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Corporate Tax Unit
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Attention: Mr Tony Regan

Email: treasury@treasury.gov.au

Dear Tony

Restoring integrity to the consolidation regime: Exposure Draft legislation

Thank you for the opportunity to provide a submission on the Exposure Draft (ED) legislation dealing with the proposed tax consolidation amendments. In this submission, we have only provided comments on the application of Part 1, "Acquired Liabilities".

As we have been involved in the Board of Taxation review on these measures (and have been involved in the detailed consideration and review of the policy of the acquired liability measures), we understand the policy reason for making these changes. Accordingly, if these measures are enacted appropriately, we do not oppose the policy decision to make these amendments.

Inappropriate outcomes for middle market taxpayers

Under the drafting contained in the Exposure Draft, we have significant reservations on how these provisions will apply to taxpayers in the middle market, especially in "owned" cases. As outlined by the Board of Taxation, an owned case is one that should be excluded from the impact of the current provisions. However, this is not the case under the current drafting which contains numerous items that would seek to inadvertently penalise this group of taxpayers.

Our submission highlights that a newly incorporated group can (inadvertently) be treated as an "acquired" group on formation of the tax consolidated group (due to the timing rule). Furthermore, we highlight that an internal restructure involving a rollover also results in entities being treated as an "acquired" group. In both cases, these measures inadvertently seek to assess the head company for liabilities that have always been owned by the ultimate owners of the group. This is the case, even though the Board of Taxation recommended that "formations" should be completely excluded from the application of these measures.

We also highlight that the provisions do not include an anti-duplication rule. This inadvertently results in a doubling of the measures for all owned cases (again being groups that should be excluded from these measures). The proposed measures also further treat forex gains under Division 775 in an asymmetrical manner as compared to forex losses. We note that this outcome does not occur for the "larger" taxpayers that apply Division 230, as the interaction provisions for Division 230 excludes all forex gains and losses. Again, we highlight that the impact of this will be borne by those taxpayers in the middle market who will not be treated in a similar manner as compared to the larger taxpayers. We believe that it would be relatively simple to address this issue and we have provided a number of suggestions for addressing this issue.

While there are a large number of additional items we have highlighted in this submission, our main taxpayer base that we represent is the middle market. Accordingly, the issues highlighted above are (by far) the most critical for this taxpayer group. We note that these issues raised are not theoretical and are issues that have been encountered in practice. We have outlined possible solutions to each issue to detail how these issues can be addressed in an appropriate manner.

<u>Prospective application date</u>

We also note that no taxpayer would have anticipated the extent of these changes and how they would apply to their taxation affairs from 14 May 2013. Accordingly, and consistent with the Board of Taxation recommendation, these measures should have a prospective application date.

We note that the 2013-14 Budget estimated the cost to revenue would be approximately $120 million up to 30 June 2015. We believe that this is a relatively small cost for ensuring certainty for taxpayers going about their affairs in a bona fide manner.

As we understand that the application date is a question for the Minister, we will also be providing this submission to the Minister to ensure that appropriate consideration be given to this issue.

<u>Stick option is critically required for middle market</u>

Finally, we highlight that in all of the cases outlined above, being owned cases, these issues would not occur if the Government sought to provide a "stick option" for formation cases as recommended by the Board of Taxation. We again stress the importance of this option for middle market taxpayers to eliminate unintended outcomes on forming a tax consolidated group. As these provisions already exist (in a transitional sense), we highlight that it would be very simple to draft this measure.

We would be happy to discuss the issues raised in this submission with you at any time. Please contact me on (03) 8610 5170 or on email at alexis.kokkinos@pitcher.com.au.

Yours sincerely

A M KOKKINOS
Executive Director

1 Application date

1.1 Recommendation

Recommendation 1
We would recommend that, consistent with the recommendation of the Board of Taxation, the deductible liabilities measure be introduced with a prospective application date.

1.2 Outline of issue

1.2.1 We highlight that there are currently a large number of outstanding issues with respect to the way in which the deductible liability measure is intended to operate. However, this is expected, simply because the new measures represent a fundamental change to how the tax consolidation provisions have operated in the past and thus even the Board of Taxation expected significant consultation to occur to ensure that the measures would be drafted in an appropriate manner.

1.2.2 That is, the Board of Taxation stated the following at paragraph 2.79 of their report to the Assistant Treasurer.

> **APPLICATION DATE OF CHANGES**
>
> 2.79 The Board considers that, if the alternative approach is implemented, the changes should apply prospectively. In this regard, as details of the changes will need to be further developed during their implementation, consideration should be given to applying the changes to joining events under transactions that commence after the date amending legislation is introduced (rather than the date of announcement).

