendments'* set out in item 119 of Schedule 1 of the ED) only "apply" to taxpayers from 1 July 2010 (or 1 July 2009 by election). In order to reflect the policy intent that the amendment to the definition of qualifying forex account take effect from 1 July 2003, in our view item 22 should be specifically excluded from the definition of financial arrangement amendments in item 119, or a separate application date for the item 22 amendment should be provided for in item 120.

Similarly, the items stated to have a commencement date of 17 December 2003 per section 2 of the ED should be similarly addressed in items 119 and/or 120 of Schedule 1 of the ED.

Retranslation - non-financial arrangements

As explained in paragraph 7.41 of the EM, the retranslation method may also (via the new Subdivision 775-F) extend to appropriate arrangements that are not Division 230 financial arrangements (per item 6 of the ED).

We understand that the intended policy is that the Div 230 amendments should only apply to arrangements commencing on or after the taxpayer's applicable start date, or to existing arrangements by election (and subject to a 4 year balancing charge).

However, the default 'grandfathering' of existing arrangements, in item 121(1) of the ED Bill, only has application to "financial arrangements". Accordingly, it would seem that where a retranslation election is made, any non-Division 230 financial arrangement retranslated for accounting purposes that has been held from before the commencement of Division 230, will be retranslated under Subdivision 775-F without any balancing charge.

This does not seem to be an appropriate outcome and we would recommend that item 121 (including its provisions in respect of both *future* arrangements and *existing* arrangements) be amended to reflect any arrangement subject to the "financial arrangement amendments" as currently defined, and not only financial arrangements.

1.5 Outstanding issues from prior submissions

The Institute has raised a number of issues in prior submissions (refer in particular to our letter dated 27 August 2008). In the time available we have been unable to ensure that all those issues have been adequately addressed in the ED Bill and EM. To the extent that in our view there are significant prior submission items that require further consideration we will advise Treasury by way of addendum to this submission.

1.6 Miscellaneous issues

In the course of our review we identified that a number of amendments appear to be required to the ED Bill or EM. The list does not purport to be comprehensive:

- Paragraph 1.22 of the EM incorrectly suggests that the exception for qualifying securities that have a remaining term of more than 12 months only is applicable to the carve-out for non-financial entities with a turnover of less than $100 million. We suggest that this paragraph be redrafted to ensure that there is no confusion or conflict with the terms of section 230-405.

- The reference in paragraph (d) of subsection 230-442(2) should be to subsection 245-65(2) of Schedule 2C of the Income Tax Assessment Act 1936. Similarly, the reference to subsection 245-65(2) in paragraph 10.85 of the EM should be to that subsection of Schedule 2C of the 1936 Act.
- We recommend that, in respect of debt forgiveness transactions, Treasury ensure that Division 230 interacts appropriately with the existing provisions of the law from the perspective of both the borrower and lender.

2. Consolidation interaction issues

2.1 TOFA liabilities and the tax consolidation provisions

On our review of the tax consolidation interactions, it is apparent that section 701-55(5A) helps to correct the TOFA interaction on an entry case for financial arrangements that are assets. That is, it helps to eliminate the entry history rule (resulting in an acquisition model), and provides taxpayers with an opportunity to use an appropriate starting value on entry where elections require a different value.

We note, however, that this only deals with half of the financial arrangements, and that an appropriate result does not appear to be achieved in relation to liabilities. We have prepared a number of examples which highlight that the application of an entry history rule to financial arrangements consisting of a liability that a head company assumes through its acquisition of a joining entity is problematic.

We believe that this treatment is inappropriate as this would result in the following outcomes for Division 230 liabilities:

- the liability not having an appropriate 'starting value' for the purpose of applying the relevant elective methods under Division 230, as the liability will have its historical value;
- any unrealised gain or loss in relation to the liability being potentially counted twice – once on exit via the exit calculation (as capital gain/loss) and, subsequently, on the realisation of the liability (given that its historical value would be used for the purposes of Division 230);
- a different model being applied to Division 230 liabilities, as compared to the 'direct acquisition' model used for Division 230 assets;
- a different result occurring depending on whether the head company purchases shares in the new subsidiary, or instead purchases the assets (and assumes liabilities) of the subsidiary.

