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02 May 2012

Mr David Bradbury
Assistant Treasurer
Australian Government
Parliament House
CANBERRA ACT 2600

Ms Nan Wang
Manager
Finance Taxation Unit
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The Treasury
Langton Crescent
PARKES ACT 2600

Dear Mr Bradbury & Ms Wang

Submission on draft Tax Laws Amendment (2012 Measures No.2) Bill 2012: Consolidation

We make the following submission on the exposure draft of Tax Laws Amendment (2012 Measures No.2) Bill 2012: Consolidation, published by the Government on 18 April 2012.

Given the limited time to prepare a submission on the draft bill, we have limited our comments to the amendments proposed by Schedule 2 of the draft bill which deals with the interaction of the consolidation provisions and the provisions regarding the taxation of financial arrangements (the TOFA rules). Therefore our comments cannot be regarded as exhaustive.

Stated rationale

The reasons for one of the proposed changes are stated as follows in the exposure draft explanatory material that accompanied the draft bill:

> 2.31 ...As a result, a head company ... is able to obtain tax outcomes for the gains and losses that accrue during the period that the joining company held the accounting liability prior to the joining time.
>
> 2.32 Such an approach is inconsistent with the TOFA overarching objective to allocate the gains and losses from a financial arrangement to 'the period to which the gains and losses relate' so as to more closely align with commercial norms. In a merger or a takeover, the head company should not be able to claim deductions for losses from financial arrangements that relate to the pre-joining/consolidation period.
>
> 2.33 It is also inconsistent with the principle of the consolidation regime to prevent the duplication of losses.

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In relation to the last reason (duplication of losses), we note that the possibility of a duplication of losses under the existing rules is not illustrated in any of the examples given in the draft explanatory materials. In our view, this reason requires substantiation. For pre-TOFA consolidations, we are not aware of situations in which the existing rules can result in duplication of losses except to the extent that any economic loss incurred by a company can result in a deduction for that company or the acquiring company (but not both) and also a reduction in the amount of consideration receivable by an owner of shares in the company when those shares are disposed of. The proposed rules, far from introducing equitable treatment of losses arising economically before a company joins a consolidated tax group, produce apparently inappropriate results by denying a head company deductions for pre-consolidation economic losses suffered by a joining company even where no deduction for that loss was (or will be) available to the joining company.

In relation to the point made in paragraphs 2.31 and 2.32 of the draft explanatory materials (the allocation of gains and losses from a financial arrangement to the period to which the gains and losses relate), we note the following:

- Firstly, there is no principle in the TOFA rules that losses (or gains) made by a company in a consolidated tax group are deductible (or assessable) only to the extent that they arose economically while that company was part of the consolidated tax group. For example, if the default accruals/realisation method applies to a gain or loss on a financial arrangement, there will be many situations in which an economic gain or loss made by a company before it is acquired by a consolidated group will not be assessable or deductible under the TOFA rules until after it is acquired. This is an inevitable result of any system of taxation in which the gains and losses that are assessable or deductible on a year by year basis are not identical to the economic gains and losses made on a year by year basis.
- Secondly, denying a head company a deduction for an economic loss that arises in a joining company before the company enters the consolidated group is bound to have capricious effects unless the tax law ensures that the loss is deductible to the joining company before it enters the consolidated tax group. The proposed changes would not make any change to the tax implications for the joining company. Consequently, the changes are potentially distortionary and will tend to result in behaviour which is driven by tax consequences and is otherwise not commercial.

Examples

The points made above are illustrated in the attached Annexure in which we repeat the examples provided in Chapter 2 of the draft explanatory materials and provide comments on the results achieved by the existing law and the proposed changes.

Submission

The proposed changes will have results that are capricious in some cases and, we would suggest, misguided in principle in other cases.

To give effect to the principles mentioned in paragraphs 2.32 and 2.33 of the draft explanatory materials, proposals could be put forward to allocate gains and losses on financial arrangements to periods before and after a company enters a consolidated tax group, but that is not the effect of the changes that are currently proposed because they deal only with the position of the head company. Accordingly, the proposals should be redrafted to ensure that they result in equitable outcomes that are consistent with the principles mentioned in the explanatory materials.