1.2.3 As the alternative approach has been adopted as the legislative solution and given the large number of interaction issues (as evidenced by this submission and other submissions), it is not possible to expect that taxpayers could have anticipated the effect of this legislative package from 14 May 2013.

1.2.4 It is noted that the whole legislative package of measures was only anticipated to have a revenue impact of $10 million for 2013-14 and $110 million for 2014-15. Accordingly, if these measures were made to be prospective from the date of introduction into Parliament (as recommended by the Board of Taxation), it would appear that the revenue cost impact would be approximately $120 million (assuming that 100% of the revenue amount in the Budget solely related to the deductible liabilities measure).

1.2.5 In the middle market, there is a lot of angst at the moment where transactions are being potentially caught up within the provisions inadvertently. For example, as outlined in this submission, newly formed tax consolidated groups are being treated as 100% acquired if the formation occurs within a short time of incorporation. Furthermore, internal restructures are also giving rise to acquired groups. We are significantly concerned that these types of taxpayers could not (in any way) have anticipated the legislation and its impact.

1.3 Suggested solution

1.3.1 We are strongly of the view that the legislation should have a prospective application date so that taxpayers can operate with some degree of certainty with respect to the measures.

2 Definition of owned

2.1 Recommendation

Recommendation 2
The proposed definition of owned does not work where there are newly created entities. We recommend that the definition of owned be changed so that the amount that is owned is determined by considering the amount that has been acquired (rather than the other way around).

2.2 Outline of issue

2.2.1 The definition of owned in proposed section 716-425 is determined under subsection (3). The term "acquired" is thus determined by taking this amount and subtracting that amount from 1. Accordingly, if the owned formula does not work, an entity is deemed to be acquired 100%.

2.2.2 This anomaly becomes readily apparent where there are newly incorporated entities. For example, assume that a subsidiary (NewCo) is incorporated 2 months before consolidation.

2.2.3 As the tax consolidated group would not have held an interest in NewCo either 12 months prior or four years prior to formation, the formula in subsection 716-425(3) results in nil divided by nil (i.e. nil). Accordingly, the newly incorporated entity is deemed to be acquired 100%, even though all of the liabilities are (in reality) owned liabilities of the tax consolidated group.

2.3 Suggested solution

2.3.1 It is believed that this would be a relatively easy item to correct. That is, currently the proposed subsection 716-425(3) and (4) looks at the membership interests that are owned. However, if this provision instead looked to determine the membership interests that are "acquired", then subsection 716-425(1) could be determined by examining the liability and reducing it by the acquired amount.

2.3.2 To demonstrate, subsection (3) could be redrafted so that it looked at the total of membership interests held at a particular time by entities that are not part of the tax consolidated group (as a comparison to the total membership interests in the relevant entity).

2.3.3 In the example previously provided, as no shares would have been owned in NewCo either one year prior or four years prior to forming the group, the acquired proportion would be nil. Accordingly, if the owned portion were defined as the total liability less the acquired portion, then 100% of the liabilities would be taken to be owned.

3 Definition of “owned” for rolled entities

3.1 Recommendation

Recommendation 3
The definition of “owned” that has been used in section 716-425 looks at shares held. Accordingly, any rollover that occurs in an “owned” cased will result in acquired liabilities. This will exacerbate and significantly increase the double tax issue that is encountered by entities that form a tax consolidated group subsequent to an internal restructure involving a rollover. This is a highly inappropriate outcome that needs to be addressed. We have provided a simple mechanism to address this issue. We do not accept that this situation should result in a taxable position to the group.

3.2 Background to issue

3.2.1 The Board of Taxation report requested that there be an exclusion for the “formation” case (para 2.69). To the extent that the formation is an owned formation, this recommendation would remove inappropriate outcomes that could occur for owned groups that form a tax consolidated group. However, this exclusion is not contained in the legislative package.

3.2.2 Without such an exclusion, we highlight that for middle market taxpayers, the definition proposed for “owned” in section 716-425 will be appropriate. This is because the formation will typically occur due to an interposition of a new holding company. For example, the interposition of a holding company under either Subdivision 615-A or Subdivision 122-A. The same occurs where an entity is rolled under Subdivision 124-M and the historical cost base is used as the entity is closely held.

3.2.3 Under all of these rollovers, the head company will only have “held” the shares from the time of the rollover. Accordingly, if the group forms a tax consolidated group the following day, all liabilities will be considered acquired liabilities as (for the purpose of section 716-425(2)), the members of the consolidated group would not have held shares for more than 12 months or four years.