We have provided two examples at Appendices A and B which demonstrate the above issues associated with applying the entry history rule to Division 230 liabilities. We have also provided some possible suggested solutions to the entry and exit case which could provide for an appropriate outcome. This alternative framework is detailed below.

Division 230 liabilities – alternative framework

We propose that an alternative framework be adopted by Treasury, instead of applying the entry history rule to Division 230 liabilities. We have attempted to reconcile the overall economic result under our alternative framework to the gain or loss that would otherwise be made on the financial arrangement if it were instead disposed of for market value. Appendices C and D provide the calculations on the alternative framework. Our calculations in this model appear to ensure an appropriate economic result. Our proposal is based on the following modifications:

- section 711-45(5) continues to operate for Division 230 liabilities (such as forex liabilities) on exit, despite the Government's announcement to repeal the provision

- section 711-45(5) be modified to include not only payments but also 'receipts' to ensure that financial arrangement liabilities that become assets (i.e. when in the money) and up-front costs paid to acquire financial arrangements (e.g. $20,000 paid in Example 2 – refer to Appendix B) are covered by the provision. We would request that a negative liability value be acceptable (i.e. negative $20,000) to help overcome this issue

- moving from an entry history model to a 'liability assumed' model by, say, ascribing a value to liabilities for Division 230 purposes. This would help to ensure that no gain or loss occurs when a Division 230 liability is subsequently disposed of straight after the acquisition date (say for $92,000 in Example 1, or for the fair value of the derivative in Example 2)

- an amendment that ensures that the liabilities on entry are the appropriate accounting starting values. This could be achieved by using a similar provision to section 701-55(5A), or by amending Step 2 so that it picks up the 'fair values' for the liabilities. Either approach would appear to achieve an appropriate start value.

Four year write off – DTAs and DTLs

We highlight that the four year write off rule proposed by section 701-55(5A) may potentially give rise to DTAs or DTLs on the acquisition of a head company with unamortised amounts. This may have flow on effects for the definition of excluded asset (for DTAs) and for Step 2 liabilities (for DTLs). We believe that Treasury may need to consider whether the current legislation appropriately caters for these additional amounts created by the four year write off.

2.2 Which financial accounts for elective methods

In general terms, we welcome the introduction of the legislative provisions to cater for the use of audited financial reports prepared by a connected entity for each of the elective tax-timing methods which rely on the existence of audited financial reports.

To assist readers of the EM appreciate the relevance of when the connected entity's accounts may be used, we would firstly recommend that the comments included at paragraphs 9.32 - 9.35 (in Chapter 9 regarding the reliance on financial reports method) be moved to Chapter 5 of the EM (immediately after existing paragraph 5.14).

We recommend that there be some additional clarification as to the notion of a "report [that] properly reflects your affairs" (as used in each of s230-180(2A), s230-220(2A), s230-275(2A) and s230-350(2A)).

Specifically, there may be some uncertainty for taxpayers as to which set of audited financial reports are the most appropriate to be used. It may be more appropriate to recognise some sort of hierarchy as to the most appropriate financial reports that would meet the relevant conditions if more than one can apply. For example, in the case of a MEC group, audited financial reports may be available in respect of the "top company" of the MEC group, but also at various holding entity levels interposed between the top company and the eligible tier-1 companies of the MEC group. Accordingly, we recommend that there be some additional comment or reference to consistency in the use of applicable financial statements and continued eligibility for use of a method.

Audited financial reports of a connected entity may not include intra-group financial arrangements which involve the relevant Division 230 taxpayer, in accordance with AASB 127 (or foreign equivalent). For example, a financial arrangement may be between a foreign subsidiary and a member of an Australian tax consolidated group, but which is not recognised in the consolidated financial reports which reflect all Australian and foreign entities. We recommend that confirmation be included in the proposed legislation or by clarification in the EM that the failure to recognise the applicable intra-group financial arrangement in the

connected entity's financial reports does not breach the requirement that the "report properly reflects your affairs".