We would be pleased to discuss this further.

Yours sincerely

Paul O'Donnell
Partner

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ANNEXURE:

EXPOSURE DRAFT TAX LAWS AMENDMENT (2012 MEASURES) BILL 2012: CONSOLIDATION

EXAMPLES IN CHAPTER 2 OF EXPOSURE DRAFT EXPLANATORY MATERIAL

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Example 2.6: Derivative liability assumed by the head company as part of a consolidation event and to which the fair value, reliance on financial reports or retranslation tax timing methods applies

On 1 July 2011, a joining entity entered into a cash-settlable forward transaction for $0. The term of the forward is three years.

On 1 July 2012, the joining entity becomes a subsidiary member of a consolidated group, which is a TOFA taxpayer (having entered the TOFA regime on 1 July 2010) and made a fair value tax timing election.

At the time of joining, the forward has a fair value of –$120. Because the forward is fair valued through profit/loss for accounting purposes, –$120 is also the amount for tax purposes under the fair value tax timing method.

On 1 July 2014, the forward matures with a fair value of –$100, and is settled with a payment of $100.

As subsection 715-375(1) is satisfied, the amended paragraph 715 75(2)(b) applies to treat the head company of the consolidated group as starting to have the forward at the joining time for receiving a payment equal to $120, the forward's Division 230 starting value at the joining time.

On disposal the head company brings to account no gain or loss for tax purposes, as the $20 gain (being the difference between the deemed receipt of $120 and actual payment of $100 to settle the forward) had been brought to account under the fair value tax timing method (being the change in fair value of the forward from the time the head company assumes the forward from the joining entity until the swap matures).

Without the amendments to subsection 715-375(2), the head company would be treated as starting to have an accounting liability at joining time, valued at –$120 (its Division 230 starting value at the joining time) for the purposes of Division 230 and the transitional balancing adjustment.

At disposal, without the amendments, the head company would be able to deduct $120 loss, as the head company paid $100 to settle the forward (which would not be offset by the deemed receipt) and brought to account $20 gain under the fair value tax timing method.

ASHURST COMMENTS

Under the existing law, as noted in the example, the head company would report a fair value gain of $20 (being the change in value of the derivative from -$120 to -$100) under the fair value method and a loss of $120 under the balancing adjustment provisions (being the actual loss of $100 on settlement of the contract plus the $20 gain previously reported as income). The net effect is that the economic loss on the contract over the life of the contract is reported by the head company.

The position of the joining company under the existing law depends on whether the joining company was in the TOFA regime at the time of joining and, if so, whether it had made the fair value election.

If the joining company was not in the TOFA regime, or was in the TOFA regime but had not made a fair value election, it would not have deducted the $120 unrealised loss on the contract before joining the consolidated group. In those circumstances:

- the existing rules produce the correct overall result for the particular financial arrangement because the loss over the life of the transaction ($100) is deductible in full and once only

(being the net of the $20 fair value gain assessed in the hands of the head company and the $120 loss deducted by the head company); and

- the proposed rules do not produce the correct overall result for the particular financial arrangement because they would result in a fair value gain of $20 being assessed in the hands of the head company, and no further assessable gains or deductible losses, whereas the actual overall result of the transaction was a $100 loss. .

If the joining company was in the TOFA regime and had made the fair value election, it would have deducted $120, being the unrealised loss on the forward contract, up to the point of joining the consolidated group. In those circumstances:

- the existing rules do not produce the correct overall result for the particular transaction: because the total amount assessable or deductible over the life of the transaction (a loss of $120 for the joining company under the fair value method, a gain of $20 for the head company under the fair value method and a $120 loss for the head company under the balancing adjustment rule, ie an overall net loss of $220) exceeds the actual net loss on the transaction ($100); and
- the proposed rules would produce the correct overall result for the particular transaction because the joining company would have deducted $120 up to the joining time and the head company would have assessable income of $20, so the net deductible amount ($100) would be equal to the overall loss on the arrangement.