3.2.4 Therefore, all of the owned liabilities will become acquire liabilities in this case. As the rollovers also deny such entities from including profits at step 3, this would essentially result in a reversal of all profits and all liabilities, thereby almost creating a “double tax” if not “triple tax” impact for SME groups using rollovers to form a tax consolidated group.

3.3 Suggested solution

3.3.1 It is requested that Treasury either consider:

(a) An appropriate exclusion for acquired liabilities for rollover entities; or

(b) An appropriate exclusion for a formation case which occurs; or

(c) A stick option for middle market taxpayers.

3.3.2 While option (c) is the easiest to draft of the two above (i.e. as the provisions are already in the transitional provisions), we understand that there is a significant chance that this option will not be accepted until the tax consolidation review has been conducted. While this is unfortunate, we understand that this may be the case.

3.3.3 In the alternative, if there is a rollover, then it is requested that the provisions contain a similar rule to that contained in the discount capital gains provisions (being s.115-30). While s.115-30 effectively does the same thing (and while it would be nice to use an existing provision), the provision is not drafted with this issue in mind. Accordingly, we have created a table below that we believe would hopefully deal with the majority of problems that would occur.

Membership interests (the asset) acquired via …	**Deemed time the asset is held by the group …**	**Reason for modification …**
A rollover under Subdivision 122-A	The acquisition date of the asset prior to the rollover.	The liabilities have been effectively owned since that time.
A rollover under Subdivision 122-B	The acquisition date of the asset prior to the rollover.	The liabilities have been effectively owned since that time.
A rollover under Subdivision 615-A	The acquisition date of the asset prior to the rollover.	The liabilities have been effectively owned since that time.
A rollover under Subdivision 124-M which is required to apply the rule in 124-782	The acquisition date (or dates if different original shareholders had different dates) of the asset prior to the rollover.	The rules are only applied if common owners or significant stakeholders exist and therefore the rollover does not really change the economic interests in the liabilities.

Membership interests (the asset) acquired via …	**Deemed time the asset is held by the group …**	**Reason for modification …**
A rollover under Division 125	The acquisition date of the asset prior to the rollover.	This is important where a group demergers an entity and then subsequently rolls the entity into a new consolidated group under 122-A.
A rollover under Subdivision 124-N	The acquisition date of the asset prior to the rollover.	The rollover of shares owned by a trust to a new company is often used to create a consolidated group.

3.3.4 It is believed that a simple table could be included (section 716-440) that deems the shares to have been held for the purpose of applying section 716-425. It is not believed that providing this extension would add integrity issues and it is not believed that drafting such a provision would be overly complicated.

3.3.5 Accordingly, it is requested that Treasury consider appropriately dealing with rollover shares and the deductible liability issue.

3.3.6 Finally, it is again noted that the Board requested that a formation case be excluded from the deductible liability provisions. To the extent that the above is not accepted, we request that the formation exception be considered by Treasury.

4 Owned cases require an anti-duplication rule

4.1 Recommendation

Recommendation 4
In owned cases, or creeping acquisitions, the owned component will give rise to double reductions for the owned liability. An anti-duplication rule is critically required. Difficulties may occur with using section 705-62 to achieve this outcome. Amendments to section 705-62 and to section 716-420 could address this issue to make it absolutely clear. In any event, amendments are required to address this issue and EM examples are required to demonstrate that the anti-duplication rule works in owned cases appropriately.

4.2 Outline of issue

4.2.1 In a very basic owned case, the removal of owned liabilities at Step 2 creates an inappropriate outcome where the liability has also reduced the step 3 owned profits. We have demonstrated this in the example below.

4.2.2 This issue will arise in almost all owned case. It is noted that the law acknowledges this for "tax losses", whereby an anti-duplication rule is contained in subsection 705-100(2). The Board of Taxation tested this issue and made the following recommendation when implementing a rule such as section 716-420(2) at para 4.26 of their report to the Assistant Treasurer.

> 4.26 Although initial testing shows that this would simplify the tax cost setting rules and produce an appropriate outcome, further testing is required to verify this conclusion. Therefore, in implementation, consideration should be given to whether, in relation to the owned component of a liability that is covered by the section 705-80 adjustment, the current adjustment can be replaced with an approach that reduces the amount at step 2 of the allocable cost amount by the amount of the deductible liability.

4.2.3 As demonstrated by the examples below, it is absolutely critical that an anti-duplication rule operate for owned liabilities that are to be ignored under subsection 716-420(2). If this is not included, it will result in CGT event L3 capital gains for owned groups, which would be clearly an inappropriate outcome.