In light of the inclusion of the recognition of the financial reports of a connected entity to be used in certain cases for purposes of assessing eligibility for the elective tax-timing methods, it is submitted that there is no need to retain proposed section 719-850 in relation to MEC groups on the basis that the "top company" of the MEC group would be a connected entity whose consolidated financial reports deal with the affairs of the provisional head company of the MEC group and any of its members.

2.3 Hedging method

The TOFA provisions still need to be tested to ensure that they work appropriately for hedging. In this regard, we have previously provided to Treasury some preliminary observations on what might be the current outcomes under the consolidation rules and where these might require modification under the TOFA rules.

Our views on this complex area are currently being developed and we hope to provide Treasury with additional comments next week as an addendum to this submission.

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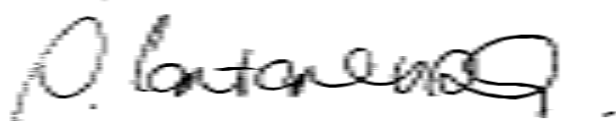
Should you wish to discuss any aspect of our submission please do not hesitate to contact me on 02 9290 5625 or Linda Wang on 02 9290 5750.

Yours faithfully



Susan Cantamessa
Tax consultant

APPENDIX A

TOFA LIABILITY EXAMPLE 1
FOREX ARRANGEMENT

Facts of the example

Assume Aco is a subsidiary member of a consolidated group with one asset, being a building with a tax and accounting cost of $100,000. The market value of the building is $200,000 at the time of leaving. The building was funded by a loan in USD. The USD loan has a USD face value of USD 90,000, which converts to AUD 100,000 at the inception time. The loan has a fixed interest rate of 10%.

On 30 June 2009, Head Co acquires Aco for $250,000. At the leaving time, there has been a forex movement so that the face value of the loan now converts to $95,000 AUD under AASB 121 at 30 June 2009.

However, market interest rates have also changed, so that market rates are now 10.326%. The fair value of the instrument is USD 87,158 at the leaving time. This converts to a market value of the debt at the leaving time of AUD 92,000. It is noted that the debt is still valued (for accounting purposes) at AUD 95,000 at the leaving time. The balance sheet on exit is as follows:

	Accounting	Tax	Market
Building	100,000	100,0000	200,000
Forex loan	($95,000)	($100,000)	($92,000)
Goodwill	-	-	143,500
DTA	-	-	-
DTL	(1,500)	-	(1,500)
Net assets	**3,500**	**-**	**$250,000**

Assume that on the following day (after joining), the forex loan is disposed of for cash equal to the market value (i.e. $92,000 AUD).

Issues examined by the example

- The continued maintenance of section 711-45(5) to deal with the unrealised forex component of the liability on the exit calculation.
- Comparing the net gain or loss calculated under an “entry history rule” as compared to a “liability assumption rule” on entry to the new tax consolidated group.
- Comparing the use of the use of the “acquiring entity” accounts versus the “joining entity” accounts under a “liability assumption rule” on entry. Alternatively, recording liabilities at their “fair value” or “market value” on entry (as an alternative to section 705-70(1A)).

APPENDIX B

TOFA LIABILITY EXAMPLE 2
DERIVATIVE ARRANGEMENT

Facts of the example

Risky Co was incorporated on 1 July 2011 with $10,020,000. It bought land for $10 million. Risky Co has not chosen one of the elective methods in Division 230 therefore the compounding accrual method will apply to any gains and losses made on the financial arrangement. On 1 July 2011 Risky Co enters into an interest rate swap with a third party. Assume that $20,000 was paid to acquire the swap, and no deduction has yet to be claimed for the payment.

