



Australian Government

The Board of Taxation

POST IMPLEMENTATION REVIEW OF CERTAIN ASPECTS OF THE CONSOLIDATION TAX COST SETTING PROCESS

A Report to the Assistant Treasurer

the **board** of **taxation**
www.taxboard.gov.au

The Board of Taxation
April 2013

the **board** of **taxation**

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FOREWORD

The Board of Taxation is pleased to submit this report to the Assistant Treasurer following its post-implementation review of certain aspects of the consolidation tax cost setting process. This report forms part of the Board's *consolidation post-implementation review*.

The Board split the *consolidation post-implementation review* into two stages. The first stage focused on the policy framework for the consolidation regime, the operation of the single entity rule, interactions between the consolidation regime and other parts of the law, and the operation of the consolidation regime for small business corporate groups. The Board has completed its consideration of these issues and provided its report to the Assistant Treasurer in June 2012.

In the second stage of this post-implementation review, the Board reviewed the tax treatment of liabilities and the tax cost setting treatment of goodwill in the consolidation regime. The Board also looked further into the treatment of deferred tax liabilities and the interaction between the consolidation regime and certain parts of the capital gains tax (CGT) rules.

The Board has made a number of recommendations and proposed a range of options that the Government could consider to address the issues raised in this review.

The Board established a Working Group chaired by Keith James to oversee the review. In the course of the review, the Board conducted consultations with stakeholders, issued a Discussion Paper and received 10 submissions. The Board would like to thank all those who so readily contributed information and time to assist the Board in conducting the review.

The Board would also like to express its appreciation for the assistance provided by Alexis Kokkinos, Andrew Mills and Ken Spence, engaged as consultants to the Working Group, and to Paul Lyon, Peter Murray, Wayne Plummer and Tony Stolarek as members of the Expert Panel, in addition to the assistance received from the Treasury and the Australian Taxation Office (ATO).

The *ex officio* members of the Board - the Secretary to the Treasury, Martin Parkinson PSM, the Commissioner of Taxation, Chris Jordan AO, and the First Parliamentary Counsel, Peter Quiggin PSM - have reserved their final views on the recommendations in this report for advice to Government.



Teresa Dyson
Chair, Board of Taxation



Keith James
Chairman of the Board's Working Group
Deputy Chairman, Board of Taxation

EXECUTIVE SUMMARY

1. On 3 June 2009 the Government announced that it had asked the Board of Taxation to undertake a post-implementation review of certain aspects of the consolidation regime.
2. During the course of this review, on 30 March 2011, the Government requested that the Board conduct a review of the consolidation rights to future income and residual tax cost setting rules.¹ The Board concluded this review and provided its findings to the Government in a report dated 31 May 2011.²
3. The Board provided its report on the first stage of the post-implementation review of certain aspects of the consolidation regime to the Assistant Treasurer in June 2012 (the 2012 Consolidation Report). The first stage focused on the policy framework for the consolidation regime, the operation of the single entity rule, interactions between the consolidation regime and other parts of the law, and the operation of the consolidation regime for small business corporate groups.
4. The Board noted in its June 2012 report that the Board considers that the consolidation regime has delivered substantial efficiency and integrity improvements to the Australian tax system when compared with the income tax grouping rules which wholly-owned groups previously had to apply. However, the Board also acknowledged that there is substantial complexity in the operation of the consolidation regime and its implementation has been attended by some difficulties.
5. In the second stage of this post-implementation review, the Board reviewed the tax treatment of liabilities and the tax cost setting treatment of goodwill in the consolidation regime. The Board also looked further into the treatment of deferred tax liabilities and the interaction between the consolidation regime and certain parts of the CGT rules. The Board's investigations and preliminary findings were outlined in its *Post-implementation review of certain aspects of the consolidation tax cost setting process Discussion Paper*³ (2012 Discussion Paper).
6. This report outlines the outcomes of the Board's review following consideration of submissions received in response to its 2012 Discussion Paper, input from stakeholders and further examination of the issues.

1 Media Release No 045 of 30 March 2011 issued by the then Assistant Treasurer and Minister for Financial Services and Superannuation.

2 Board of Taxation, Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules (May 2011).

3 September 2012.

7. A summary of the Board's key recommendations made in this report regarding those aspects of the consolidation regime within the scope of this review is set out as follows:

- Rules should be introduced to include the amount of deductible liabilities added at step 2 of the entry tax cost setting process in assessable income (either over a 12 month period or over a 48 month period following joining time, depending on whether the liability is a current or non-current liability for accounting purposes) (Chapter 2).
- Removal of deferred tax liabilities from the entry and exit tax cost setting process (Chapter 3).
- Removal of the adjustment which applies if the head company's accounting value of a liability is different to the joining entity's accounting value of the liability from the entry tax cost setting process (Chapter 4).
- Removal of the adjustment for unrealised gains and losses on liabilities from the entry tax cost setting process in full acquisition cases (Chapter 4).
- Modifications to the entry and exit tax cost setting rules where there is asymmetry in the recognition of assets and related liabilities (Chapter 5).
- Although no changes to the tax cost setting rules should be made in relation to the goodwill of a joining entity, the impact of changes to the income tax law that were made in 2012 which restrict the tax cost setting rules to assets that are recognised for taxation purposes should be monitored to determine whether any further changes are necessary (Chapter 6).
- If certain recommendations in the Board's 2012 Consolidation Report are not accepted, consideration of systematic rules relating to the interaction of the CGT rollover rules and the consolidation regime (Chapter 7).
- Amendments to the CGT rollover rules where a new holding company is interposed over an existing tax consolidated group under a restructure so that the new holding company is taken to be the new head company of the old consolidated group and no exit or entry tax cost setting calculations are required (Chapter 7).
- Amendments to the CGT event J1 rules to rectify the duplication of capital gains and capital losses made on the disposal of rolled over assets when a subsidiary member that is not an eligible tier-1 entity leaves a multiple entry consolidated (MEC) group (Chapter 7).

8. The Board acknowledges that the date of application of any changes to the law is a matter for Government. However, the Board considers that any changes to the

consolidation regime emerging from this report should apply prospectively. That is, if at the time of announcement of a change there is sufficient clarity and certainty as to how the change will apply, the change could apply to joining events under transactions that commence after the date of announcement. Otherwise, the change should apply to joining events under transactions that commence after the date amending legislation is introduced or enacted.

9. In limited circumstances, there may be scope for consideration for a change to impact on joining or leaving events that happened before the date of announcement. This would be the case, for example, where a change is made to correct a clear and unintended anomaly which results in an outcome that is inconsistent with what was thought to be the original policy intent. In addition, in some cases a retrospective change to the law may be warranted to confirm a long standing view about the operation of the law, where the ATO subsequently takes a contrary view.

10. However, in these cases care needs to be taken to ensure that the change does not have an adverse impact on transactions that were undertaken before the date of announcement. Therefore, to protect taxpayers from being adversely affected by any retrospective changes to the law, consideration could be given to preventing the Commissioner of Taxation from amending prior year income tax assessments to increase the amount of a tax liability. In addition, taxpayers who have received rulings from the ATO, or who have disclosed relevant positions in Annual Compliance Arrangements with the ATO, could be protected from any adverse impact of any retrospective changes to the law.

CHAPTER 1: INTRODUCTION

BACKGROUND TO THE REVIEW

1.1 On 3 June 2009, the Government announced that the Board of Taxation would undertake a post-implementation review of certain aspects of the consolidation regime.

1.2 During the course of this review, on 30 March 2011, the Government requested that the Board conduct a review of the consolidation rights to future income and residual tax cost setting rules.⁴ The Board concluded this review and provided its findings to the Government in a report dated 31 May 2011.⁵

1.3 In its report on the consolidation rights to future income and residual tax cost setting rules, the Board recommended, among other things, that the Government investigate the following two aspects of the tax consolidation rules:

- the treatment of liabilities held by an entity joining a tax consolidated group; and
- whether the tax cost setting amount allocated to any asset held by a joining entity should be capped at the greater of its market value or terminating value.

1.4 The Government announced its response to the Board's *Review of the consolidation rights to future income and residual tax cost setting rules* on 25 November 2011.⁶ As part of this announcement, the Government requested that the Board include the two areas it identified for further investigation into its post-implementation review of certain aspects of the consolidation regime.

1.5 The Board's 2010 *Post-implementation review into certain aspects of the consolidation regime*⁷ Position Paper (2010 Consolidation Position Paper) also identified a number of issues and uncertainties that arise as a result of the interaction of the consolidation regime and other parts of the income tax law, including certain parts of the CGT regime.

4 Media Release No 045 of 30 March 2011 issued by the then Assistant Treasurer and Minister for Financial Services and Superannuation.

5 Board of Taxation, *Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules* (May 2011)

6 Media Release No 159 of 25 November 2011 issued by the then Assistant Treasurer and Minister for Financial Services and Superannuation.

7 Board of Taxation, *Post-Implementation Review Into Certain Aspects of the Consolidation Regime* (October 2010).

1.6 The Board has completed the first stage of this review and provided its *Post-implementation review of certain aspects of the consolidation regime* report to the Assistant Treasurer in June 2012 (2012 Consolidation Report). The timing of release for the Board's report to the public is a matter for the Government to decide. In line with past practice, it is expected that the report will be available at the time the Government releases its response to the report.

1.7 Given the time available and the substantial overlap between the treatment of liabilities and other issues being considered, the Board decided to defer its advice on the following consolidation issues for inclusion in a separate report to the Government:

- the treatment of liabilities;
- the treatment of deferred tax assets and deferred tax liabilities;
- investigating whether the tax cost of assets of entities joining a consolidated group should be capped;
- issues arising in the operation of CGT event J1; and
- issues arising in the interaction between the CGT roll-over rules and the consolidation provisions.