4.3 Example 1 – Owned profits reduced by deductible liability

Outline of example

4.3.1 Assume that a company is incorporated with $10 of share capital and $10 of cash. It derives $200 of sales income and incurs a $100 provision (future deductible). The DTA is equal to $30. The income tax paid is $60. The cash at bank is now equal to $150 (sales after tax of $140 plus $10 of original cash). The balance sheet is as follows.

Item	$
Cash at bank	$150
DTA	$30
Provisions	($100)
Share capital	($10)
Retained earnings	($70)

4.3.1 Applying the proposals, the provision amount of $100 would be considered an "owned" liability. Accordingly, this amount would be ignored at Step 2. This will result in the following ACA amount.

Item	$
Step 1	$10
Step 2	-
Step 3	$70
Total	$80

4.3.2 As the ACA is less than the cash at bank, there would be a capital gain equal to $70 under CGT event L3.

4.3.3 It is noted that this will be a common scenario that is likely to occur in most formation and owned cases. This would be entirely inappropriate for this outcome to occur. This outcome occurs because the liability value has been reduced at Step

2, but has also reduced the Step 3 amount (i.e. by way of an expense). Accordingly, an appropriate outcome occurs due to the duplicated reduction.

Correcting the problem

4.3.4 The amount of the duplication in this example is equal to $70. That is, the amount of the Step 3 reduction for the same liability is equal to $100 (being the expense), reduced by $30 (for the income tax benefit recorded).

4.3.5 To correct this issue, there needs to be an "anti-duplication" increase to the ACA equal to $70. This would result in a total ACA of $150, being an appropriate amount in this case.

4.4 Additional examples outlining the operation of the rule

4.4.1 The following additional examples are provided to demonstrate that an anti-duplication rule would be appropriate in different cases, irrespective of the profit and loss levels of the entity. The following table outlines the examples tested.

Case	**Outcome if an anti-duplication rule is introduced**
1. Owned profits are reduced by a deductible liability	As outlined earlier, the correct ACA is provided in this case.
2. Owned profits with a deductible liability in a subsequent year	The correct ACA is provided in this case.
3. Owned losses incurred after owned profits	The correct ACA is provided in this case.
4. Owned losses only (no owned profits)	The correct ACA is provided in this case.

Example 2 – owned taxed profits subsequently reduced by a provision

4.4.2 The key difference between this second example and the Example 1 is that the provision is expensed in a period after the taxed profits (i.e. not in the same period).

4.4.3 Under the current tax law, the provision would be treated as an "owned loss" under section 705-80. However, the key benefit of the current law is that the owned loss has an anti-duplication rule in section 705-100(2), whereby the reduction to the Step 3 is reversed so that it does not result in a double reduction.

4.4.4 Accordingly, the anti-duplication is currently performed by section 705-100(2) which ensures that there is only one adjustment for the same economic attribute.

4.4.5 Provided that a new “anti-duplication” provision is incorporated into the new provisions, then this would also achieve an appropriate result (i.e. it would provide the same outcome as in Example 1). That is, it would ensure that the Step 2 amount is only reduced to the extent that the amount has also reduced the Step 3 profits.

Example 3 – Entity with owned profits that moves to owned losses

4.4.6 This third example covers a case where an entity has owned profits that moves to an owned loss scenario.

4.4.7 In this example, assume the same facts as in Example 2, however assume the share capital is instead $400. Further, assume that subsequent to the year of taxable income, the entity incurred $300 of deductions and $100 of provisions. Accordingly, the bank account has decreased by $300 in paying the expenses, there is a DTA for losses equal to $90 and a DTA for the provision of $30. The retained earnings is now a negative $140 (retained loss) position. The balance sheet is as follows.

Item	Example 2	Movement	Example 3
Cash at bank	$540	($300)	$240
DTA – Provision	$30	-	$30
DTA – Losses	-	$90	$90
Provisions	($100)	-	($100)
Share capital	($400)	-	($400)
(Earnings) / losses	($70)	$210	$140

4.4.8 If an ACA is performed under the proposals, it would mean that no amount would be included for provisions at Step 2. This would result in the following ACA.

Item	$
Step 1	$400
Step 2	-
Step 3	-
Step 5	($300)
Step 5 – Application of section 705-100(2)	$70
Total	$170

4.4.9 As can be seen by the result, the ACA is only $170, which means that a capital gain of $70 will occur under CGT event L3. This issue occurs simply due to a lack of an anti-duplication rule regarding $70 due to the non-recognition of the liability at Step 2 (whereby that amount has already reduced retained earnings at Step 3).