Clearly, therefore, both the existing rules and the proposed rules produce capricious tax results.

The aim of any new rule should be to ensure that for each "financial arrangement" taken on by the head company, the overall gain or loss on the arrangement is assessable or deductible over the life of the transaction. This would be achieved, for a financial arrangement that is a liability of a joining company at the time of consolidation, by deeming the head company to have paid an amount equal to the value of the liability only if the joining company had deducted the unrealised loss up to that point.

Example 2.7: Foreign currency denominated loan assumed by the head company as part of a consolidation event and to which the accrual/realisation tax timing method applies

On 1 July 2011, a joining entity entered into a foreign currency denominated liability under which:

- it receives US$100 on 1 July 2011,
- must pay AU$10 interest on 1 July 2012, 1 July 2013 and 1 July 2014; and
- must repay US$100 on 1 July 2014.

As at 1 July 2011, AU$1 buys US$1. As a result, the AUD value of the US$100 received is $100.

On 1 July 2012, and just after the interest payable on 1 July 2012 is paid, the joining entity becomes a subsidiary member of a consolidated group, which is a TOFA taxpayer (having entered the TOFA regime on 1 July 2010). The head company makes no TOFA tax timing method election, and as a result applies the accruals/realisation tax timing method to its financial arrangements (including the liability).

At the time of joining, the joining entity's accounting principles for tax cost setting determine the amount of the liability as –$120. This is because, at the time of joining, AU$1 buys US$0.8333.

On 1 July 2014, the US$100 is repaid. The AUD value of this payment, at the time of payment, is $120.

As subsection 715-375(1) is satisfied, the new paragraph 715 375(2)(a) applies to treat the head company of the consolidated group as starting to have the accounting liability at the joining time for receiving a payment equal to $120. This is the amount of the liability determined in accordance with the joining entity's accounting principles for tax cost setting at the joining time.

On 1 July 2014, the liability comes to an end. For the purposes of working out the Subdivision 230-G balancing adjustment for the liability, the head company is deemed to have received $120 for assuming the liability under step 1(a) of the method statement. And the amount of the liability in the hands of the head company at the joining time (that is –$120) is used to work out the gain or loss and the spreading of that gain or loss on an on-going basis.

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In order to illustrate the effect of the proposed change, it is convenient to make an assumption about the AUD value of the liability when it is repaid by the head company. Assume that the AUD amount paid to discharge the liability on 1 July 2014 is $140. On that basis, under the proposed rules the head company would report aggregate losses (or a gain and a loss amounting to a net loss) of $20 in the 2012/13 and 2013/14 income years and no balancing adjustment in the 2014/15 income year.

If the joining company was not in the TOFA regime, or was in the TOFA regime but had not made a foreign exchange retranslation election, it would not have deducted the $20 unrealised loss on the liability before joining the consolidated group. In those circumstances:

- the existing rules produce the correct overall result for the particular financial arrangement because the loss over the life of the transaction ($40) is deductible in full and once only (being the net of the $40 retranslation loss for the head company); and
- the proposed rules do not produce the correct overall result for the particular financial arrangement because they would result in a retranslation loss of $20 for the head

company, and no further assessable gains or deductible losses, whereas the actual overall result of the transaction was a $40 loss. .

If the joining company was in the TOFA regime and had made the foreign exchange retranslation election, it would have deducted $20, being the unrealised loss on the liability, up to the point of joining the consolidated group. In those circumstances:

- the existing rules do not produce the correct overall result for the particular transaction: because the total amount assessable or deductible over the life of the transaction (a retranslation loss of $20 for the joining company under the fair value method, a loss of $20 for the head company under the retranslation method and a balancing adjustment loss of $20, ie an overall net loss of $60) exceeds the actual net loss on the transaction ($40); and
- the proposed rules would produce the correct overall result for the particular transaction because the joining company would have deducted $20 up to the joining time and the head company would have assessable income of $20, so the net deductible amount ($40) would be equal to the overall loss on the arrangement.

