Submission
(non-confidential)

Exposure Draft

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

Schedule 2: TOFA / Consolidation

2 May 2012

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1 Limited period for submissions

While the media release foreshadowing these changes was issued on 25 November 2011, it has taken almost five months for the exposure draft material to be released, and then only two weeks has been allowed for public submissions. This is extremely disappointing, particularly as the then Assistant Treasurer in his media release stated that the drafting of legislation would be undertaken as a matter of priority.

Given it has taken the Treasury five months to draft the provisions, it is unsatisfactory to only provide taxpayers two weeks to review them.

As such, the points contained in our submission are preliminary only, as we have not had the opportunity to either consider a number of these issues in more depth, or to canvass our clients for comments.

2 Summary

The fundamental point of this submission relates to the retrospective nature of the changes in relation to pre-TOFA acquisitions.

We believe that the changes in relation to pre-TOFA acquisitions reflect a fundamental retrospective change in law which will only affect a limited class of taxpayers – i.e. taxpayers that have elected to un-grandfather their TOFA financial arrangements. As the un-grandfathering election was only ever intended as a compliance measure (to allow taxpayers to apply one set of provisions to all their TOFA financial arrangements) we cannot see any justification for now altering this position such that taxpayers that made the un-grandfathering election are now retrospectively denied tax deductions while taxpayers that did not make the un-grandfathering election are still entitled to the deductions.

We have considered these issues in further detail in section 4 below.

In sections 5 and 6 we have also made various other specific points in relation to the draft provisions.

3 Treatment of liabilities

The main aim of the TOFA/consolidation amendments is to amend the treatment of liabilities (that are TOFA financial arrangements) assumed when a consolidated group acquires another entity.

The provisions operate to effectively reset the tax cost of the financial liabilities assumed to the accounting value of the liability at the joining time. Although this is achieved by treating the head company as receiving consideration equal to the accounting value of the liability at the joining time, for the purposes of this submission, we have referred to this mechanism as resetting the tax cost of the liability.

Resetting the tax cost of the liability to the accounting value at the joining time operates to deny the consolidated group a tax deduction for the liability when it is ultimately discharged – the amount of the deduction denied being equal to the accounting value of the liability at the joining time.

When a consolidated group acquires another entity which has open liabilities then there has always been the potential for the acquiring group to obtain a double impact. This

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arises from the fact that (i) the amount of "tax cost" (ACA) that the acquiring group obtains to push into the assets acquired is increased by the after-tax amount of the liability and (ii) the group should receive a tax deduction for the amount of the liability when it is ultimately discharged (assuming that it is otherwise deductible).

This issue has always been recognised in the consolidation regime, and in a manner broadly consistent with the financial accounting consolidation treatment, had sought to address it by reducing the step 2 ACA amount by the tax impact of associated future deductions (i.e. at 30%). While this approach was traditionally seen as appropriate in the context of the more common employee leave type liabilities, it has recently been recognised that this 30% ACA reduction may not be adequate in all circumstances, being a point raised by the Board of Taxation in its May 2011 report to the Government.

Unfortunately, at no stage in the explanatory memorandum to the exposure draft provisions is this "issue" referred to. Furthermore, as well as not referring to this issue the explanatory memorandum appears to suggest that the changes reflect mere *"technical deficiencie*s" (paragraph 2.14) and are simply achieving timing results that are consistent with the *"overarching policy design of the TOFA regime"* (paragraph 2.37). We do not believe that this is an accurate reflection of the reasons driving the changes in relation to liabilities or the actual effect that such changes would have.

We believe that Treasury should clearly set out in the explanatory memorandum the underlying reasons for the changes in relation to liabilities. Without such an explanation there will always be a risk that any court interpreting the provisions will not fully understand the context or reasons for the introduction of the provisions.

4 Retrospective nature of the amendments

As reflected in section 3 above, we believe that taxpayers would be aware of the underlying reasons that have caused Treasury to change the tax treatment of financial liabilities assumed as part of a corporate acquisition (in relation to future acquisitions).

What we cannot understand is why Treasury has chosen to make the amendments retrospective – i.e. why Treasury has chosen to apply the TOFA/consolidation provisions to corporate acquisitions that took place prior to the commencement of TOFA.

Furthermore, we cannot understand why Treasury has chosen to only apply the amendments on a retrospective basis to a limited class of taxpayers (being, only those taxpayers that have elected to un-grandfather their TOFA financial arrangements).

The retrospective nature of the provisions is reflected in one and a half pages of new provisions (new subitem 104B). In our view, the extent of the amendments required clearly demonstrates that the TOFA/consolidation interaction provisions were never intended to apply to historic corporate acquisitions.