4.4.10 If the additional amount of $70 is included at Step 2, the ACA would be equal to $240. This would be an appropriate result in this case and would produce the same result that would occur under the current law for owned cases.

Example 4 – owned losses with no prior owned profits

4.4.11 This last example is an adjustment to the prior Case 3, whereby there are no prior taxed profits for the group. It is assumed that the entity is capitalised for $400 of share capital and subsequently incurs $300 of deductions and a $100 provision. The balance sheet and movement is as follows.

Item	Case 2	Change	Case 3
Cash at bank	$400	($300)	$100
DTA – Provision	-	$30	$30
DTA – Losses	-	$90	$90
Provisions	-	($100)	($100)
Share capital	($400)	-	($400)
Retained losses	-	$280	$280

4.4.12 Applying the proposed legislation, the provisions of $100 would be ignored at Step 2. This would produce the following ACA.

Item	$
Step 1	$400
Step 2	-
Step 3	-
Step 5	($300)
Step 5 – Application of section 705-100(2)	-
Total	$100

4.4.13 In this example, the ACA amount of $100 is matched to the cash at bank of $100. As this case does not involve a double reduction due to the provision account (i.e. it is only counted once and it does not reduce the ACA at any other step), no adjustment is necessary. Accordingly, as there is no need for an anti-duplication rule in this case, the provision would not need to operate to produce the correct results.

4.5 Suggested solution

4.5.1 We recommend the introduction of an anti-duplication rule that works with section 716-420(2). Our proposed solution is contained in the next part of this submission.

5 Proposed anti-duplication rule

5.1 Recommendation

Recommendation 5
While section 705-62 is an anti-duplication principle, we highlight that difficulties may arise in trying to apply this section to owned cases. That is, technical difficulties may occur with the interpretation of section 705-62 as to whether there has been a double reduction under two steps by virtue of an <u>income tax law</u>. We have proposed changes to section 705-62 and to subsection 716-420(2) which could address this issue. **However, we highlight that it may be simpler to just include a new provision based on the wording in section 705-100(2) (being the current provision used at Step 5).** EM examples need to be provided to show that the anti-duplication rule works in owned cases appropriately.

5.2 Problems in using the current section 705-62

5.2.1 Section 705-62 is the general ACA provision that ensures that economic attributes do not result in two ACA reductions. This provision therefore aims to ensure that the 7 steps interact coherently. The original EM to section 705-62 appropriately provides an example of a double reduction (Example 5.17). In that example, there is a reduction to the Step 1 amount (due to Subdivision 165-CD), coupled with Step 5 losses of the same amount.

5.2.2 As demonstrated earlier, there is a duplication that occurs to the extent that: (a) the liability is ignored for Step 2 purposes; and (b) the liability has reduced the Step 3 owned profits.

5.2.3 However, the current drafting used in subsection 716-420(2) states that "an amount is not to be added for the joining liability under section 705-70, to the extent of owned part (if any) of the joining liability". That is, there is no reduction to Step 2, it is simply excluded *ab initio*.

5.2.4 The same happens for Step 3. That is, the starting point for Step 3 is the retained earnings, which have already been reduced by the after tax expense. Accordingly, the reduction is not under a provision of the Act, with the starting point being already reduced.

5.2.5 Accordingly, it is it would be unclear as to whether two or more provisions of the income tax law have operated to reduce the ACA for a particular economic attribute. That is, while both Steps are lower than what they would be due to the economic attribute it is unclear that an income tax law has reduced those amounts (or instead whether the income tax law just simply starts at those adjusted amounts).

5.2.6 The drafting of section 705-62 also suggests that (in this case) two or more provisions have not operated. That is, the choice made under subsection (3) requires one to choose which of the alterations made by the two income tax laws is to apply. In the case of the owned profits adjustments, arguably only subsection 716-420(2) would make an alteration. There is no provision in section 705-90 that is altered as it is simply the starting position of owned profits.

5.2.7 Compare this to the drafting contained in subsection 705-100(2). That is, it specifically reduces the Step 5 amount to the extent that the loss has reduced the undistributed profits amount (not by virtue of an income tax law, but instead by virtue of the calculation of the amount).

5.2.8 Accordingly, there would be significant doubt as to whether the current drafting of section 705-62 would operate to provide an appropriate outcome.