Clearly, therefore, both the existing rules and the proposed rules produce capricious tax results.

The aim of any new rule should be to ensure that for each "financial arrangement" taken on by the head company, the overall gain or loss on the arrangement is assessable or deductible over the life of the transaction. This would be achieved, for a financial arrangement that is a liability of a joining company at the time of consolidation, by deeming the head company to have paid an amount equal to the value of the liability only if the joining company had deducted the unrealised loss up to that point.

Example 2.8: Derivative asset acquired by the head company as part of a pre-TOFA joining and transitioning into the TOFA regime

On 1 July 2008, a joining entity entered into a cash-settlable forward transaction for $0. The term of the forward is four years.

On 1 July 2009, the joining entity becomes a subsidiary member of a consolidated group. At the time of joining, the forward has a fair value of $120. Because the forward is fair valued through profit/loss for accounting purposes, $120 is also the amount of the asset for tax purposes applying the fair value tax timing method.

The head company continues to hold the forward until it enters into the TOFA regime on 1 July 2010, which is the start of the head company's first TOFA year. At that time, the fair value of the asset is $100.

On 1 July 2010, the head company makes an irrevocable election under item 104(2) of the TOFA Act to apply the TOFA provisions in relation to all of the financial arrangements it had on 1 July 2010. It also makes a valid fair value tax timing election under Subdivision 230-C.

As such, the asset satisfies the conditions under the new subitem 104B(1). Paragraph 104B(2)(a) applies in relation to the asset. The assumed application of subsection 701-55(5A) to the asset has the following consequences:

- for the purposes of applying subitem 104(13) of the TOFA Act in working out the transitional balancing adjustment for the asset, the head company is treated as if it acquired the asset at the joining time for a payment equal to the asset's Division 230 starting value at the joining time; and
- for the purposes of applying section 230-445 in working out the Subdivision 230-G balancing adjustment for the forward when it matures on 1 July 2012, the head company is deemed to have paid an amount equal to the forward's Division 230 starting value at the joining time.

Transitional balancing adjustment

Applying this assumption, the result of the transitional balancing adjustment would be as follows:

Step 1: $0 (This is because the subitem 104(13) method statement is to be calculated on the assumption that subsection 701-55(5A) applied in relation to the asset at the joining time which resulted in the head company starting to have the asset. As such, the increase in fair value of the forward that occurred between 1 July 2008 and 1 July 2009 is ignored for the purposes of step 1).

Step 2: $20 (The decrease in the fair value from the joining time would have been a loss that would have been made from the forward had Subdivision 230-C applied in relation to the forward after the joining time).

Step 3: $0 (No amounts have been assessed since the joining time.)

Step 4: $0 (No amounts have been deducted since the joining time.)

Step 5: $0

Step 6: $20

Step 7: $20 loss allowed as a deduction, and spread in accordance with subitem 104(17) — Subdivision 230-G balancing adjustment

Applying the method statement in section 230-445 when the forward matures on 1 July 2012:

Step 1(a): $0 (on the assumption the forward matures on 1 July 2012 with fair value of $0).

Step 1(b): $110 (This includes the transitional balancing adjustment amount included so far allowed as a deduction and the decline in fair value from 1 July 2010 to 1 July 2012 which has already been deducted over those two years under the fair value method).

Step 1(c): $0

Step 1(d): $10 (the transitional balancing adjustment amount yet to be allowed as a deduction).

Step 1 result: $120

Step 2(a): $120 (the deemed acquisition in accordance with the assumed application of paragraph 701-55(5A)(b) by paragraph 104B(2)(a)).

Step 2(b): $0

Steps (c) to (e): $0

Step 2 result: $120

Step 3: Subdivision 230-G balancing adjustment of $0 upon maturity.