Under the swap, the notional principal is $100 million. The term of the swap is three years. Both the fixed rate and floating rate payments are due on 30 June 2012, 30 June 2013 and 30 June 2014. Under the swap, Risky Co makes floating rate payments and receives fixed rate payments. Risky Co is acquired by Head Co on 30 June 2012, who also has not made any of the elections under Division 230. The estimated and actual cash flows for Risky Co under the swap arrangement are:

Date	Pays floating	Receives fixed	Net cash flow
30 June 2012	$5,250,000	$5,750,000	$500,000
30 June 2013	$5,760,000	$5,750,000	-$10,000
30 June 2014	$6,290,000	$5,750,000	-$540,000
Overall loss			**-$50,000**

On 30 June 2012, Risky Co is acquired by Head Co for $15 million. At that time, the market value of the land is $12 million and the fair value of the swap is equal to a liability of $497,348 (assuming PV rate on 30 June 2012 is 5.21%), calculated as follows:

Payment date	Estimated/actual payment amount	Discount factor	Present value of remaining cash flows
30 June 2013	-$10,000	$1 / (1 + 5.21\%)$	-$9,505
30 June 2014	-$540,000	$1 / (1 + 5.21\%)^2$	-$487,843
Present value of cash flows			**-$497,348**

Issues examined by the example

- The treatment of the $20,000 acquisition cost of the derivative and whether this becomes a “blackhole” expenditure amount on exit under the current law.

- Comparing the treatment of the derivative to the new Head Company under an “entry history rule” as compared to a “liability assumption rule” on entry to the new tax consolidated group.

- Examining the future payments of $10,000 and $540,000 and determining the tax treatment of those payments under TOFA to the new head company. That is, whether a deduction is achieved for the total payments of $550,000, or whether the difference between $550,000 and $497,348 is deductible (and the timing of such deductions).

APPENDIX C
Example 1

CONSOLIDATION ENTRY MODEL
LIABILITY ADJUSTMENT MODEL
ENTITY ENTERS GROUP WITH NO ELECTION

Balance sheet before joining

Use consolidated accounts (Y) or single entity accounts (N) Y

	Acc	Tax	DTA	DTL	MV
Assets and liabilities					
Interest bearing account	0.00	0.00	0.00	0.00	0.00
Foreign currency loan	0.00	0.00	0.00	0.00	0.00
Plant and equipment	0.00	0.00	0.00	0.00	0.00
Derivative (interest rate swap)	0.00	0.00	0.00	0.00	0.00
Loan payable at interest	0.00	0.00	0.00	0.00	0.00
Foreign currency loan	(92,000.00)	(100,000.00)	0.00	(8,000.00)	(92,000.00)
Hedging derivative (interest account)	0.00	0.00	0.00	0.00	0.00
Hedging derivative (plant and equip)	0.00	0.00	0.00	0.00	0.00
Deferred gain or loss on hedge (P&E)	0.00	0.00	0.00	0.00	0.00
Other asset	343,500.00	100,000.00			343,500.00
Income tax accounts					
Income tax liability	0.00	0.00			0.00
DTA	0.00	0.00			0.00
DTL	(1,500.00)				(1,500.00)
Equity					
Share capital	0.00	0.00			
Net profit	(3,500.00)	0.00			
Movement in assets	(246,500.00)				
Total	0.00	0.00	0.00	(8,000.00)	250,000.00

ACA determination

Step 1	
- Cost of membership interests	250,000.00
Step 2	
- Accounting liabilities	93,500.00
- Future deduction	0.00
Step 3	0.00
Step 4	0.00
Step 5	0.00
Step 6	0.00
Step 7	0.00
Total ACA	343,500.00

APPENDIX C
Example 1

CONSOLIDATION ENTRY MODEL
LIABILITY ADJUSTMENT MODEL
ENTITY ENTERS GROUP WITH NO ELECTION

ACA allocation

Retained cost base assets	Retained		Election		Value
Interest bearing account	Yes	0.00	No	0.00	0.00
Foreign currency loan	No	0.00	No	0.00	0.00
Plant and equipment	No	0.00	No	0.00	0.00
Derivative (interest rate swap)	No	0.00	No	0.00	0.00
Loan payable at interest	No	0.00	No	0.00	0.00
Foreign currency loan	No	0.00	No	0.00	0.00
Hedging derivative (interest account)	No	0.00	No	0.00	0.00
Hedging derivative (plant and equip)	No	0.00	No	0.00	0.00
Deferred gain or loss on hedge (P&E)	No	0.00	No	0.00	0.00
Total					0.00
Remaining ACA					343,500.00