1.8 These issues were explained in detail in the Board's 2012 Discussion Paper. As this report builds on the background and investigative work outlined in the 2012 Discussion Paper, it should be read in conjunction with the 2012 Discussion Paper.

SCOPE OF THE REVIEW

1.9 As stated above, the Board investigated the following aspects of the consolidation regime:

- the treatment of certain types of liabilities held by an entity joining a tax consolidated group;
- whether the tax cost setting amount allocated to any asset held by a joining entity should be capped at the greater of its market value or terminating value; and
- the interaction between the consolidation regime and certain parts of the CGT regime.

1.10 The Board notes that some of the issues raised in different parts of this paper are inter-related and raise complex interactions. The Board has considered these interactions to ensure that the outcomes are coherent before making its recommendations.

REVIEW TEAM

1.11 The Board of Taxation is an independent, non-statutory body established to advise government on various aspects of the Australian taxation system.

1.12 The Board appointed a Working Group of its members to oversee the review. The members of the Working Group were Keith James (Chairman of the Working Group, and Deputy Chairman of the Board), Teresa Dyson (Chair of the Board), Chris Jordan AO (Chairman of the Board until 31 December 2012) and Curt Rendall.

1.13 Alexis Kokkinos, Andrew Mills and Ken Spence were engaged as consultants to assist with the review. The Board also appointed an Expert Panel comprising Paul Lyon, Peter Murray, Wayne Plummer and Tony Stolarek to provide further specialist assistance to the Board in understanding the complex operation of the relevant taxation law and its practical application.

1.14 The Working Group was also assisted by officials from the Treasury and the ATO and members of the Board's Secretariat.

REVIEW PROCESS

1.15 Following the announcement of the review, the Board conducted targeted consultations with key stakeholders. Drawing on these consultations and other information, the Board developed a Discussion Paper which was released on 11 September 2012.

1.16 The Board received 10 submissions (one of which was confidential), in respect of the issues raised in the 2012 Discussion Paper. A list of submissions, other than the confidential submission, is provided in Appendix B.

1.17 The Board acknowledges the assistance provided by those who made submissions to the review. These submissions made a vital contribution to the review and, together with views expressed during consultations, were integral in helping to shape the recommendations contained in this report. Apart from the submission made in confidence, submissions have been published on the Board's website.

1.18 In undertaking this review, the ATO, with the assistance of the Board's engaged consultants, conducted a significant amount of testing of the various options that were being considered by the Board. This testing was integral in helping the Board to reach the conclusions contained in this report with confidence.

BOARD'S REPORT

1.19 In developing this report, the Board considered the views raised by stakeholders in their submissions and at the consultation meetings, and the views of the Board's

consultants and members of the Expert Panel. However, the recommendations made by the Board in this report reflect the Board's independent judgment.

IMPLEMENTATION CONSIDERATIONS

Transitional issues

1.20 The Board's recommendations include changes to both the entry and exit tax cost setting process. During implementation, consideration should be given as to whether transitional rules will be needed where an entity has already joined a tax consolidated group under the current law and subsequently leaves, applying any new rules.

Application date of any changes

1.21 The Board acknowledges that the date of application of any changes to the law is a matter for Government. However, the Board considers that any changes to the consolidation regime emerging from this report should apply prospectively. That is, if at the time of announcement of a change there is sufficient clarity and certainty as to how the change will apply, the change could apply to joining events under transactions that commence after the date of announcement. Otherwise, the change should apply to joining events under transactions that commence after the date amending legislation is introduced or enacted.

1.22 In limited circumstances, there may be scope for consideration for a change to impact on joining or leaving events that happened before the date of announcement. This would be the case, for example, where a change is made to correct a clear and unintended anomaly which results in an outcome that is inconsistent with what was thought to be the original policy intent. In addition, in some cases a retrospective change to the law may be warranted to confirm a long standing view about the operation of the law, where the ATO subsequently takes a contrary view.

1.23 However, in these cases care needs to be taken to ensure that the change does not have an adverse impact on transactions that were undertaken before the date of announcement. Therefore, to protect taxpayers from being adversely affected by any retrospective changes to the law, consideration could be given to preventing the Commissioner of Taxation from amending prior year income tax assessments to increase the amount of a tax liability. In addition, taxpayers who have received rulings from the ATO, or who have disclosed relevant positions in Annual Compliance Arrangements with the ATO, could be protected from any adverse impact of any retrospective changes to the law.

CHAPTER 2: LIABILITIES HELD BY AN ENTITY THAT JOINS A CONSOLIDATED GROUP

BACKGROUND

2.1 Under Australia's income tax rules, the taxation of gains and losses on assets is dealt with more comprehensively than the taxation of gains and losses on liabilities. Some liabilities are dealt with under the general rules, while others are subject to more specific regimes, such as the rules relating to foreign currency exchange gains, limited recourse debt, commercial debt forgiveness, qualifying securities, life insurance companies, general insurance companies and the taxation of financial arrangements (TOFA). However, some liabilities (such as certain gains or losses on liabilities held on capital account) are not currently dealt with under the tax system.

2.2 A number of problems associated with the role of liabilities in establishing the tax value of assets have become apparent since the introduction of the tax consolidation regime in 2002. During the course of the Board's review of the consolidation rights to future income and residual cost setting rules⁸, the Board became aware of various issues that arise in respect of certain types of liabilities included in the tax cost setting process for a joining entity. In particular, these issues arise for liabilities that are ultimately deductible, including derivatives, provisions and foreign currency loans which are liabilities at the joining time. The then Assistant Treasurer asked the Board to consider these issues further.⁹

2.3 The tax costs of most assets held by a joining entity are reset at the time the entity joins a consolidated group under the tax cost setting rules.¹⁰ This systematically prevents the double taxation of unrealised gains or double recognition of unrealised losses in respect of those assets.

8 Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules, Board of Taxation, May 2011

9 Media Release No 159 of 25 November 2011 issued by the then Assistant Treasurer and Minister for Financial Services and Superannuation.

10 The remaining assets 'retain' their historic existing tax costs or are allocated a particular cost.

2.4 In its 2012 Discussion Paper the Board noted that, in contrast to the treatment of assets, the values of liabilities held by the joining entity that are brought into a consolidated group are not reset. Where the head company is subsequently entitled to a deduction for a liability (or part of a liability), this can result in:

- double recognition of liabilities¹¹ – that is, in some cases part or all of the same liability is effectively recognised at both the vendor shareholder level (through lower proceeds on the sale of shares) and at the entity level on payment of the liability; and
- a mismatch of commercial and tax outcomes – that is, in some cases the amount brought to tax does not reflect the commercial outcomes.

2.5 In this regard, unrealised gains and losses on liabilities held by a joining entity that are acquired by a consolidated group are effectively taken into account at the shareholder level. As the consolidation regime does not consistently reset the value of a joining entity's liabilities, if the head company of the consolidated group can deduct an amount in respect of a liability when it is discharged or otherwise changes in value, the unrealised gain or loss is recognised again. As a result, generally, there is a systemic duplication of gains and losses on deductible liabilities.

2.6 In some cases, the double recognition of liabilities can result in a mismatch between commercial and tax outcomes. That is, where a liability brought into a consolidated group by a joining entity is allowed as a tax deduction at the time the liability is discharged or otherwise comes to an end, the head company may obtain a tax benefit, in addition to the greater values for allocation under the tax cost setting process.

2.7 In short, a double tax benefit arises for deductible liabilities because, first, the group can push the value of the joining entity's liabilities into the tax costs of the entity's assets through the tax cost setting process. Second, the group can subsequently deduct the cost of discharging the liabilities.

2.8 The Board notes that the liabilities to which this chapter applies are only deductible liabilities to which subsection 705-75(1) of the *Income Tax Assessment Act 1997* (ITAA 1997) applies¹² that is, where the value of an accounting liability of a joining entity that is included in step 2 of the entry tax cost amount is reduced because

11 The problem was first noted with respect to financial derivatives (that are not in the TOFA regime). The scope was then found to extend to all deductible liabilities (that is liabilities where an adjustment would be made under subsection 705-75(1) ITAA 1997), including the portion of a foreign exchange liability that would be deductible. Further Board investigations found that where there is a foreign exchange liability that would give rise to a gain under the foreign exchange provisions there can be related duplication of the gain that would be made on the liability.

12 Examples of deductible liabilities include financial derivative liabilities that are outside the scope of the TOFA rules, foreign exchange liabilities, provisions for leave and provisions for warranty claims.

the head company is entitled to a future income tax deduction for the liability.¹³ For the purposes of this report, references to 'deductible liabilities' have this meaning.

2.9 Therefore, the proposals in this chapter do not apply to:

- an accounting liability of a joining entity that is included in step 2 of the entry tax cost where an amount of that liability does not give rise to a future income tax deduction; or
- accounting liabilities that are Division 230 financial arrangements that are subject to the TOFA regime.¹⁴

2.10 The Board received a submission from the Financial Services Council as to the application of proposals affecting deductible liabilities to life insurance policyholder liabilities. Although this issue has not been fully explored, the Board agrees that the concerns relating to the treatment of deductible liabilities do not appear to arise in the case of accounting liabilities that are life insurance policy liabilities, where a specified amount is included in step 2 of the entry tax cost setting amount.¹⁵

2.11 Similarly, the concerns do not appear to arise in the case of accounting liabilities that are general insurance policyholder liabilities, where a specified amount is included in step 2 of the entry tax cost setting amount.¹⁶

2.12 The Board also notes that the issues which have been identified generally arise to the extent that all of the interests in an entity are acquired by the tax consolidated group in a single transaction, as distinct from cases where the tax consolidation group has owned an interest in the joining entity prior to the entity joining the tax consolidated group acquiring all of the remaining interests in the entity (that is, the issues generally relate to acquired deductible liabilities, as distinct from owned deductible liabilities).