5.3 Possible solution 1 – specific anti-duplication rule

5.3.1 The first (and perhaps the simplest) solution would be to introduce a specific anti-duplication rule. This would involve a minor modification to subsection 716-420(2), coupled with a new provision that is based on subsection 705-100(2). That is, subsection 716-420(2) could be redrafted as follows:

> subsection 716-420(2) The amount added for the joining liability under section 705-70 is to be reduced to the extent of the *owned part (if any) of the joining liability. **[i.e. modified version of subsection 716-420(2)]**
>
> ss. 716-420(2A) However, the reduction is not to occur to the extent that it reduced the undistributed profits comprising the step 3 amount in the table in section 705-60. **[i.e. replicated provision of subsection 705-100(2)]**

5.3.2 This simple proposed amendment would correct the issues outlined in the examples in the previous section. Furthermore, as it is based on the current wording of subsection 705-100(2), which is an existing provision dealing with the same issue for Step 5, this would seem to be the easiest modification to draft in dealing with this issue.

5.3.3 It is acknowledged that introducing this type of section would defeat the purpose of having a principle in section 750-62. However, if amendments to section 705-62 would be too difficult, then we would strongly recommend that this alternative approach be taken.

5.4 Possible solution 2 – Modifying section 705-62

5.4.1 In our view, it would be better (systemically) to address the issues with section 705-62 rather than using solution 1. However, it is acknowledged that this proposed solution 2 would be more difficult to implement. Nonetheless, we provide this solution to the problem for consideration.

5.4.2 We highlight that the following proposed amendments would be required to the Exposure Draft to ensure that section 705-62 can operate as intended to avoid a duplication of reductions relating to an owned deductible liability.

(a) Firstly, it is proposed that the wording of section 716-420(1A) be changed so that the amount added at Step 2 under section 705-70 is to be <u>reduced</u> by the owned part (if any) of the joining liability. Accordingly, it is clear that the amount is first included and then is reduced by an income tax law. This is similar to the wording used in the current section 705-75(1), whereby the amount at Step 2 is reduced by the tax effect amount. The proposed wording would be:

subsection 716-420(2) The amount added for the joining liability under section 705-70 is to be reduced to the extent of the *owned part (if any) of the joining liability.

(b) Secondly, an adjustment should be made to subsection 705-62 to make it clear that the alteration described in subsection 705-62(2) can be by virtue of the way in which the amount for the Step has been calculated. That is, if the Step is calculated including or excluding the economic attribute, then this will be considered an alteration

subsection 705-62(2A) To avoid doubt, to the extent that one of the steps mentioned in section 705-60 is calculated after taking into account the particular economic attribute (see subsection (6)), this section is to be applied as though a provision of this Act has operated with the result of altering the relevant allocable cost amount because of the particular economic attribute of the joining entity.

(c) Thirdly, if the mechanism used to avoid the anti-duplication is section 705-62 rather than a special provision, then it should be made absolutely clear that the “economic attribute” can include a part of an economic attribute. Accordingly, while accounting liabilities are listed in section 705-62(6)(e) and profits are listed in section 705-62(6)(a), it is proposed that subsection (7) make it clear that an economic attribute can include a part of an economic attribute.

subsection 705-62(7) To avoid doubt, an economic attribute mentioned in this section can include a part of an economic attribute.

Note: This means that a part of an accounting liability mentioned in paragraph 705-62(6)(e) can be regarded as an economic attribute for the purpose of this section.

(d) Fourthly, the Explanatory Memorandum should include all four examples contained in this document to demonstrate the application (or intended application) of the amended section 705-62 so that there can be no doubt as to how the provision would apply in those basic cases.

6 Subdivision 705-C acquisition

6.1 Recommendation

Recommendation 6
It is recommended that a special rule be considered when Subdivision 705-C is applied and the joining entity has an unamortised section 716-420 amount.

6.2 Outline of issue

6.2.1 The provisions and EM appear silent on how they are intended to operate when a tax consolidated group acquires another tax consolidated group, especially where the former group already has a section 716-420 unamortised assessable amount.

6.2.2 The Board requested that appropriate consideration be given to this issue as it may result in a duplication of the same amount. The Exposure Draft appears to have no consideration of this issue. To demonstrate the issue, the following examples are provided.

Background facts

6.2.3 Aco is acquired by HCo (being a $2 company), where it's balance sheet consists of cash at bank ($2,000), provision for leave – non-current ($100) and share capital ($100). Hco pays $1,000 to acquire the shares in Aco.

6.2.4 On entry, applying the proposals, the ACA would be equal to $2,000, which would be applied to the cash at bank. Furthermore, Aco would be assessable on $1,000 over four years.

Case 1 – Hco is immediately acquired by NHco

6.2.5 Assume that Hco is acquired by NHco immediately after and that Subdivision 705-C is applied. Under section 701-5, NHco would inherit the assessable (unamortised) section 716-420 amount of $1,000. Furthermore, it would also be assessable on a new amount on a subsequent application of section 716-420 to Hco equal to $1,000.