Reset cost base assets	MV	%	ACA
Interest bearing account	0.00	0.00%	0.00
Foreign currency loan	0.00	0.00%	0.00
Plant and equipment	0.00	0.00%	0.00
Derivative (interest rate swap)	0.00	0.00%	0.00
Loan payable at interest	0.00	0.00%	0.00
Foreign currency loan	0.00	0.00%	0.00
Hedging derivative (interest account)	0.00	0.00%	0.00
Hedging derivative (plant and equip)	0.00	0.00%	0.00
Deferred gain or loss on hedge (P&E)	0.00	0.00%	0.00
Other asset	343,500.00	100.00%	343,500.00
Deferred tax asset	0.00	0.00%	0.00
Total	343,500.00	100.00%	343,500.00

APPENDIX C
Example 1

CONSOLIDATION ENTRY MODEL
LIABILITY ADJUSTMENT MODEL
ENTITY ENTERS GROUP WITH NO ELECTION

Updated balance sheet after joining

	Acc	Tax	DTA	DTL	MV
Assets and liabilities					
Interest bearing account	0.00	0.00	0.00	0.00	0.00
Foreign currency loan	0.00	0.00	0.00	0.00	0.00
Plant and equipment	0.00	0.00	0.00	0.00	0.00
Derivative (interest rate swap)	0.00	0.00	0.00	0.00	0.00
Loan payable at interest	0.00	0.00	0.00	0.00	0.00
Foreign currency loan	(92,000.00)	(92,000.00)	0.00	0.00	(92,000.00)
Hedging derivative (interest account)	0.00	0.00	0.00	0.00	0.00
Hedging derivative (plant and equip)	0.00	0.00	0.00	0.00	0.00
Deferred gain or loss on hedge (P&E)	0.00	0.00	0.00	0.00	0.00
Other asset	343,500.00	343,500.00			343,500.00
Income tax accounts					
Income tax liability	0.00	0.00			0.00
DTA - ACA	0.00	0.00			0.00
DTL	(1,500.00)				(1,500.00)
Equity					
Share capital	0.00	0.00			
Net profit	(3,500.00)	0.00			
Movement in tax balances	0.00	0.00			
Movement in asset balances	(246,500.00)	(251,500.00)			
Total	0.00	0.00	0.00	0.00	250,000.00

APPENDIX C
Example 1

CONSOLIDATION EXIT MODEL
LIABILITY ADJUSTMENT MODEL
ENTITY EXIT CALCULATION - NO ELECTION

Balance sheet

	Acc	Tax	DTA	DTL	MV
Assets and liabilities					
Interest bearing account	0.00	0.00	0.00	0.00	0.00
Foreign currency loan	0.00	0.00	0.00	0.00	0.00
Plant and equipment	0.00	0.00	0.00	0.00	0.00
Derivative (interest rate swap)	0.00	0.00	0.00	0.00	0.00
Loan payable at interest	0.00	0.00	0.00	0.00	0.00
Foreign currency loan	(95,000.00)	(100,000.00)	0.00	(5,000.00)	(92,000.00)
Hedging derivative (interest account)	0.00	0.00	0.00	0.00	0.00
Hedging derivative (plant and equip)	0.00	0.00	0.00	0.00	0.00
Deferred gain or loss on hedge (P&E)	0.00	0.00	0.00	0.00	0.00
Other assets	100,000.00	100,000.00			343,500.00
Income tax accounts					
Income tax liability	0.00	0.00			0.00
DTA	0.00	0.00			0.00
DTL	(1,500.00)				(1,500.00)
Equity					
Share capital	0.00	0.00			
Net profit	(3,500.00)	0.00			
Total	0.00	0.00	0.00	(5,000.00)	250,000.00