2.13 However, the Board acknowledges that, during the implementation phase, it may be established that the scope of the proposals needs to be extended to cover a broader range of liabilities.

2.14 In its 2012 Discussion Paper the Board noted the following options which were considered as possible solutions to the deductible liability problem described above:

13 In considering how to resolve this issue the Board has also sought to formulate a solution that may be able to apply, with minimal changes, to gains arising from foreign exchange liabilities.

14 Section 715-375 ITAA 1997 contains special rules to ensure that TOFA liabilities are taxed appropriately.

15 Section 713-520 ITAA 1997 specifies the step 2 amount for certain life insurance policy liabilities.

16 Section 713-715 and 713-725 ITAA 1997 specify the step 2 amount for certain liabilities of general insurance companies.

- Option 1: Deem deductible liabilities to be assumed by the head company, at their accounting value, at the time the entity joins a consolidated group;
- Option 2: Deny the deduction for deductible liabilities (equal to the step 2 amount) after the entity has joined the consolidated group;
- Option 3: Disregard deductible liabilities at step 2 of the entry tax cost amount; and
- Option 4: Deem the acquiring consolidated group to have realised a capital gain at the joining time equal to the final step 2 amount for deductible liabilities.

2.15 The Board sought stakeholder comment on its preferred solution – to deem deductible liabilities to be assumed by the head company, at their accounting value, at the joining time (Option 1). Advantages of this option are that it would have the effect of removing the double taxation of gains and losses on liabilities and that it produces the correct tax cost setting outcomes in a full acquisition case.

VIEWS FROM SUBMISSIONS

2.16 Submissions received generally agreed with the Board’s identification and analysis of the issue that there can be potential for double recognition of deductible liabilities as part of the tax consolidation cost setting process.¹⁷

2.17 However, many submissions raised concerns about the Board’s preferred solution that is, Option 1. Some submissions noted that this would significantly increase the compliance burden on taxpayers.

2.18 The submission from the Institute of Chartered Accountants in Australia noted:

Although option 1 might appear to be simple in its design, it would still require taxpayers to track relevant liabilities that existed at the joining time for purposes of working out any subsequent tax deduction. The option 1 approach seems to be modelled on the TOFA rule in section 715-375 (noting that TOFA seeks to recognize a net gain or loss from a financial arrangement), but such an approach is not suited to non-TOFA liabilities where future deductions are generally claimed, for example, as incurred under section 8-1.

....

17 The Board received a joint submission from the Property Council of Australia and the Retirement Village Association raising specific concerns about the treatment of resident loan liabilities and capital growth payments under the tax cost setting rules. Given the specific nature of these concerns, they have not been considered during the course of conducting this view. However, the Board considers that the issues raised by the Property Council of Australia and the Retirement Village Association should be considered during the implementation of the Board’s recommendations.

The Institute is very concerned about the additional compliance costs associated with either of options 1 and 2 and therefore recommend either option 2 but with administrative shortcuts or option 3.

2.19 This concern was also raised in the submission from CPA Australia, which noted:

...we anticipate that the Board's preferred solution will give rise to a significant compliance burden for taxpayers, in particular SMEs, who will be required to track deductible liabilities after the joining time.

2.20 The Corporate Tax Association noted the following in this regard:

The CTA would not support an Option 1 approach as the *Income Tax Assessment Act* does not currently contain a comprehensive and prescriptive regime for regarding liabilities as having a 'tax value' and for dealing with gains in respect of liabilities (other than the TOFA regime in the context of financial arrangements and certain FX transactions). Without a comprehensive and prescriptive liability regime an Option 1 approach would appear to be extremely problematic.

2.21 Concerns were also expressed in relation to the potential additional compliance costs under Option 2 (deny the deduction for deductible liabilities, equal to the step 2 amount, after the entity has joined the consolidated group), citing a requirement to trace the reduction of relevant accounting provisions which existed at joining time (even if applying a 'first in first out' approach) would be very onerous.¹⁸

2.22 While acknowledging that Option 3 (disregard deductible liabilities at step 2 of the entry tax cost amount) may give rise to distortions, some submissions provided views in support of this option. The Institute of Chartered Accountants in Australia noted:

While we agree that option 3 may give rise to potential distortions in the tax cost setting amounts allocated to assets, it should achieve a significant reduction in the scenarios that might give rise to a duplication of deductions arising in relation to liabilities. Option 3 also has the benefit of easily fitting into the existing legislative framework, likely requiring only minor amendments to section 705-75 and is simple in its application as there is no ongoing monitoring of liabilities that existed at the joining time.

2.23 Submissions that commented in this regard noted that Option 4 (deem the acquiring consolidated group to have realised a capital gain at the joining time equal to the final step 2 amount for deductible liabilities) would not be a suitable solution from a policy and/or an outcome perspective¹⁹ and that it would be inappropriate to create a

18 Institute of Chartered Accountants in Australia.

19 Institute of Chartered Accountants in Australia, Corporate Tax Association.

tax liability at the joining time when the underlying future deduction may not arise until many years later.²⁰

2.24 Two submissions²¹ agreed with the Board's view that there is a duplication of liabilities, but queried whether any amendments to the tax cost setting rules are necessary, noting that recent changes to the TOFA/consolidation interaction provisions²² include an equivalent to the Board's preferred solution. The CPA Australia submission noted the following in this regard:

We note that foreign currency loans would be financial arrangements under the TOFA rules. It is also expected that many derivatives are also likely to be financial arrangements that are subject to those rules. Accordingly, it is only provisions, which are unlikely to be financial arrangements, to which any additional amendments would apply. We query whether it is necessary to introduce amendments simply to deal with provisions, particularly given that the Board's preferred approach is expected to result in significant compliance burden for taxpayers because of the need to track these liabilities after the joining time.

...

This compliance burden will no doubt be more pronounced for small to medium enterprises (SMEs). Furthermore, given that many SMEs may not be subject to the TOFA rules because they do not exceed the relevant asset or turnover thresholds, acquiring consolidated groups that are SMEs will be required to track not just provisions but other liabilities such as out-of-the-money derivatives such as swaps, options or forwards, and unrealised gains or losses on foreign currency loans.

2.25 The Pitcher Partners submission noted the following with regard to progressive acquisitions:

In general we agree with the analysis with respect to Example 2.1 to 2.3 where an entity that is part of a tax consolidated group is acquired by another tax consolidated group. However, we note that the same issue does not appear to arise to the extent that the joining entity has been owned, or partly owned, by the tax consolidated group.

2.26 Many submissions raised concerns with regard to the application date of any changes to the income tax law that are made as a result of the Board's recommendations. Submissions were of the view that, given the complexity of the issues and the significant changes proposed, any changes to the existing tax

20 Institute of Chartered Accountants in Australia.

21 CPA Australia, Deloitte.

22 Subsection 715-375(2) ITAA 1997.

consolidation regime should apply to arrangements that commence after the date legislation is introduced or enacted. However, if the changes are explained in detail at the time of their announcement, they could apply from the date of announcement.

2.27 The Financial Services Council noted:

More generally, any changes recommended by the BoT as a result of its review should be prospective and only apply to acquisitions or arrangements that commence on or after the date in which any amendments are announced by Government...

2.28 The Institute of Chartered Accountants in Australia noted:

...any new provisions should ideally commence from the date legislation is introduced or enacted. In the event that any changes commence to apply from the date a specific announcement is made by Government, it is critical that there is sufficient clarity around how the changes will apply.

THE BOARD'S CONSIDERATIONS

2.29 In working out the scope of the duplication issue arising from deductible liabilities, the Board observed duplication in situations where all the membership interests in the subsidiary had been acquired by the head company in one transaction (the 'full acquisition' situation). However, the duplication was not observed where the subsidiary had been incorporated by the future head company, and therefore had been part of a wholly-owned group which then consolidated (the 'formation' or 'owned' situation).

2.30 Under the current law, the basic case dealt with in the tax cost setting rules is the case where a single entity becomes a subsidiary member of a consolidated group.²³ There are nine steps for working out the tax cost setting amount. Where all the membership interests in an entity are acquired in a single transaction, and the subsidiary immediately joins the consolidated group, only some of those steps are applicable.²⁴

2.31 In contrast, where the membership interests are acquired over a period of time, or there is a delay between the acquisition of all the membership interests and the formation of the group, then all nine steps may need to be considered. In particular,

23 Subdivision 705-A ITAA 1997.

24 The steps of the tax cost setting rules applicable are steps 1, 2, 6, 7 and 8.

adjustments are made to take into account profits, distributions and losses that are owned by the acquiring consolidated group before the joining time.²⁵

2.32 The effect of these rules is that, where the head company has owned all or part of the subsidiary before the joining time, there are adjustments for profits, distributions, pre-joining time CGT rollovers, losses and unrealised gains and losses. To the extent of those adjustments, there is an 'owned' component. An 'acquired' component is one to which the head company has not been commercially exposed prior to the joining time.

2.33 The law makes modifications to the operation of the tax cost setting rules that apply in the basic case in the case of a group formation, the case where a consolidated group is acquired and the case where multiple entities are linked by membership interests.²⁶

2.34 Where an acquisition takes place in stages, that is, it is a progressive acquisition, the current law does not have targeted tax cost setting rules. Rather, the effect of the adjustments to the tax cost setting rules in formation scenarios is to adjust for what has previously accrued to the head company, that is, the 'owned' component. The 'owned' component is broadly worked out by hypothesising what amount would have been received by the head company on membership interests it holds continuously in the joining entity until the joining time.²⁷

2.35 With respect to the deductible liabilities issue, the Board found where the deductible liability was 'acquired' the effect of the liability is duplicated only to the extent it was acquired.²⁸

2.36 That is, in a full acquisition case, the liability is duplicated, and the adjustments to the entry tax cost setting rules operate to reduce the duplicated benefit only by the amount of the future tax deduction available to the group (that is, 30 per cent of the deduction amount).