For taxpayers that have elected to un-grandfather their existing TOFA financial arrangements, the provisions now operate to deny tax deductions in relation to financial liabilities assumed as part of corporate acquisitions prior to 1 July 2010 (the TOFA commencement date for most taxpayers). However, such tax deductions will not be denied in relation to a taxpayer that has chosen not to un-grandfather its existing TOFA financial arrangements. We can see no logical reason why this distinction has been made.

We have attempted to illustrate this issue through a simple example.

Example

- Widget Co was expanding its business in 2008 (Widget Co is the head company of a tax consolidated group). As part of this expansion, Widget Co acquired Manufacturing Co in 2008.

- Manufacturing Co had a number of financial liabilities at this time – on close-out of the financial liabilities, Manufacturing Co would be required to pay $1000 (the accounting value of the liabilities at this time was negative $1000).
- When Widget Co acquired Manufacturing Co, Widget Co was treated for income tax purposes as assuming these financial liabilities.
- On close-out of the liabilities and payment of $1000 by Manufacturing Co (assuming no further movement in the value of the liabilities) Widget Co would be entitled to tax deductions of $1000.
- On 1 July 2010, the TOFA provisions applied to Widget Co on a mandatory basis. Subject to the un-grandfathering election, the TOFA provisions would only apply to Widget Co in relation to new financial arrangements – i.e. financial arrangements entered into on or after 1 July 2010.
- At this time, Widget Co had to decide whether to un-grandfather its existing financial arrangements – i.e. Widget Co had to decide whether to apply the TOFA provisions to all of its existing financial arrangements (including those acquired/assumed when it acquired Manufacturing Co).
- When considering whether to make the un-grandfathering election, Widget Co considered the consequences in relation to its financial arrangements. As part of this, Widget Co considered the financial liabilities assumed from Manufacturing Co. Based on the TOFA provisions at this time, it was clear that the TOFA/Consolidation interaction provisions did not apply to pre-TOFA acquisitions. As such, although the financial liabilities assumed from Manufacturing Co would be subject to TOFA (if Widget Co made the un-grandfathering election), Widget Co's tax cost in the liabilities would not be reset and Widget Co would still be entitled to deductions of $1000 on close-out of the liabilities.
- The effect of the proposed amendments is to retrospectively change this position and to deny Widget Co tax deductions for the $1000 loss incurred on close-out of the liability. This is achieved by the new subitem 104B which will now operate to effectively reset Widget Co's tax cost in the liabilities assumed at negative $1000 in 2008 (i.e. when Widget Co acquired Manufacturing Co). As such, when Manufacturing Co pays $1000 on close-out of the liability, Widget Co will no longer be entitled to tax deductions for the loss incurred.

We cannot understand on what basis this retrospective change can be justified.

As a starting point, any retrospective change in law is extremely problematic as taxpayers will have made decisions on the basis of the previous law. In this example, Widget Co made the decision to un-grandfather its existing financial arrangements on the basis of the TOFA provisions in 2010. In particular, Widget Co elected to un-grandfather the financial liabilities assumed on the basis that it would be entitled to tax deductions of $1000 on close-out of the liabilities. Indeed, at this time, Widget Co would have believed that it was entitled to the deductions irrespective of whether or not it made the TOFA un-grandfathering election.

If Widget Co had been aware that the tax treatment of the liabilities assumed from Manufacturing Co would change then Widget Co would have been unlikely to make the un-grandfathering election – it would have had to weigh up the consequences of losing the $1000 tax deductions against the compliance benefits of applying TOFA to its existing financial arrangements.

Furthermore, we cannot understand why a retrospective change of law should only apply to a limited class of taxpayers.

In the example above, if Widget Co had not elected to un-grandfather its existing TOFA financial arrangements then it would still be entitled to tax deductions of $1000 on close-out of the liabilities. Furthermore, if Widget Co was not subject to TOFA, Widget Co would also still be entitled to tax deductions on close-out of the liabilities. How can it be logically

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correct that only taxpayers that are subject to TOFA and who have elected to un-grandfather their existing financial arrangements should be subject to this retrospective change in law which effectively wipes-out tax deductions in relation to liabilities assumed as a result of a pre-TOFA acquisition?

The intention of the TOFA un-grandfathering election was never to fundamentally change the income tax position of a taxpayer by eliminating tax deductions from the system. Rather, the un-grandfathering election is simply a mechanism which allows taxpayers that are subject to TOFA to apply a single set of provisions to all of their financial assets/liabilities – rather than having to apply the pre-TOFA law to existing financial arrangements and the TOFA provisions to new TOFA financial arrangements. This “compliance” objective is clearly reflected in the explanatory memorandum to the proposed new provisions which provides:

> *“subitem 104(2) allows a head company to elect to bring its existing financial arrangements (those that it acquired/assumed before it entered into the TOFA regime) into the TOFA regime and apply the TOFA provisions to work out the gains and losses from the financial arrangements. This provision is designed to reduce the head company’s compliance costs by ensuring that the head company does [not] need to apply two sets of tax provisions to their financial arrangements”. (paragraph 2.10)*

We agree completely with this statement which reflects the fundamental objective of the un-grandfathering election. Significantly, at no stage in the TOFA consultation process has there been any suggestion that the effect of un-grandfathering would be to permanently change the tax treatment of liabilities acquired as part of a pre-TOFA acquisition and to effectively permanently wipe out deductions that a taxpayer would otherwise be entitled to. If this was the case then it is difficult to imagine that many taxpayers would have made the un-grandfathering election.