APPENDIX C
Example 1

CONSOLIDATION EXIT MODEL
LIABILITY ADJUSTMENT MODEL
ENTITY EXIT CALCULATION - NO ELECTION

Profit and loss / Tax calculation

	Acc	**Tax**
Income account		
Sales income	0.00	0.00
Interest account (interest)	0.00	0.00
Interest account (hedge movement)	0.00	0.00
Foreign currency loan (forex)	0.00	0.00
P&E (hedge movement)	0.00	0.00
P&E (depreciation)	0.00	0.00
Interest rate swap (FV)	0.00	0.00
Interest rate swap (interest)	0.00	0.00
Loan payable (interest)	0.00	0.00
Foreign currency loan (forex)	5,000.00	0.00
Hedge of interest account (FV)	0.00	0.00
Hedge of interest account (interest)	0.00	0.00
Hedge of P&E (FV)	0.00	0.00
Hedge of P&E (disposal amount)	0.00	0.00
Hedge of P&E (depreciation)	0.00	0.00
Deferred gain or loss on P&E	0.00	0.00
Net profit	5,000.00	0.00
Income tax expense	(1,500.00)	
Income tax payable		0.00

CONSOLIDATION EXIT MODEL
LIABILITY ADJUSTMENT MODEL
ENTITY EXIT CALCULATION - NO ELECTION
Carryforward loss benefit

Net profit after tax	3,500.00	0.00

Calculate appropriate 711-45(5) adjustment amount

Step 4 gross value for financial arrangements	(95,000.00)
Less: Step 4 reduction for 30%	0.00
Net amount otherwise used at step 4	(95,000.00)
Terminating values for financial arrangements	(100,000.00)
Adjustment to terminating value (no gain or loss)	(5,000.00)

APPENDIX C
Example 1

CONSOLIDATION EXIT MODEL
LIABILITY ADJUSTMENT MODEL
ENTITY EXIT CALCULATION - NO ELECTION

Calculate exit ACA for leaving subsidiary

Step 1		
- Terminating value of asset	711-25	100,000.00
Step 2		
- Inherited deductions	711-35	0.00
Step 3		
- Intragroup receivables	711-40	0.00
Step 4		
- Liability value	711-45(1)	(96,500.00)
- Future deduction	711-45(3)	0.00
- Adjustment to terminating value	711-45(5)	(5,000.00)
Total ACA		(1,500.00)
Market value of shares		250,000.00
Taxable gain		251,500.00

Total amount assessable to head company

Expected result for head company

Accounting income	5,000.00
Accounting expenses	0.00
Other gains (market value less accounting value)	246,500.00
DTA	0.00
Total	251,500.00

Taxable result for head company on exit of subsidiary

Capital gain / loss on disposal	0.00	251,500.00
Taxable income		0.00
Total		251,500.00
Discrepancy		0.00

CONSOLIDATION ENTRY MODEL | **APPENDIX D**
LIABILITY ADJUSTMENT MODEL | **Example 2**
ENTITY ENTERS GROUP WITH NO ELECTION

Balance sheet before joining

Use consolidated accounts (Y) or single entity accounts (N) — **Y**

	Acc	Tax	DTA	DTL	MV
Assets and liabilities					
Interest bearing account	500,000.00	500,000.00	0.00	0.00	500,000.00
Foreign currency loan	0.00	0.00	0.00	0.00	0.00
Plant and equipment	0.00	0.00	0.00	0.00	0.00
Derivative (interest rate swap)	(497,348.00)	20,000.00	517,348.00	0.00	(497,348.00)
Loan payable at interest	0.00	0.00	0.00	0.00	0.00
Foreign currency loan	0.00	0.00	0.00	0.00	0.00
Hedging derivative (interest account)	0.00	0.00	0.00	0.00	0.00
Hedging derivative (plant and equip)	0.00	0.00	0.00	0.00	0.00
Deferred gain or loss on hedge (P&E)	0.00	0.00	0.00	0.00	0.00
Other assets	14,992,143.60	10,000,000.00			14,992,143.60
Income tax accounts					
Income tax liability	(150,000.00)	(150,000.00)			(150,000.00)
DTA	155,204.40	0.00			155,204.40
DTL	0.00				0.00
Equity					
Share capital	(10,020,000.00)	(10,020,000.00)			
Net profit	12,143.60	(350,000.00)			
Movement in assets	(4,992,143.60)				
Total	0.00	0.00	517,348.00	0.00	15,000,000.00