2.37 Duplication was also observed in scenarios where the deductible liability could be considered to be partly acquired, such as a progressive acquisition, or to the extent that a formation substantively involved an acquired component, such as where the subsidiary holding the deductible liability was acquired by a non-consolidated

25 Sections 705-80 (step 2), 705-90 (step 3), 705-93 (step 3A), 705-95 (step 4) and 705-100 (step 5) ITAA 1997.

26 Subdivisions 705-B, 705-C and 705-D ITAA 1997.

27 Subject to the following assumptions: (1) the amounts were distributed to the holders of membership interests as they accrued; and (2) any interposed entity successively distributed those amounts.

28 In the context of deductible liabilities, the 'acquired' and 'owned' components were determined by considering the percentage of ownership in the joining entity, based on the risks and rewards until the joining time, and applying that percentage to the total deductible liabilities held by the joining entity at the joining time. This amount is the 'owned' component in the context of deductible liabilities; the remainder is the 'acquired' component.

company and then a consolidated group was immediately formed. The extent of the duplication was seen to be related to the proportion of shares that were 'acquired'.

2.38 Conversely, to the extent that a deductible liability was 'owned' the duplication issue was not observed. That is, no duplication was observed in a formation case. Similarly, in a progressive acquisition case, the duplication issue was not observed in relation to the 'owned' component, but was observed to exist to the extent of the 'acquired' component.

THE BOARD'S VIEW

2.39 The Board considers that, within the consolidation regime, the treatment of assets and liabilities should be broadly symmetrical. A key object of the consolidation regime is to systematically prevent the double taxation of gains and a double benefit being obtained from the use of losses that can arise outside of consolidation.²⁹ In the case of gains and losses on assets, the tax cost setting rules are the primary mechanism that is used to achieve this objective. However, as there are no systematic tax cost setting rules for liabilities within the consolidation regime, the Board considers that the consolidation regime should be modified to prevent a double benefit being obtained from deductible liabilities brought into a consolidated group by a joining entity.

2.40 The Board considered the comments received from stakeholders on how to address concerns about the current treatment of deductible liabilities and was mindful that any resolution should aim to balance the elimination of loss and gain duplication on liabilities with the need to minimise compliance costs.

2.41 The Board understands from discussions with stakeholders that, notwithstanding the recent changes to the TOFA/consolidation interaction rules introduced in 2012³⁰, there are still deductible liabilities to which the issues identified by the Board will occur and that these deductible liabilities are significant. Accordingly, the Board is of the view that amendments to the tax cost setting rules to address the issues are still necessary to reinforce the integrity of the rules.

2.42 One of the benefits of the Board's preferred solution, Option 1, was that it is modelled on an existing regime (that is, the TOFA regime³¹). The Board considers that having the liability itself carry the necessary tax adjustment would be a robust approach from a tax law design perspective.

29 Section 701-10 ITAA 1997.

30 Subsection 715-375(2) ITAA 1997.

31 While a TOFA model may have been appropriate for full acquisition cases, further consideration would have been necessary to determine the treatment of 'owned' components or 'acquired' components where an acquisition takes places in stages.

2.43 The Board considered the concerns raised by stakeholders with regard to Option 1 – that tracking the relevant liabilities that existed at the joining time for the purposes of determining any subsequent tax deduction could give rise to an onerous compliance burden for taxpayers. The Board understands that items such as annual leave and long service leave provisions (which can accrue over years and in some cases are calculated actuarially) would be difficult to track. Other examples of provisions that would require tracking would include sick leave provisions and some warranty provisions.

2.44 Stakeholders also raised concerns with regard to the risk that Option 1 would require complex legislative change because of the broad range of liabilities recognised for accounting purposes, as well as the greater risk of unintended outcomes.³²

2.45 Some submissions expressed concerns about the potential additional compliance costs associated with Option 2, arguing that a requirement to trace the reduction of relevant accounting provisions that existed at the joining time would be very onerous.

2.46 Although the Board received support from some stakeholders for Option 3, the Board's investigation showed that Option 3 will give rise to distortions to the tax cost setting amounts allocated to assets in an acquisition scenario. If the amount of the deductible liability is not taken into account in the tax cost setting process, the tax cost setting amount allocated to assets will be understated. As a result, the reset tax costs of those assets will not reflect the commercial cost to the consolidated group of acquiring the assets.

2.47 The Board agreed with stakeholder views that Option 4 would not be an appropriate solution. As noted in the Board's 2012 Discussion Paper, under this option, the head company would not have to track deductible liabilities. However, this option would cause a tax liability to arise at the joining time, resulting in potential cash flow issues and capital/revenue mismatches.³³

2.48 In determining the most appropriate treatment of deductible liabilities, the Board's preference is for a solution that combines the most appropriate tax and commercial outcome with a practical application. With this in mind, the Board considered possible variations of the options, and has ultimately settled on an alternative approach, described below.

32 Institute of Chartered Accountants in Australia.

33 The Board notes that any consideration of this option should include thought as to whether an Option 4 capital gain could be offset against a CGT event L4 or CGT event L8 amount. A capital gain arises under CGT event L4 if, broadly, a joining entity has no reset cost base assets against which to apply excess allocable cost amount (section 104-515 ITAA 1997). A capital gain arises under CGT event L8 if, broadly, the allocable cost amount allocated to a joining entity's reset cost base assets that are revenue assets is reduced (due to the capping rule), and the amount of the reduction cannot be allocated to other reset cost base assets (section 104-535 ITAA 1997).

Alternative Approach

2.49 In considering possible variations of and shortcuts to the Board's options, to ease the added compliance burden on taxpayers, the Board considered the following solution put forward by the Corporate Tax Association:³⁴

However, if Option 2 were to be utilised, then at a minimum, in order to strike an appropriate balance in relation to these compliance issues, the CTA would propose the following approach:

(1) where a taxpayer chooses to do so, future outcomes in respect of future deductible liabilities could be individually tracked such that deductions are progressively denied up to the quantum of the associated liability provision at the joining time;

(2) otherwise, liabilities would be fully deductible as incurred but an amount equivalent to the quantum of the associated joining time liability would be assessable progressively as follows:

- over 12 months from the joining time in respect of a liability that was recognised as a current liability in the accounts of the joining entity; or
- otherwise, over four years in respect of non-current future deductible liabilities.

2.50 In considering the options for addressing the Board's concerns about the treatment of deductible liabilities, the Board concluded that, to give both the appropriate tax and commercial outcome without adding significant compliance costs, an alternative approach based on the Corporate Tax Association's suggestion should apply in preference to any of the specific options outlined in the Board's 2012 Discussion Paper.

2.51 Under this alternative approach, in a full acquisition case, the head company would include an amount in its assessable income equal to the amount of the deductible liabilities at joining time added at step 2 of the entry tax cost setting process over the following periods (spread on a daily basis):

- where the deductible liability is a current liability for accounting purposes, the assessable income would be brought to account over the 12 month period³⁵ following the joining time; and

³⁴ The Institute of Chartered Accountants in Australia agreed with this approach.

³⁵ The 12 month period reflects the short term nature of a deductible current liability and is consistent with the accounting concept of a current liability.

- where the deductible liability is a non-current liability for accounting purposes, the assessable income would be brought to account over the 48 month period³⁶ following the joining time.

2.52 The Board's investigations into this alternative approach showed that it produces a suitable balance between the appropriate overall commercial and tax outcomes within and across consolidated groups and on liquidation in full acquisition cases – that is, in cases relating to the acquisition of a joining entity in a single transaction (where the acquirer did not previously have any membership interest in the joining entity prior to acquiring all of the membership interests of the joining entity).³⁷

2.53 In determining the proposed treatment of deductible current liabilities, the Board considered whether an amount should be included in assessable income immediately after joining the consolidated group or spread over the 12 month period following the joining time. The Board concluded that it would be preferable to spread the assessable income over the 12 month period following the joining time. This will remove the incentive to delay corporate acquisitions to just after the start of an income year to avoid an immediate income tax liability.

2.54 The Board also sought to balance the elimination of loss and gain duplication on deductible liabilities with the need to minimise complexity, uncertainty and compliance costs. The Board accepts that the proposed treatment of deductible non-current liabilities (spreading the assessable amount over a period of 48 months following the joining time) reflects an inexact proxy of when the deduction might be incurred. However, this approach represents a reasonable compromise as it addresses concerns about the compliance costs associated with precisely tracking every type of deductible liability.

2.55 The Board also considered the Corporate Tax Association's proposal to make this alternative approach optional, so that taxpayers who could individually track the deductible liabilities would be given the option to progressively deny themselves the quantum of those deductions in the particular income years. However, in light of the concerns raised by stakeholders with regard to the compliance burden and the

36 The 48 month period which represents a reasonable compromise for bringing deductible non-current liabilities included in step 2 of the entry tax cost setting amount to account into assessable income over a reasonable period of time and is consistent with the period for recognising certain amounts relating to financial arrangements held by a joining entity in certain circumstances (section 701-61 ITAA 1997). The Board acknowledges that, like any arbitrary compliance cost savings rule, the 48 month period may result in distortionary outcomes in some circumstances. However, this approach could be adopted if desired using a longer or shorter period.

37 The degree to which there would be approximate character matching was considered. The Board notes that consolidation as a whole does not match character with any precision, and therefore some degree of mismatch was considered to be acceptable. Further, it was recognised that the tax cost setting process would not perfectly align the commercial cost of each individual asset with the tax cost of membership interests, even if there was overall alignment, and this was also considered to be acceptable.

difficulties with tracking these liabilities, the Board's preference is for the application of the alternative approach to all full acquisitions by a consolidated group.

2.56 Introducing separate rules for taxpayers who could track deductible liabilities would add further complexity to the existing rules and could create opportunities for taxpayers to maximise benefits. Applying the alternative approach on a mandatory basis would minimise tax risk and reduce complexity and compliance costs.

