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Dear Nan

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

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

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

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

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

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

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

First category – taxpayers that made transitional elections

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

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

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

<u>Example – pre-TOFA acquisition</u>

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

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

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

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

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

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

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

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

Second category – taxpayers that made post-TOFA acquisitions

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

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

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

Additional clarification required for accruals and realisation taxpayers

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

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

Yours sincerely

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