ACA determination

Step 1	
- Cost of membership interests	15,000,000.00
Step 2	
- Accounting liabilities	647,348.00
- Future deduction	(155,204.40)
Step 3	0.00
Step 4	0.00
Step 5	0.00
Step 6	0.00
Step 7	0.00
Total ACA	15,492,143.60

CONSOLIDATION ENTRY MODEL
LIABILITY ADJUSTMENT MODEL
ENTITY ENTERS GROUP WITH NO ELECTION

APPENDIX D
Example 2

ACA allocation

Retained cost base assets	Retained		Election		Value
Interest bearing account	Yes	500,000.00	No	0.00	500,000.00
Foreign currency loan	No	0.00	No	0.00	0.00
Plant and equipment	No	0.00	No	0.00	0.00
Derivative (interest rate swap)	No	0.00	No	0.00	0.00
Loan payable at interest	No	0.00	No	0.00	0.00
Foreign currency loan	No	0.00	No	0.00	0.00
Hedging derivative (interest account)	No	0.00	No	0.00	0.00
Hedging derivative (plant and equip)	No	0.00	No	0.00	0.00
Deferred gain or loss on hedge (P&E)	No	0.00	No	0.00	0.00
Total					500,000.00
Remaining ACA					14,992,143.60

Reset cost base assets

	MV	%	ACA
Interest bearing account	0.00	0.00%	0.00
Foreign currency loan	0.00	0.00%	0.00
Plant and equipment	0.00	0.00%	0.00
Derivative (interest rate swap)	0.00	0.00%	0.00
Loan payable at interest	0.00	0.00%	0.00
Foreign currency loan	0.00	0.00%	0.00
Hedging derivative (interest account)	0.00	0.00%	0.00
Hedging derivative (plant and equip)	0.00	0.00%	0.00
Deferred gain or loss on hedge (P&E)	0.00	0.00%	0.00
Other assets	14,992,143.60	100.00%	14,992,143.60
Deferred tax asset	0.00	0.00%	0.00
Total	14,992,143.60	100.00%	14,992,143.60

CONSOLIDATION ENTRY MODEL
LIABILITY ADJUSTMENT MODEL
ENTITY ENTERS GROUP WITH NO ELECTION

APPENDIX D
Example 2

Updated balance sheet after joining

	Acc	Tax	DTA	DTL	MV
Assets and liabilities					
Interest bearing account	500,000.00	500,000.00	0.00	0.00	500,000.00
Foreign currency loan	0.00	0.00	0.00	0.00	0.00
Plant and equipment	0.00	0.00	0.00	0.00	0.00
Derivative (interest rate swap)	(497,348.00)	(497,348.00)	0.00	0.00	(497,348.00)
Loan payable at interest	0.00	0.00	0.00	0.00	0.00
Foreign currency loan	0.00	0.00	0.00	0.00	0.00
Hedging derivative (interest account)	0.00	0.00	0.00	0.00	0.00
Hedging derivative (plant and equip)	0.00	0.00	0.00	0.00	0.00
Deferred gain or loss on hedge (P&E)	0.00	0.00	0.00	0.00	0.00
Other assets	14,992,143.60	14,992,143.60			14,992,143.60
Income tax accounts					
Income tax liability	(150,000.00)	(150,000.00)			(150,000.00)
DTA - ACA	155,204.40	0.00			155,204.40
DTL	0.00				0.00
Equity					
Share capital	(10,020,000.00)	(10,020,000.00)			
Net profit	12,143.60	(350,000.00)			
Movement in tax balances	0.00	0.00			
Movement in asset balances	(4,992,143.60)	(4,474,795.60)			
Total	0.00	0.00	0.00	0.00	15,000,000.00