As such, we consider that the amendments should not be retrospective in nature and should only apply to acquisitions on a prospective basis – i.e. acquisitions that take place on or after 26 November 2011 (the date of the “Attachment B” press release). This approach also deals with the second retrospective application of the provisions, in that, the provisions will apply to all acquisitions by a TOFA taxpayer from the time that TOFA commenced for the taxpayer (generally, 1 July 2010) regardless of whether or not the taxpayer un-grandfathered its existing financial arrangements.

Furthermore, the retrospective nature of the changes is not consistent with the approach adopted in relation to the “rights to future income” legislation in Schedule 1. In that legislation, Treasury has distinguished taxpayers that have relied on provisions and lodged tax returns on the basis of the provisions (see, in particular, the approach adopted in relation to the “interim period” from 12 May 2010 to 30 March 2011). The approach adopted in relation to this period is essentially to protect taxpayers that had lodged tax returns and acted on the basis of the legislation as it stood at that time. This approach is completely inconsistent with the approach adopted in the TOFA/consolidation amendments which simply applies the new provisions on a retrospective basis to all taxpayers that have elected to un-grandfather their TOFA financial arrangements.

In our view, the very least that Treasury should do is adopt a similar approach to the “rights to future income” changes and provide that taxpayers that had adopted tax positions (for instance, by making an irrevocable TOFA election or lodging tax returns) on the basis of the law as it stood when they made the election or lodged their tax return should not be subject to these changes. In other words, taxpayers that had adopted these positions prior to the 25 November 2011 press release should not be subject to the changes foreshadowed in Attachment B of that press release as now set out in the draft provisions (including, under the transitional balancing adjustment calculations and on ultimate disposal/close-out of the financial arrangements – even if the financial arrangements are disposed of a number of years later).

We urge Treasury to reconsider the nature of the retrospective amendments. How can taxpayers be retrospectively denied tax deductions because they made an un-grandfathering election which, as reflected in the explanatory memorandum, is simply intended to reduce compliance costs?

5 Readjusting historic ACA calculations

In the Example set out in section 4 above, when Widget Co acquired Manufacturing Co it would have undertaken an ACA calculation and then pushed amounts down into the assets of Manufacturing Co.

As part of the ACA calculation, the amount that Widget Co would have included at Step 2 in relation to the financial liabilities assumed would have been $700 - i.e. the $1000 liabilities would have been reduced to $700 pursuant to s.705-75(1) as Widget Co would have expected to receive a deduction of $1000 on close-out of the liabilities (note: for these purposes we have assumed that s.705-80 does not apply).

As a result of the changes made by subitem 104B, Widget Co will no longer be entitled to a tax deduction for the $1000 paid on close-out of the liabilities.

As such, the ACA that Widget Co calculated in 2008 will now be made retrospectively incorrect as a result of the proposed changes. In particular, following the proposed changes, Widget Co should have been entitled to a Step 2 amount of $1000 in relation to the financial liabilities assumed (i.e. rather than the $700 originally reflected).

The question then becomes how should this position be rectified?

Under current law, we do not consider that the position is entirely clear – indeed, the position may vary from taxpayer to taxpayer depending on their own particular circumstances.

Relevantly, under Subdivision 705-E if an “error” is made in relation to the amount pushed into a reset cost base asset and it is “unreasonable” to require a recalculation of the amounts involved (i.e. the ACA and amounts pushed into the assets) then a capital gain or loss will arise (under CGT event L6). However, if it is reasonable for the ACA to be amended then the ACA can be amended.

The ATO consider that an “error” will include a retrospective change in law (see paragraph 9 of Taxation Ruling TR 2007/7). As such, the changes introduced by subitem 104B should be an “error” for the purposes of s.705-315(3).

The important question is then whether or not it is unreasonable to require a recalculation of amounts (see s.705-315(3)). Having regard to the factors in s.705-315(4) this is likely to depend on a variety of factors including the amount of changes required, how long ago the ACA calculation was undertaken, the IT systems of the taxpayer (i.e. whether the taxpayer has computer systems which allow it to track the changes easily), etc. Having regard to these factors and the individual positions of taxpayers there is unlikely to be one answer for all taxpayers.