Interaction considerations

2.57 During the course of the Board's review, the Board considered a range of scenarios as to how the alternative approach interacted with the existing tax cost setting rules.

Consequential changes

2.58 The alternative approach involves including an amount, equal to the step 2 amount under the entry tax cost setting rules for deductible liabilities, in assessable income. As a consequence, the entry step 2 amount would no longer need to be reduced for the tax effect of the deduction.^{38, 39} Furthermore, it would no longer be necessary to make similar adjustments under step 4 of the exit tax cost setting rules.⁴⁰

2.59 It should also be noted that the Board's testing is predicated on no amount of the deductible liability being included in the exit tax cost setting process.⁴¹

Integrity concerns

2.60 It was suggested to the Board that recognising income over 48 months could create opportunities for arbitrage. That is, advantages could arise if an entity holding a deductible non-current liability joins a consolidated group and the liability immediately leaves the group with a leaving entity. Similarly, advantages could arise if an entity holding a deductible non-current liability joins a consolidated group in a situation where the group is liquidated within the 48 month year period. Therefore, during the development of legislation to implement this proposal, consideration should be given to specific integrity rules which address these concerns.

2.61 For example, in these circumstances, consideration could be given to introducing a balancing adjustment/recoupment rule to deal with the remaining assessable income amount.

38 Subsection 705-75(1) ITAA 1997.

39 Chapter 4 discusses consequential changes to the adjustment for liabilities that give rise to a future gain or loss (section 705-80).

40 Subsection 711-45(3) ITAA 1997.

41 That is, subsection 711-45(5) ITAA 1997 will operate but subsections 711-45(8)-(10) ITAA 1997 will not operate.

Multiple entry consolidated groups (MEC groups)

2.62 When an entity (other than an eligible tier-1 company) becomes a subsidiary member of a MEC group, the tax cost setting rules apply to reset the tax costs of the entity's assets in broadly the same way that they apply when an entity becomes a member of a consolidated group. Therefore, the Board's proposal relating to the treatment of deductible liabilities will systematically apply to deductible liabilities held by an entity (other than an eligible tier-1 company) that becomes a member of a MEC group.

2.63 However, if the joining entity is an eligible tier-1 company, the tax cost setting rules do not apply to reset the tax costs of the eligible tier-1 company's assets.⁴² Therefore, it follows that the Board's proposal relating to the treatment of deductible liabilities will not apply to deductible liabilities held by an eligible tier-1 company that becomes a member of a MEC group.

2.64 During its investigations the Board has observed that there can be inappropriate outcomes at the level of eligible tier-1 companies and at the level of lower tier subsidiary entities. Therefore, given that there are commercial/tax mismatches in relation to MEC groups more generally, the Board considers that these issues be further examined in implementation.

Foreign currency gains and losses

2.65 As noted above, the duplication issues can arise in relation to the foreign currency loss component of a loan amount. The duplication of a gain can arise where the subsidiary holds a foreign currency loan that has an unrealised foreign currency gain. The Board considers the starting point for tax purposes should be symmetrical treatment of the gains and losses. Unless anomalous outcomes are identified as to why this is not the case, the alternative approach ought to have the effect that a foreign exchange liability in a gain position gives rise to an allowable deduction in a similar way to a foreign exchange liability in a loss position gives rise to assessable income.

Successive acquisitions of existing consolidated groups

2.66 When a consolidated group acquires an existing consolidated group, there are modifications to the tax cost setting rules that effectively treat the joining consolidated group as a single entity.⁴³ The purpose of these rules is to reduce compliance costs.

2.67 The Board considered the interaction of the alternative approach with these rules and found that where a consolidated group acquires an existing consolidated group, the alternative approach resulted in broadly appropriate tax and commercial outcomes. However, the Board also found that successive acquisitions of existing consolidated groups can give rise to certain assessable amounts being duplicated to an extent. This

42 Subdivision 719-C ITAA 1997.

43 Subdivision 705-C ITAA 1997.

can occur where, for example, an entity that joins a consolidated group (the first consolidated group) holding a deductible non-current liability leaves the group taking the deductible liability with it and subsequently joins another consolidated group (the second consolidated group). In these circumstances, the first consolidated group and the second consolidated group may both be taxed on the amount of the deductible liability.

2.68 This issue should be further considered as part of the implementation of the alternative approach to ensure that the amount of the deductible liability is taxed only once.

Formation cases

2.69 The deductible liabilities issues identified generally arise in cases where an entity is acquired by an existing tax consolidated group. To the extent that the subsidiary is 'owned' the same issues do not arise. Accordingly, it is the Board's view that the alternative approach should not apply when a tax consolidated group is formed.

2.70 Issues associated with the treatment of liabilities on formation are further explored in Chapter 4 of this report.

Progressive acquisitions

2.71 In a progressive acquisition, the membership interests in an entity are acquired over a period of time. Therefore, at the time of a subsequent acquisition, the acquirer already 'owned' part of the entity. That is, a progressive acquisition has features of both a formation case and an acquisition case.

2.72 Under the current law, the overall effect of the adjustments⁴⁴ to step 2 of the tax cost setting process is to adjust for the 'owned' amounts of deductible liabilities to remove unrealised gains and losses.

2.73 The Board's investigations showed that, if the alternative approach is applied to both the owned and acquired component of deductible liabilities in a progressive acquisition⁴⁵, there is eventually a commercial/tax match. However, it can initially result in distortions because the full amount of the joining entity's deductible liabilities would be included in step 2 of the entry allocable cost amount and in the head company's assessable income. In comparison to limiting the alternative approach to the acquired component of the deductible liabilities, the tax cost setting amount allocated to assets is overstated and the head company is required to include an excess amount in assessable income.

⁴⁴ Subsection 705-75(1) and section 705-80 ITAA 1997.

⁴⁵ That is, where all of the membership interests of the joining entity is acquired other than through a single transaction.

2.74 Therefore, to prevent these distortions from arising, the alternative approach should apply only to the acquired component of the deductible liabilities. However, due to the nature of progressive acquisitions, it is very difficult to work out the acquired component of the deductible liabilities with any degree of precision. The Board considered three potential 'shortcut' methods which could be applied to determine the acquired component of deductible liabilities in progressive acquisition cases:

- Method 1 – The deductible liabilities of a joining entity at the joining time would be taken to have been acquired by the consolidated group if at least 20 per cent⁴⁶ of the membership interests in the joining entity had been acquired by the group in the 12 month period before joining time. Otherwise, the deductible liabilities would be taken to be owned by the group.
- Method 2 – The deductible liabilities of a joining entity at the joining time would be split into an owned component and an acquired component. The current law would apply to the owned component of deductible liabilities. Therefore, the alternative approach would apply only to the acquired component of deductible liabilities.
 - For deductible current liabilities held by a joining entity at the joining time:
 - : the owned component would be determined based on the percentage of membership interests owned for more than 12 months before the joining time⁴⁷ – for example, if a joining entity became a member of a consolidated group on 1 July 2013 holding deductible current liabilities with a value of \$100, and the group owned 40 per cent of the membership interests in the joining entity on 30 June 2012, the owned component of deductible current liabilities would be taken to be \$40.
 - : the acquired component would conversely be determined based on the percentage of membership interests purchased within 12 months of the joining time – for example, if a joining entity became a member of a consolidated group on 1 July 2013 holding deductible current liabilities with a value of \$100, and 60 per cent of the membership interests in the joining entity were purchased by the group on or after 1 July 2012, the acquired component of deductible current liabilities would be taken to be \$60. Therefore, \$60 would be included in assessable income over the 12 months period following the joining time.

⁴⁶ 20 per cent has been chosen because it aligns with the test in the scrip for scrip CGT rollover provisions (section 124-784A ITAA 1997) for determining when an arrangement is taken to be a restructure. However, this method could be adopted using a higher or lower level percentage of ownership if desired.

⁴⁷ The 12 month period reflects the short term nature of a deductible current liability and is consistent with the accounting concept of a current liability.

- For deductible non-current liabilities held by a joining entity at the joining time:
 - : the owned component would be determined based on the percentage of membership interests owned for more than four years before the joining time⁴⁸ – for example, if a joining entity became a member of a consolidated group on 1 July 2013 holding deductible non-current liabilities with a value of \$600, and the group owned 20 per cent of the membership interests in the joining entity on 30 June 2009, the owned component of deductible non-current liabilities would be taken to be \$120.
 - : the acquired component would conversely be determined based on the percentage of membership interests purchased within four years of the joining time – for example, if a joining entity became a member of a consolidated group on 1 July 2013 holding deductible non-current liabilities with a value of \$600, and 80 per cent of the membership interests in the joining entity were purchased by the group on or after 1 July 2009, the acquired component of deductible non-current liabilities would be taken to be \$480. Therefore, \$480 would be included in assessable income over the 48 months period following the joining time.
- Method 3 – This is similar to Method 2, the primary difference being that the owned component of the deductible liabilities would be disregarded for the purposes of working out the step 2 amount of the entry tax cost setting amount (as opposed to applying the current law). Here, the deductible liabilities of a joining entity at the joining time would be split into an owned component and an acquired component using the same methodology as Method 2.
 - The owned component of deductible liabilities would be disregarded for the purposes of working out the step 2 amount of the entry tax cost setting amount⁴⁹ – therefore, in relation to the example outlined in Method 2:
 - : the step 2 amount for deductible current liabilities would be reduced to \$60; and
 - : the step 2 amount for deductible non-current liabilities would be reduced to \$480.

48 The four year period is an arbitrary period for working out the owned component of a deductible non-current liability. However, this method could be adopted using a longer or shorter period if desired.