CONSOLIDATION EXIT MODEL
LIABILITY ADJUSTMENT MODEL
ENTITY EXIT CALCULATION - NO ELECTION

APPENDIX D
Example 2

Balance sheet

	Acc	Tax	DTA	DTL	MV
Assets and liabilities					
Interest bearing account	500,000.00	500,000.00	0.00	0.00	500,000.00
Foreign currency loan	0.00	0.00	0.00	0.00	0.00
Plant and equipment	0.00	0.00	0.00	0.00	0.00
Derivative (interest rate swap)	(497,348.00)	20,000.00	517,348.00	0.00	(497,348.00)
Loan payable at interest	0.00	0.00	0.00	0.00	0.00
Foreign currency loan	0.00	0.00	0.00	0.00	0.00
Hedging derivative (interest account)	0.00	0.00	0.00	0.00	0.00
Hedging derivative (plant and equip)	0.00	0.00	0.00	0.00	0.00
Deferred gain or loss on hedge (P&E)	0.00	0.00	0.00	0.00	0.00
Other asset	10,000,000.00	10,000,000.00			14,992,143.60
Income tax accounts					
Income tax liability	(150,000.00)	(150,000.00)			(150,000.00)
DTA	155,204.40	0.00			155,204.40
DTL	0.00				0.00
Equity					
Share capital	(10,020,000.00)	(10,020,000.00)			
Net profit	12,143.60	(350,000.00)			
Total	0.00	0.00	517,348.00	0.00	15,000,000.00

CONSOLIDATION EXIT MODEL
LIABILITY ADJUSTMENT MODEL
ENTITY EXIT CALCULATION - NO ELECTION

APPENDIX D
Example 2

Profit and loss / Tax calculation

	Acc	Tax
Income account		
Sales income	0.00	0.00
Interest account (interest)	500,000.00	500,000.00
Interest account (hedge movement)	0.00	0.00
Foreign currency loan (forex)	0.00	0.00
P&E (hedge movement)	0.00	0.00
P&E (depreciation)	0.00	0.00
Interest rate swap (FV)	(517,348.00)	0.00
Interest rate swap (interest)	0.00	0.00
Loan payable (interest)	0.00	0.00
Foreign currency loan (forex)	0.00	0.00
Hedge of interest account (FV)	0.00	0.00
Hedge of interest account (interest)	0.00	0.00
Hedge of P&E (FV)	0.00	0.00
Hedge of P&E (disposal amount)	0.00	0.00
Hedge of P&E (depreciation)	0.00	0.00
Deferred gain or loss on P&E	0.00	0.00
Net profit	(17,348.00)	500,000.00
Income tax expense	5,204.40	
Income tax payable		(150,000.00)
Carryforward loss benefit		
Net profit after tax	(12,143.60)	350,000.00

Calculate appropriate 711-45(5) adjustment amount

Step 4 gross value for financial arrangements	(497,348.00)
Less: Step 4 reduction for 30%	155,204.40

CONSOLIDATION EXIT MODEL **APPENDIX D**
LIABILITY ADJUSTMENT MODEL **Example 2**
ENTITY EXIT CALCULATION - NO ELECTION

Net amount otherwise used at step 4	(342,143.60)
Terminating values for financial arrangements	20,000.00
Adjustment to terminating value (no gain or loss)	362,143.60

CONSOLIDATION EXIT MODEL
LIABILITY ADJUSTMENT MODEL
ENTITY EXIT CALCULATION - NO ELECTION

APPENDIX D
Example 2

Exit ACA calculation

Step 1		
- Terminating value of asset	711-25	10,500,000.00
Step 2		
- Inherited deductions	711-35	0.00
Step 3		
- Intragroup receivables	711-40	0.00
Step 4		
- Liability value	711-45(1)	(647,348.00)
- Future deduction	711-45(3)	155,204.40
- Adjustment to terminating value	711-45(5)	362,143.60
Total ACA		10,370,000.00
Market value of shares		15,000,000.00
Taxable gain		4,630,000.00

Total amount assessable to head company

Expected result for head company

Accounting income		500,000.00
Accounting expenses		(517,348.00)
Other gains (market value less accounting value)		4,992,143.60
DTA		155,204.40
Total		5,130,000.00

Taxable result for head company

		Model 2
Capital gain / loss on disposal	0.00	4,630,000.00
Taxable income		500,000.00
Total		5,130,000.00

Discrepancy 0.00