6.2.6 This would mean that NHco would be assessable on $2,000, but would only be able to claim a deduction for $1,000.

Case 2 – Hco is acquired by NHco after two years – deduction equals income

6.2.1 Assume that Hco is acquired by NHco two years after and that Subdivision 705-C is applied. Under section 701-5, NHco would inherit the assessable (unamortised) section 716-420 amount of $500. Assume that Hco has taken a deduction for $500 and that only $500 of the liability remains.

6.2.2 NHco would be assessable on the application of section 716-420, being the $500 of the remaining liability, but would also be able to claim a deduction for $500. However, as NHco would also inherit an addition $500 amount under section 701-5, this would again duplicate the assessable component.

6.2.3 This would mean that NHco would be assessable on $1,000, but would only be able to claim a deduction for $500.

Case 3 – Hco is acquired by NHco after two years – deduction fully claimed

6.2.4 Assume that Hco is acquired by NHco two years after and that Subdivision 705-C is applied. Under section 701-5, NHco would inherit the assessable (unamortised) section 716-420 amount of $500. Assume that Hco has taken a deduction for $1,000 and that the liability has been fully discharged.

6.2.5 Section 716-420 will not apply to NHco on application of Subdivision 705-C, but NHco would inherit a $500 assessable amount under section 701-5.

6.2.6 This would mean that NHco would be assessable on $500, but would not be able to claim a deduction for any amount. This would seem to be an appropriate outcome as this is simply clawing back the deduction claimed prior to acquisition.

6.3 Analysis of the examples

6.3.1 The application of section 701-5 in a Subdivision 705-C case seems like an inappropriate outcome where the liability that gave rise to the original section 716-420 adjustment is still on foot (or has not been discharged). That is, examples 1 and 2 as contained above. Example 3 seems to provide an appropriate outcome as it simply claws back the deductions previously claimed.

6.3.2 It is acknowledged that this is not an easy issue to address. That is, by addressing this issue, it could require taxpayers to “track” the deductible liabilities. However, while this issue may not seem common, it is likely that this issue will occur on most applications of Subdivision 705-C. That is, where one group (new group) takes over another group (old group), where the old group has recently acquired just one entity.

6.3.3 To simplify the solution to this issue, we would recommend that Treasury consider a principles based approach for making an adjustment. This could help to reduce the onus or requirement for including a very prescriptive tracking rule.

6.4 Suggested solution

6.4.1 In our view, this issue could be addressed by stating that any subsection 716-420 amount that is inherited under section 701-5 (the **inherited amount**) on the application of Subdivision 705-C, is to be reduced to the extent that it is reasonable to assume that the liability (or a portion of the liability) that gave rise to the inherited amount is also taken into account under Subdivision 705-C. The provision could specifically state that the object of the provision is to avoid double counting the same amount twice under section 716-420.

6.4.2 We would recommend that Treasury consider this proposed adjustment, as recommended by the Board of Taxation at paragraph 2.68 of their report.

7 Forex provisions

7.1 Recommendation

Recommendation 7
It is unclear why the proposed section 716-430 is limited to forex event 4. This will create asymmetry as between forex losses and forex gains on entry and exit, as the deductible liability measure applies to all forex events, while the gain measure is limited to forex event 4. This (in our view) is not an appropriate outcome. It also creates a bias for large business taxpayers that apply Division 230, whereby all forex gains of the joining entity are excluded by virtue of section 715-375.

7.2 Outline of issue

7.2.1 It is unclear why the provision has been drafted so that the only liability that is picked up is a forex event 4 liability. It is understood that the Board's testing included swaps, which included forex denominated swaps, and thus there is no reason to limit this provision.

7.2.2 Furthermore, to the extent that a forex swap (that is not a Division 230 financial arrangement) is a deductible liability, section 716-420 will apply to the liability irrespective of whether it involves forex event 3, 4 or 5. However, if the liability will result in a gain, it is unclear why swaps have been removed from this provision by virtue of limiting the section to forex event 4.

7.2.3 Accordingly, limiting forex gains to forex event 4 will not provide asymmetry between gains and losses on forex related amounts.

7.2.4 By way of an example, assume that there is a foreign currency swap where the taxpayer will receive foreign currency and pay Australian currency. The swap may have an unrealised gain, however this will not trigger forex event 4 9as it does nto involve an obligation to pay foreign currency). We cannot understand why this would be excluded from the provisions by virtue of paragraph (c)(ii).

7.2.5 Furthermore, we highlight that if forex event 3 applies to this swap, the event is triggered by the receipt of an amount of foreign currency rather than the payment of an amount. Accordingly, paragraph (c)(i) should not be drafted as being limited to payments.