As such, from the head company's perspective, the forward has an overall loss of $120 over its term, of which $20 loss was brought to account as the TOFA transitional adjustment; and $100 loss was brought to account under the fair value tax timing method.

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Under the existing rules, if the view is taken (correctly, we believe) that s 701-55(5A) of ITAA 1997 does not apply to deem the head company to have acquired the asset at the joining time for its Division 230 starting value, then:

- the head company's transitional balancing adjustment for the arrangement would be a gain of $100 (being the untaxed increase in value of the asset from the time the joining company acquired the financial arrangement to the time the head company entered the TOFA regime), of which $25 would be assessed in each of the 4 income years starting from the 2010/11 income year; and
- the head company would include aggregate losses (or a gain and a loss amounting to a net loss) of $100 in the 2010/11 and 2011/12 income years under the fair value method.

The overall net result, for the head company, would be nil net assessable income or loss.

Given that the TOFA regime commenced after the joining time, the joining company would not have been assessed on the $120 unrealised gain on the transaction before joining the consolidated group. Consequently:

- the existing rules produce the correct overall result for the particular financial arrangement because over the life of the transaction the overall economic gain or loss on the arrangement is nil and this is the same as the total net assessable or deductible amount (being the net of the $100 transitional balancing adjustment gains included in the head company's assessable income and the $100 fair value losses deductible to the head company); whereas

- the proposed rules do not produce the correct overall result for the particular financial arrangement because they would result in an overall deductible loss of $120 (being a transitional balancing adjustment loss of $20 and a $100 fair value loss to the head company and no assessable gain or deductible loss to the joining company).

Clearly, therefore, the existing rules produce the correct overall tax result over the term of the transaction and the proposed rules produce an incorrect result.

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Example 2.9 Derivative liability assumed by the head company as part of a pre-TOFA joining and transitioning into the TOFA regime

On 1 July 2008, a joining entity entered into a cash-settlable forward transaction for $0. The term of the forward is four years.

On 1 July 2009, the joining entity becomes a subsidiary member of a consolidated group. At the time of joining, the forward has a fair value of -$120. Because the forward is fair valued through profit/loss for accounting purposes, -$120 is also the amount of the liability for tax purposes, applying the fair value tax timing method.

The head company continues to hold the forward until it enters into the TOFA regime on 1 July 2010, which is the start of the head company's first TOFA year. At that time, the fair value of the liability is -$100.

On 1 July 2010, the head company makes an irrevocable election under subitem 104(2) of the TOFA Act to apply the TOFA provisions in relation to all of the financial arrangements it had on 1 July 2010. It also makes a valid fair value election under Subdivision 230-C.

As such, the liability satisfies the preconditions under the new subitem 104B(1). Paragraph 104B(2)(b) applies in relation to the liability. The assumed application of section 715-375 to the liability has the following consequences:

- for the purposes of applying subitem 104(13) of the TOFA Act to work out the transitional balancing adjustment for the liability, the head company is treated as starting to have the liability at the joining time for receiving a payment equal to the liability's Division 230 starting value at joining time (which, in this case, is $120); and
- for the purposes of applying section 230-445 to work out the Subdivision 230-G balancing adjustment for the liability when it matures on 1 July 2012, the head company is deemed to have received a payment equal to the forward's Division 230 starting value at the joining time.

Transitional balancing adjustment

Applying this assumption, the result of the transitional balancing adjustment would be as follows:

Step 1: $20 (the increase in fair value from the joining time would have been a gain that would have been made from the forward).

Step 2: $0 (Because the subitem 104(13) method statement is to be calculated on the assumption that section 715-375 applied to deem the head company starting to have the liability at the joining time, the increase in fair value of the forward that occurred between 1 July 2008 and 1 July 2009 is ignored for the purposes of step 2).

Step 3: $0 (No amounts have been assessed since the joining time.)

Step 4: $0 (No amounts have been deducted since the joining time.)

Step 5: $20

Step 6: $0

Step 7: $20 gain included in assessable income, and spread in accordance with subitem 104(17).