49 Consistent with Option 3 in the Board’s 2012 Discussion Paper, as noted in paragraph 2.14 of this chapter.

- The alternative approach would apply to the acquired component of deductible liabilities, so that the outcome would be the same as in Method 2.

2.75 The Board considers that Method 1, as a 'bright line' test, would be more likely to result in the timing of the acquisition of membership interests being dictated by the outcome and is therefore not preferred.

2.76 On this basis, the Board is of the view that Methods 2 and 3 should be further considered during the development of legislation to implement the alternative approach. However, to reduce compliance costs, any shortcut adopted should be mandatory.

Recommendation 2.1

The Board recommends that the income tax law be amended so that:

a) where an entity that has deductible liabilities is acquired by a consolidated group, the head company includes the amount at step 2 of the entry tax cost setting rules for those deductible liabilities in assessable income at the following times:

- where the deductible liability is a current liability for accounting purposes, the assessable income is brought to account over the 12 month period following the joining time; and
- where the deductible liability is a non-current liability for accounting purposes, the assessable income is brought to account over the 48 month period following the joining time;

b) integrity rules be considered where a subsidiary exits with group with a non-current liability, or a group is liquidated, within the 48 month period; and

c) in the case of an entity that is acquired progressively, the assessable amount reflects the acquired component of the deductible liabilities included at step 2 of the entry tax cost setting rules using a shortcut method to work out the acquired component.

UNEARNED INCOME

2.77 It was suggested to the Board that the issues which arise with deductible liabilities may also arise in relation to an accounting liability of a joining entity that is unearned income - for example, where there is an obligation to provide services to a third party after the joining time, where the third party has paid for those services before the joining time, to the extent the amount has been assessed prior to the joining time. This problem is largely apparent where tax recognises the income at an earlier time than accounting would recognise it as revenue.

2.78 The Board has not had the opportunity to fully consider this issue in the context of its consolidation post-implementation review. However, preliminary testing indicates that commercial/tax mismatches may arise. Therefore, the issue should be further explored during the development of legislation to implement the alternative approach.

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).

CHAPTER 3: DEFERRED TAX LIABILITIES

3.1 The Board first raised the issue of deferred taxes within the consolidation regime in its October 2010 Consolidation Position Paper⁵⁰, seeking stakeholder comments on how best to simplify the current treatment of deferred tax assets and deferred tax liabilities.

3.2 In relation to deferred tax liabilities⁵¹, the primary issues identified by the Board are that the current treatment results in:

- a mismatch of commercial and tax outcomes – that is, in some cases a commercial benefit that arises as a result of a change in value of a liability is not taxed; and
- integrity risks and uncertainty.

3.3 The submissions received in response to the Board's October 2010 Consolidation Position Paper acknowledge that the inclusion of deferred taxes, particularly deferred tax liabilities, added complexity to the tax cost setting process. Many of the submissions suggested that the resolution of these issues may need to be a trade-off between the 'correct' result and reducing complexity.

VIEWS FROM SUBMISSIONS

3.4 Submissions received in response to the Board's 2012 Discussion Paper generally supported the proposal advanced by the Board to remove deferred tax liabilities from entry and exit tax cost setting calculations.

3.5 The Institute of Chartered Accountants in Australia noted the following in this regard:

We agree with the Board's proposal to remove DTLs (relating to income tax of the relevant entities) from exit ACA calculations, as the lack of an equivalent to the existing section 705-70(1A) in the exit rules may produce inequitable outcomes. However, introducing an equivalent to section 705-70(1A) in an exit scenario is inappropriate as the vendor would need to factor in the tax treatment actually adopted by the purchaser which may not be ascertainable. Therefore the

50 Board of Taxation, Post-Implementation Review into Certain Aspects of the Consolidation Regime (October 2010).

51 The references to deferred tax liabilities in this paper are references to deferred tax liabilities as calculated under AASB 112. Provisions for other taxes that are not deferred tax liabilities under AASB 112 are not within the scope of this chapter.

best practical solution appears to be a complete exclusion of DTLs from exit ACA calculations.

3.6 The Corporate Tax Association noted:

....on balance the CTA concurs with the preliminary views of the BoT that DTLs should be excised from both ACA entry and ACA exit calculations. In this regard the CTA also notes that this approach would also be consistent with the application of recent amendments which in effect excise deferred tax assets (DTAs) as being assets to which ACA may need to be allocated when an entity joins a consolidated group.

3.7 The Board received varying responses with regard to situations where deferred tax liabilities should continue to be recognised. The Deloitte submission noted the following in this regard:

We advocate for the uniform removal of DTLs from the entry and exit ACA calculations. Exceptions to such an approach would more likely result in confusion amongst taxpayers than achieve any significant benefits.

3.8 Some submissions noted that any potential changes in relation to deferred tax liabilities should be limited to deferred tax liabilities in respect of Australian income tax and should not extend to deferred tax liabilities in respect of any other taxes (such as the minerals resources rent tax, foreign taxes and state taxes).⁵²

3.9 The submission from the Financial Services Council raised an issue with regard to deferred tax liabilities relating to life insurance policyholder assets that are retained cost base assets:

Policyholder DTLs are also a critical element of policy liabilities and must continue to be included in ACA calculations without change. Otherwise inappropriate outcomes will arise.

3.10 The submission from the Institute of Chartered Accountants in Australia also raised an issue with regard to deferred tax liabilities relating to retained cost base assets:

The Institute notes that there will be DTLs in relation to assets whose tax cost is not reset under the tax consolidation tax cost setting rules, or for DTLs arising otherwise than in relation to assets. This is particularly relevant in relation to the 2012 changes to rights to future income (RFI) assets. ...

If there was no limited recognition of such DTLs, then purchasers would factor any potential DTL exposures into the calculation of the purchase price of the

52 Institute of Chartered Accountants in Australia, Corporate Tax Association.

target entity to compensate them for any exclusion of any relevant DTLs from entry ACA calculations On balance, this would be our preferred approach.

Another approach to deal with this issue would be to allow limited recognition of DTLs for assets whose tax cost is not reset under the consolidation tax cost setting rules and/or for DTLs arising otherwise than in relation to assets.

THE BOARD'S CONSIDERATIONS

3.11 The Board's review examined whether there was a continuing need for the recognition of deferred tax liabilities in the entry or exit tax cost setting process in order for there to be a commercial/tax match. These considerations included an examination of deferred tax liabilities arising from minerals resource rent tax and foreign taxes.

3.12 With respect to deferred tax liabilities arising from assets and liabilities that have Australian income tax consequences, the Board observed that there is commercial/tax mismatch under the entry and exit tax cost setting processes.

3.13 On entry, the mismatch arises because the deferred tax liability relating to a reset cost base asset is included in step 2 of the entry tax cost setting rules. As a result a higher tax cost is allocated to the reset cost base asset. This has the effect of reducing the future tax liability when the asset is sold.

3.14 A similar but converse mismatch arises on exit. That is, under the exit tax cost setting rules, the terminating value of assets is included in step 1. This value does not reflect the value of a deferred tax liability relating to the asset. However, the deferred tax liability is included in step 4 of the exit tax cost setting rules. This has the effect of reducing the tax costs of the membership interests in the leaving entity, thereby increasing the taxable gain made by the head company on the disposal of those membership interests, by the amount of the deferred tax liability.

3.15 The Board's investigations show that the same mismatches do not occur in relation to deferred tax liabilities arising from foreign taxes and the minerals resource rent tax. In relation to deferred tax liabilities arising from foreign assets, the mismatch does not arise to the extent that the asset does not give rise to Australian tax consequences. For deferred tax liabilities arising from the minerals resource rent tax, the interactions between the minerals resource rent tax and income tax result in some degree of mismatch. However, the issues that arise are different to those that arise for income tax deferred tax liabilities because minerals resource rent tax is an allowable deduction for income tax purposes.

3.16 The Board considers that the integrity and uncertainty risks associated with Australian income tax deferred tax liabilities are relevant in considering deferred tax liabilities arising from the minerals resource rent tax and foreign taxes. In this regard, the tax cost setting adjustments for deferred tax liabilities are very complex and give

rise to integrity risks. Therefore, the Board is concerned that unnecessary complexity would arise if certain types of deferred tax liabilities continued to be recognised.

3.17 With regard to deferred tax liabilities arising from retained cost base assets, the Board's examination into the application of the 'alternative approach' discussed in Chapter 2 included instances where an asset is recognised as a retained cost base asset which, in turn, results in a deferred tax liability being recognised for accounting purposes.

THE BOARD'S VIEW

3.18 The Board's view is that deferred tax liabilities (including those arising from the minerals resource rent tax and foreign taxes) should cease to be included in both entry and exit tax cost setting calculations.

3.19 The Board considers that this will reduce the circumstances in which the tax outcomes differ from the commercial outcomes. It will also reduce the complexity of the consolidation regime and overcome integrity concerns that arise with the recognition of deferred tax liabilities.

3.20 In this regard, the Board's investigations relating to the alternative approach discussed in Chapter 2 included instances where an asset is recognised as a retained cost base asset which, in turn, results in a deferred tax liability being recognised for accounting purposes. The Board observed that ignoring the deferred tax liabilities resulted in the correct tax and commercial outcomes.

3.21 Accordingly, the Board's testing showed that no exceptions are required in relation to the removal of deferred tax liabilities from the tax cost setting process on entry or exit from a consolidated group. However, during the development of legislation to implement the recommended approach, further consideration should be given to the concerns raised by the Financial Services Council about the impact of removing deferred tax liabilities relating to life insurance policyholder assets.

3.22 While the Board has considered the deferred tax liability issue in conjunction with the issues considered in Chapter 2, the Board's recommendation to remove deferred tax liabilities from the entry and exit tax cost setting calculations is independent of those issues.

Recommendation 3.1

The Board recommends that the income tax law be amended so that adjustments relating to deferred tax liabilities in the entry and exit tax cost setting rules are removed from those rules.