7.2.6 Finally, limiting the provision to Division 775 is also unwarranted. That is, to the extent that none of the provisions in Division 775 apply, the amount may be assessable as ordinary income. An inappropriate outcome would occur if no deduction is provided for this forex related amount. Again, where the same outcome occurs with respect to a forex liability that is outside of Division 775, section 716-420 will still apply if a deduction is claimed under section 8-1. We note that there are a large number of forex liabilities that do not fall within Division 775 (due to the specific drafting of Division 775).

7.2.7 This provision is unlikely to apply to the "big end of town" as those taxpayers apply Division 230 to foreign currency. However, for middle market taxpayers, this is a crucial provision. Accordingly, we highlight that it is not appropriate that asymmetry should occur as between 716-420 and section 716-430 with respect to deductible forex liabilities.

7.3 Suggested solution

7.3.1 We recommend that Treasury make the following adjustments:

(a) The removal of the requirement in subparagraph 716-430(1)(c)(ii) that forex event 4 must apply to the joining liability.

(b) The requirement that there be a "payment" in subparagraph 716-430(1)(c)(i) should be removed so that the words read as follows "the head company had discharged the joining liability for an arm's length amount".

8 MEC Groups

8.1 Recommendation

Recommendation 8
It is unclear how a MEC group will be required to determine the owned and acquired component. We would recommend that Treasury provide clarity on this issue.

8.2 Background to issue

8.2.1 The Board requested consideration as to whether the provisions will work appropriately for MEC groups. We are unclear if the provisions being proposed determine the correct owned or acquired liabilities where an ET1 is brought into the group holding shares in a subsidiary entity.

8.2.2 By way of example (Example 1), assume the Top Company acquires a new ET1 and subsidiary entity. Assume the ET1 has held the shares in the subsidiary for 10 years. In this example, will the shares in the subsidiary be considered owned or acquired?

8.2.3 Examining the definition proposed in section 716-425(2), it is assumed that (as no member of the consolidated group held any interest in the subsidiary either 12 months or four years prior) the liabilities would all be treated as acquired. Accordingly, this example may operate appropriately.

8.2.4 However in a second example (Example 2), take the same facts, but the Top Company now has owned 80% of the shares in ET1 for 10 years (which in turn has held 100% of the shares in the subsidiary).

8.2.5 In this example, one would expect the “owned” component to be 80%. However, the only modification that appears relevant is section 719-160(2), which treats the ET1 as being a part of the head company of the group.

8.2.6 However, accessing this rule in this is section 719-160(2) would mean that the subsidiary may be treated as owned in both Example 1 and Example 2. That is, (via the entry history rule) if section 719-160(2) treats the head company as owning the shares for the prior 10 years, it would seem to:

(a) Apply in both Example 1 and 2 to treat them both as owned; and

(b) Would include 100% of the shares in both cases, as the ET1 has always owned 100% of the subsidiary (i.e. whereby 80% is the correct result in example 2).

8.3 Suggested solution

8.3.1 If the analysis outlined above is not correct, then it is believed that the EM should explain how the new provisions interact with subsection 719-160(2) to ensure an appropriate outcome occurs. It would be greatly appreciated if the two examples contained above are included in the EM to demonstrate how an "owned" and an "acquired" case works in a MEC group.

9 Deferred tax liabilities

9.1 Recommendation

Recommendation 9
We understand that a previous version of the Exposure Draft contained amendments to remove deferred tax liabilities. We would strongly support the reintroduction of those amendments, with a prospective application date.

9.2 Background to issue

9.2.1 We do not have further information to add on this item. We support the removal of deferred tax liabilities from both entry and exit calculations and would support the introduction of this measure with a prospective application date.

10 Entry and exit rule

10.1 Recommendation

Recommendation 10
It is unclear why paragraph (d) has been included in section 716-435. We would recommend that this be clarified in the EM.

10.2 Background to issue

10.2.1 It is unclear why paragraph 716-435(d) is limited to arrangements involving CGT events.

10.2.2 That is:

(a) Why the provision should apply if there is simply a disposal of 1 share within 12 months.

(b) Why the provision would not apply if there is an exit via an issue of one share (in contrast to the previous paragraph).

(c) Why the provision would not apply if there is an exit via an issue of shares followed by the disposal of the shares.

10.3 Suggested solution

10.3.1 If there is a reason for introducing paragraph (d), it should (at the very least) be explained in the Explanatory Memorandum. The EM should explain the difference between an issue of shares versus a disposal of shares and why the provision is targeted at one transactions versus another.