Subdivision 230-G balancing adjustment

Applying the method statement in section 230-445 on 1 July 2012, when the forward matures:

Step 1(a): $120 (the deemed assumption in accordance with the assumed application of section 715-375 by paragraph 104B(2)(b)).

Step 1(b): $0

Step 1(c): $0

Step 1(d): $0

Step 1 result: $120

Step 2: $0 (on the assumption that the forward matures on 1 July 2012 with a fair value of $0).

Step 2(b): $110 (The increase in fair value from 1 July 2010 to 1 July 2012 which has already been included as assessable income over those two years under the fair value method and the transitional balancing adjustment amount included so far in assessable income.)

Step 2(c): $0

Step 2(d): $10 (the transitional balancing adjustment amount yet to be included in assessable income).

Step 2 result: $120

Step 3: 230-G balancing adjustment of $0 upon maturity.

As such, from the head company's perspective, the forward has an overall gain of $120 over its term, of which $20 gain was and is to be brought to account as the TOFA transitional adjustment; and $100 gain was brought to account under the fair value tax timing method.

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Under the existing rules:

- the head company's transitional balancing adjustment for the arrangement would be a loss of $100 (being the untaxed decrease in value of the financial arrangement from the time the joining company acquired the arrangement to the time the head company entered the TOFA regime), of which $25 would be deductible in each of the 4 income years starting from the 2010/11 income year; and
- the head company would include aggregate gains (or a gain and a loss amounting to a net gain) of $100 in the 2010/11 and 2011/12 income years under the fair value method.

The overall net result, for the head company, would be nil net assessable income or loss.

Given that the TOFA regime commenced after the joining time, the joining company would not have been assessed on the $120 unrealised gain on the transaction before joining the consolidated group. Consequently:

- the existing rules produce the correct overall result for the particular financial arrangement because over the life of the transaction the overall economic gain or loss on the arrangement is nil and this is the same as the total net assessable or deductible amount

(being the net of the $100 transitional balancing adjustment losses included in the head company's assessable income and the $100 fair value gains assessable to the head company); whereas

- the proposed rules do not produce the correct overall result for the particular financial arrangement because they would result in overall assessable gains of $120 (being a transitional balancing adjustment gain of $20 and a $100 fair value gain to the head company and no assessable gain or deductible loss to the joining company).

Clearly, therefore, the existing rules produce the correct overall tax result over the term of the transaction and the proposed rules produce an incorrect result.

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Example 2.10: Derivative asset acquired by the head company as part of a pre-TOFA joining, transitioning into the TOFA regime and to which the head company applies the fair value, reliance on financial reports or retranslation tax timing methods

This is a continuation of Example 2.3.

On 1 July 2009 the head company acquires all of the joining entity's membership interests for $1050. Consequently, the joining entity joins head company's consolidated group.

The joining entity has two assets, the forward which has a fair value of $120 and cash at bank of $1000.

In setting the tax costs of the assets of the joining entity, assuming the joining entity has no liabilities, the allocable cost amount (ACA) for the joining entity is $1050.

Cash at bank is a retained cost base asset and has its tax cost set at $1000.

The remaining ACA of $50 is allocated to the forward which is a reset cost base asset. The tax cost of the forward is set at $50, despite the fact that its fair value at the joining time is $120.

Applying subitem 104B(5), the Division 230 starting value at the joining time is $120. The tax cost setting amount at the joining time was $50. This means that the Division 230 starting value at the joining time exceeds the tax cost setting amount. Because of this, $17.50 (that is, 25 per cent of this excess) is to be included in the head company's assessable income for:

- the income year that started on 1 July 2010; and
- each of the three subsequent income years.

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This provision ensures that a discount or premium on the acquisition of a company (that is, a shortfall or surplus of consideration paid, including the value of liabilities assumed, over the value of assets acquired), to the extent that the discount or premium is allocated to an asset that is a financial arrangement, is assessable or deductible to the head company over a 4 year period. This would seem to be appropriate and does not affect any conclusion in relation to examples 2.06 to 2.08.