OTHER ISSUES

3.23 The income tax law was changed in 2012 to restrict the application of the tax cost setting rules to assets that are recognised for taxation purposes⁵³ (as recommended by the Board in its *Review of the consolidation rights to future income and residual tax cost setting rules*). One effect of these changes is that deferred tax assets are not recognised for consolidation tax cost setting purposes. In addition, when these changes were made, the concept of an 'excluded asset'⁵⁴ was removed from the tax cost setting rules, on the basis that excluded assets would not be assets that are recognised for taxation purposes.

3.24 It has recently been brought to the Board's attention that these changes may have given rise to unintended benefits in circumstances covered by Taxation Determination TD 2006/57⁵⁵ in relation to deferred tax assets. These benefits will not arise if the Board's recommendation in Chapter 4 to remove the adjustment that arises if a liability is taken into account at a later time for tax purposes than it is for accounting purposes, and, if the accounting and tax treatments had been the same, the group's allocable cost amount would have been different (the section 705-80 adjustment) is adopted. However, if that recommendation is not adopted, these issues should be further explored to ensure that deferred tax assets do not give rise to unintended benefits.

APPLICATION DATE OF ANY CHANGES

3.25 The Board considers that, if its recommendation to remove deferred tax liabilities from the entry and exit tax cost setting process 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).

53 Section 701-67 ITAA 1997.

54 Former subsection 705-35(2) ITAA 1997.

55 Taxation Determination TD 2006/57: Income tax: consolidation: what is an excluded asset under subsection 705-35(2) of the *Income Tax Assessment Act 1997*.

CHAPTER 4: ADJUSTMENTS TO THE VALUE OF LIABILITIES UNDER THE TAX COST SETTING RULES

4.1 This chapter discusses the adjustments to step 2 of the entry tax cost setting process where:

- the head company and the joining entity have a different accounting value of a liability;⁵⁶ and
- a liability of the joining entity subsequently gives rise to tax gain or loss for the head company.⁵⁷

DIFFERENT VALUE OF LIABILITIES FOR THE HEAD COMPANY

4.2 The value of a liability that is included in step 2 of the entry tax cost setting amount is adjusted if the head company's accounting value of a liability is different to the joining entity's accounting value (the subsection 705-70(1A) adjustment). In these circumstances, the step 2 amount is the head company's accounting value.

4.3 The Board's 2012 Discussion Paper sought stakeholder views about the circumstances in which the subsection 705-70(1A) adjustment applies, whether it is relevant only for deferred tax liabilities and whether it should be retained.

Views from submissions

4.4 The Board received mixed responses in submissions about the scope of the subsection 705-70(1A) adjustment. Some stakeholders agreed with the Board's preliminary view that the adjustment is relevant only for deferred tax liabilities and should therefore be removed if deferred tax liabilities are no longer recognised in the tax cost setting process (as recommended in Chapter 3).

4.5 The submission from CPA Australia noted:

We are not aware of any liabilities other than DTLs to which subsection 705-70(1A) applies. We agree that this provision could be repealed if the effect of DTLs is removed from the exit and ACA calculations.

56 Subsection 705-70(1A) ITAA 1997.

57 Section 705-80 ITAA 1997.

4.6 The submission from Deloitte noted:

We have not encountered any circumstances where subsection 705-70(1A) applies to liabilities other than DTLs. Accordingly, if the consolidation rules are amended such that DTLs cease to be recognised for tax cost setting purposes, this provision would no longer be required.

4.7 Conversely, some stakeholders did not consider that the adjustment is currently restricted to deferred tax liabilities. The Institute of Chartered Accountants in Australia noted:

In the Institute's view section 705-70(1A) is not limited in its application to DTLs. The adjustment may apply where the head company's accounting value of a liability is different to the joining entity's accounting value, provided that the head company's value is determined in accordance with the joining entity's accounting principles.

Retaining section 705-70(1A) is necessary particularly if proper regard is to be given to all the factors that have influenced the purchaser's determination of the purchase price of the acquired entity/group (including the reset tax base of underlying assets and the purchaser's assessment of the entity's liabilities): this is particularly valid for 100 per cent acquisition cases (but should not be limited just to those cases).

4.8 The submission from Pitcher Partners noted:

It is difficult to determine whether section 705-70(1A) was intended to be limited to deferred tax liabilities. That is, the words to the provisions are unambiguous in terms that they would apply to any liability of the joining entity.

Furthermore, in our view, it is difficult to suggest that the Explanatory Memorandum to the introduction of section 705-70(1A) was written in a way to suggest that the provision was intended to be limited to DTLs.

1.42 In working out the amount of liabilities to be added under step 2 in working out the allocable cost amount, it is the value of the liability to the joined group and not the value of the liability to the entity becoming a subsidiary member that is the relevant amount [Schedule 2, item 25, subsection 705-70(1A)]. This ensures that the liabilities are correctly valued in working out the cost to the consolidated group of acquiring the entity.

...

Accordingly, whether the Board believes that section 705-70(1A) should be retained would need to have regard to the policy of the provisions, compliance costs, and the integrity of the system.

The Board's view

4.9 The Board agrees with stakeholders who have noted that, in considering whether the subsection 705-70(1A) adjustment should be retained, there should be regard to the policy of the provisions, compliance costs and the integrity of the system.

4.10 The Board remains of the view that the subsection 705-70(1A) adjustment was originally introduced primarily to address a joining entity having deferred tax liabilities. Accordingly, if deferred tax liabilities are no longer recognised in the tax cost setting amount calculation (as recommended in Chapter 3), this adjustment should also be removed.

4.11 The Board has been advised that differences between a head company's accounts and a joining entity's accounts can arise for various reasons, including differences in accounting policies and different methods of calculating fair value. The Board has also been advised that, in practice, material differences between the head company's value and the joining entity's value of an asset or liability are not common, but may occur more frequently in certain industries.⁵⁸ However, where differences arise, the amount involved can be significant.

4.12 The operation of subsection 705-70(1A) is uncertain and open to different interpretations. In particular, there are uncertainties as to whether the difference in value is to be determined based on the accounts of the head company, the accounts of the accounting consolidated group, or solely from the perspective of the joining entity's accounts. This uncertainty results in unintended flexibility as it creates potential arbitrage opportunities and therefore gives rise to integrity concerns. Rules to address these integrity concerns would add further complexity to the tax cost setting rules.

4.13 Therefore, on balance, the Board considers that the removal of the subsection 705-70(1A) adjustment would reduce the uncertainty and complexity of the tax cost setting rules. Furthermore, the Board is of the view that the removal of this adjustment would add to the integrity of the consolidation regime as it would prevent arbitrage opportunities. As there appears to be no overwhelming case to retain the subsection 705-70(1A) adjustment, the Board recommends it should be removed from the entry tax cost setting process.

4.14 In this regard, the Board considers that, if the subsection 705-70(1A) adjustment is removed, any detrimental impact would be reflected in the price paid by a consolidated group for a joining entity.

58 Such as the mining industry, which deals with long-term contracts.

Recommendation 4.1:

The Board recommends that the income tax law be amended so that the adjustment which applies if the head company's accounting value of a liability is different to the joining entity's accounting value of the liability (the subsection 705-70(1A) adjustment) is removed from the entry tax cost setting process.

Application date of any changes

4.15 The Board considers that, if its recommendation to remove the subsection 705-70(1A) adjustment is implemented, the changes should apply prospectively. Given that the changes do not require significant further development, the changes could apply to joining events under transactions that commence after the date of announcement.

LIABILITIES THAT GIVE RISE TO A FUTURE TAX GAIN OR LOSS

4.16 The value of a liability that is included in step 2 of the entry tax cost setting process is adjusted if the liability is taken into account at a later time for tax purposes than it is for accounting purposes, and, if the accounting and tax treatments had been the same, the group's allocable cost amount would have been different (the section 705-80 adjustment). In these circumstances, the step 2 amount is the joining entity's accounting value for the liability increased or decreased by the amount of the difference.⁵⁹

4.17 The purpose of the section 705-80 adjustment is to remove the unrealised gain or loss on the liability at the joining time from the tax cost setting process where the subsidiary entity becomes a joining entity upon the initial formation of a consolidated group.

4.18 The Board's 2012 Discussion Paper sought stakeholder comment on whether the section 705-80 adjustment for unrealised gains and losses is required in full acquisition cases, given that the unrealised gain or loss would be reflected in the price paid for the shares.

Views from submissions

4.19 Submissions received generally supported the view advanced in the Board's 2012 Discussion Paper that the section 705-80 adjustment is not required in full acquisition cases. However, submissions considered that the section 705-80 adjustment should continue to apply in formation cases and in progressive acquisition cases (in respect of the 'owned' component).

⁵⁹ Section 705-80 ITAA 1997.

4.20 The submission from CPA Australia noted:

In relation to the proposed removal of section 705-80, we agree that this provision does not have any practical effect in full acquisition cases.

4.21 Similarly, the Institute of Chartered Accountants in Australia noted:

We support the repeal of section 705-80 in relation to unrealized gain/loss liabilities in a full acquisition case (as the adjustments would typically be nil for either an unrealized gain or loss situation).

In respect of the treatment of liabilities with unrealized gains, arising in creeping acquisition or formation cases, we agree that section 705-80 should be retained in order to provide the correct economic reflex.

The Board's considerations

4.22 The Board's review has shown that the section 705-80 adjustment is not required in a full acquisition case in the entry tax cost setting process. However, there is a need for the section 705-80 adjustment in situations where the unrealised gains and losses accrued to the head company before the joining time. This can arise in formation cases and in relation to the owned component of a progressive acquisition.⁶⁰

4.23 Where no unrealised gains or losses arise in relation to deductible liabilities that have accrued to the head company, there is no need for the section 705-80 adjustment. For example, the acquired component of a progressive acquisition (as defined in Chapter 2) does not require such an adjustment. Nor is an adjustment required in a 'formation case' where there have been no unrealised gains or losses which have accrued between the time a consolidatable group comes into existence and the formation of the consolidated group.⁶¹ In both these situations the Board has observed that appropriate commercial/tax matches can be achieved when the alternative approach (see Chapter 2) is applied.