Furthermore, even if a taxpayer has sophisticated computer systems which easily allow it to track all the changes (and make adjustments to future tax returns) it is not clear whether or not that taxpayer can chose to make the adjustments or alternatively is required to simply recognise a capital loss under CGT event L6.

In light of the nature of the retrospective amendments made by subitem 104B in terms of denying taxpayers tax deductions which have arisen in relation to financial liabilities assumed as part of pre-TOFA corporate acquisitions, we consider that it should be made clear that taxpayers that wish to readjust historic ACA calculations in order to reflect the correct amount at Step 2 should be able to do so (this should be the case in relation to both reset and retained cost base assets).

In this regard, it is worth noting that the taxpayers affected by this change will be taxpayers that have elected to un-grandfather their existing TOFA financial arrangements and accordingly are likely to be large taxpayers with sophisticated IT systems that will allow them to track all the changes/adjustments. We consider that it should be made completely clear that such taxpayers should be free to adjust their historic ACA calculations and reallocate ACA if they are able to do this (and that they should be able to do this notwithstanding the extent of the adjustments required).

As these taxpayers will have had tax deductions denied retrospectively in relation to these liabilities they should, at the very least, have the ability to make these historic adjustments.

6 Further specific comments

6.1 Section 715-375(2)(a)(i)

The effect of s.715-375(2)(a)(i) is to reset the tax cost of financial liabilities which are subject to the default accruals or realisation methods. This is despite the original explanatory memorandum to the TOFA provisions clearly stating that this would not be the case (see paragraph 12.43 of the TOFA explanatory memorandum).

Treasury have acknowledged that this change represents a change in law.

Although we do not agree with this amendment, we believe that if this amendment is made then it should not apply retrospectively – the original provisions and explanatory memorandum were clear on this point and taxpayers that had relied on the law as it stood should not be retrospectively affected by this change. In this regard, we reiterate the comments at section 4 above.

6.2 Section 715-375(2)(a)(ii)

We are uncertain precisely what Treasury is intending to achieve in relation to resetting the tax cost of liabilities that will be subject to the hedging method. In particular, is the resetting process relevant to the hedging financial arrangement or the hedged item – we assume the hedging financial arrangement?

Furthermore, in the context of the hedging method, we are not sure that there is any need to have a starting value as the gain or loss recognised in relation to the hedging financial arrangement will simply be the overall gain or loss that the taxpayer makes from the arrangement (s.230-300(2)). Furthermore, we are not sure what relevance the Subdivision 230-G balancing adjustment calculations have to the hedging financial arrangement (unless it ceases to be a hedging financial arrangement).

In summary, to the extent that this deeming is necessary in relation to hedging financial arrangements then we consider that the reasons for this should be clearly thought through and articulated in the explanatory memorandum.

6.3 Section 715-375(2)(a)(iii) and (iv)

As a general matter, the TOFA/consolidation interaction provisions are intended to ensure that a taxpayer that acquires another entity can apply the TOFA provisions to the acquired/assumed financial arrangements on a go forward basis – frequently this involves resetting the tax cost of the asset/liability at the accounting value of the asset/liability at the joining time.

The proposed s.715-375(2)(a)(iii) and (iv) involve using accounting values based on the accounts of the joining entity rather than those of the acquiring entity. This has the potential to cause compliance difficulties for the acquiring group which will want to recognise amounts based on the accounting value reflected in its accounts. As such, we recommend that the accounting value of the acquiring entity (rather than the joining entity) is used provided that the accounts of the acquiring entity are audited in accordance with Australian accounting standards.

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6.4 Subitem 104B(4) to (7)

The new subitem 104B(4) to (7) effectively replicate the principles in s.701-61 in relation to pre-TOFA acquisitions.

We assume that any amounts recognised under subitem 104B(6) and (7) (i.e. the four year spread of the differences between the prima facie tax cost of an asset and its Division 230 starting value) will not be reflected in the calculation of a balancing adjustment amount in relation to the asset under Subdivision 230-G (for instance, on disposal of the asset). We believe that this is the effect of the provisions.

Assuming that this is the case then we recommend that this position is clearly reflected in the explanatory memorandum. This could be achieved by including a specific example which reflects this. Alternatively, we consider that this issue could be addressed by the expansion of Example 2.8 – for instance, the asset used in Example 2.8 could have a tax cost of $80 and a Division 230 starting value of $120.

6.5 Interest and penalties

As a general matter, we submit that if the provisions are enacted in their current form (such that retrospective changes of law are made) then taxpayers should not be subject to interest and penalties in relation to any amendments that they are required to make. Assuming that this is the case then this position should be made clear. In particular, there should be no argument that taxpayers have incorrectly lodged historic tax returns (i.e. based on the previous law) such that they would be potentially subject to interest and penalties.

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If you would like to discuss any of the points raised in this submission then please contact either Tony Frost or Andrew Hirst.

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