4.24 The Board notes that the section 705-80 adjustment is often complex and may be unclear in its application. As a consequence the Board considered whether, in all scenarios, it is possible to determine the 'owned' and 'acquired' amounts that relate to a deductible liability. The Board's testing shows that an adjustment should be made to the 'owned' component (to remove any unrealised gain or losses that arise in relation to the deductible liability) and the 'acquired' component should have the alternative approach applied to it.

⁶⁰ See discussion in Chapter 2.

⁶¹ Such as where both the consolidatable group and the consolidated group are formed on the same day.

4.25 Given the complexity involved in applying the current form of the section 705-80 adjustment, particularly when applying it to only a fraction or part of the deductible liability, the Board has considered whether, with the respect to the 'owned' component in a formation case and a progressive acquisition case, the current approach could be replaced with an approach that reduces the amount at step 2 of the allocable cost amount by the amount of the deductible liability.⁶²

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.

4.27 The Board's consideration of the alternative approach discussed in Chapter 2 showed that no amount should be counted for the deductible component of the liability at step 4 of the exit tax cost setting process.⁶³

The Board's view

4.28 The Board remains of the view that the section 705-80 adjustment is not required in a full acquisition case.

4.29 However, the Board notes that the section 705-80 adjustment, or an alternative adjustment that achieves a similar outcome, is required to adjust for unrealised gains and losses on liabilities in situations where these unrealised gains and losses have accrued to the head company before the joining time. This can arise in both formation cases and in progressive acquisition cases (to the extent of the owned amount of the deductible liability).

4.30 Therefore, the Board considers that further consideration should be given to whether the current section 705-80 adjustment mechanism is retained or can be replaced with a mechanism that reduces the amount at step 2 of the allocable cost amount by the owned amount of the deductible liability.

62 Option 3 from Chapter 2.

63 Consideration should be given to ensure that subsection 711-45(5) ITAA 1997 operates in this manner.

Recommendation 4.2:

The Board recommends that the income tax law be amended so that the adjustment for unrealised gains and losses on liabilities (the section 705-80 adjustment) is removed from the entry tax cost setting process in full acquisition cases. In addition, in the case of the adjustment for unrealised gains and losses that have accrued to the head company before the joining time, further consideration should be given to whether the section 705-80 adjustment mechanism can be replaced with a mechanism that reduces the amount at step 2 of the allocable cost amount by the owned amount of the deductible liability.

Application date of any changes

4.31 The Board considers that, if its recommendations to adjust the section 705-80 adjustment are implemented, the changes should apply prospectively. Given that the changes do not require significant further development, the changes could apply to joining events under transactions that commence after the date of announcement.

CHAPTER 5: ASSETS AND LIABILITIES RECOGNISED ON DIFFERENT BASES

5.1 The Board's 2012 Discussion Paper outlined the Board's concern that there may be circumstances in which an asset may be recognised for consolidation purposes but a related liability may be disregarded, or vice versa. This can cause distortions to arise under the tax cost setting rules.

5.2 To overcome these concerns, the Board's preliminary view was that:

- where an asset is recognised under the consolidation tax cost setting rules and a related liability is not an accounting liability, the related liability should be recognised for tax cost setting purposes; and
- where an asset is not recognised under the consolidation tax cost setting rules and a related liability is an accounting liability, the related liability should not be recognised for tax cost setting purposes.

VIEWS FROM SUBMISSIONS

5.3 Submissions generally agreed with the Board's concerns with regard to the potential for distortions as a result of asymmetrical treatment of assets and liabilities.

5.4 The Institute of Chartered Accountants in Australia noted:

The treatment of common securitisation arrangements under the tax cost setting framework is complicated. The proposal for a systemic approach which ensures the congruous treatment of an asset/liability is welcome.

...

The Institute agrees with the Board's preliminary view for resolving this issue, namely that where the asset is tax recognised, so should the accounting liability and where the accounting liability is recognised, and not the related asset, it should be.

Implementation and transitional issues

5.5 While the Institute of Chartered Accountants in Australia submission agreed with the Board's preliminary view, the submission noted that the method for valuing the non-accounting liability would need to be considered. Similarly, the Corporate Tax Association noted the following with regard to the implementation of the Board's suggestion:

In circumstances where an asset is recognised under the consolidation tax cost setting rules but a related liability is not an accounting liability, the BoT is appropriately suggesting that the related liability should be recognised for tax cost setting purposes. However, the Discussion Paper does not outline how the quantum of this additional entry ACA step 2 amount or exit ACA step 4 amount should be determined.

5.6 In addition, stakeholders raised concerns that transitional rules may be necessary where an entity has already joined a tax consolidated group under the current law and then subsequently leaves, applying the proposed new rules.⁶⁴

5.7 These issues should be further considered during the development of legislation to implement the Board's recommendation.

Finance leases

5.8 The tax cost setting rules are modified when an entity that joins or leaves a consolidated group is subject to a finance lease.⁶⁵ The modifications recognise the different treatment of finance leases under accounting standards and the income tax law.

5.9 Some submissions raised specific concerns about the operation of the modification to the tax cost setting rules that applies when a liability of a leaving entity is an obligation to make finance lease payments.⁶⁶

5.10 In this regard, the submission from the Institute of Chartered Accountants in Australia noted that:

We wish to draw to the Board's attention the problems taxpayers encounter when considering the treatment of finance leases created while the leaving entity was a member of a consolidated group and recommend that the Board consider this further.

64 Pitcher Partners.

65 Section 705-56 and subsection 711-45(2A) ITAA 1997.

66 Subsection 711-45(2A) ITAA 1997.

5.11 The Corporate Tax Association submission similarly noted that:

For the avoidance of doubt, the CTA wishes specifically to bring to the attention of the BoT that, contrary to the description in paragraph 5.5, the current exit ACA provisions do not comprehensively address issues associated with finance leases. In particular, subsection 711-45(2A) only makes the appropriate adjustment where the relevant finance lease existed at an earlier joining time, and therefore very anomalous outcomes can arise in respect of finance leases that exist at a leaving time but were not present at an earlier joining time.

THE BOARD'S VIEW

5.12 The Board considers that, in accordance with its preliminary view, modifications should be made to the entry and exit tax cost setting rules where there is asymmetry in the recognition of assets and related liabilities. This asymmetry can arise and result in anomalous outcomes in the case of, for example, finance leases, securitisation arrangements and trading stock consignment arrangements.

5.13 For example, in the case of a mortgage loan securitisation arrangement, where a financial institution's interest in mortgages is equitably assigned:

- the consideration received for the assignment is recognised as an accounting liability and therefore is taken into account under the entry and exit tax cost setting rules; and
- the mortgage loan asset (being the assigned mortgage loan), which is recognised as an asset for accounting purposes, may not be recognised as an asset for tax purposes and therefore may have no tax cost allocated to it under the entry or exit tax cost setting rules.

5.14 As a result, in the case of a securitised asset held by an entity that joins a consolidated group, a mismatch that is beneficial to the group may arise because the accounting liability increases the entry tax cost setting amount but no tax cost is allocated to the securitised asset (the value of the accounting liability is instead allocated to other reset cost base assets held by the joining entity).

5.15 However, in the case of a securitised asset held by an entity that leaves a consolidated group, a mismatch that is detrimental to the group may arise because the accounting liability reduces the exit tax cost setting amount, so that the tax cost allocated to the leaving entity's shares is understated (with the result that the group makes a higher capital gain on the disposal of those shares).

5.16 Therefore, the Board recommends that where anomalous outcomes arise because of the recognition or non-recognition, respectively and alternatively, of an asset or an accounting liability, targeted rules should be developed to deal with the identified issues. That is, in principle, where an anomalous outcome arises because an asset is

recognised for tax cost setting purposes, and the related liability is not an accounting liability, the related liability should be recognised for tax cost setting purposes to the extent that is necessary to address the anomaly.

5.17 Similarly, in principle, where an anomalous outcome arises because an asset is not recognised under the consolidation tax cost setting rules and a related liability is an accounting liability, the related liability should not be recognised for tax cost setting purposes to the extent that is necessary to address the anomaly.

5.18 When an entity that joins or leaves a consolidated group is subject to a finance lease, the law currently makes appropriate modifications to the operation of the tax cost setting rules to recognise the different treatment of finance leases under accounting standards and the income tax law. However, these modifications do not apply when a liability of a leaving entity is an obligation to make finance lease payments, where the finance lease is created during the period that the leaving entity was a member of the group. Therefore, further consideration should be given to a specific exit tax cost setting rule for finance leases created while the leaving entity was a member of the tax consolidated group.

Recommendation 5.1

The Board recommends that the income tax law be amended so that, in principle:

- where an anomalous outcome arises because an asset is recognised under the consolidation tax cost setting rules and a related liability is not an accounting liability, the related liability should be recognised for tax cost setting purposes to the extent that is necessary to address the anomaly; and
- where an anomalous outcome arises because an asset is not recognised under the consolidation tax cost setting rules and a related liability is an accounting liability, the related liability should not be recognised for tax cost setting purposes to the extent that is necessary to address the anomaly.

Application date of any changes

5.19 As a general proposition, the Board considers that any changes to the consolidation regime arising from this report should apply prospectively.

5.20 However, some stakeholders have recently suggested that any changes to address concerns that arise when assets and liabilities are recognised on different bases should apply retrospectively from the date of the primary legislative provisions that is, 2002.

5.21 In this regard, it is apparent that the current law is somewhat ambiguous and potentially operates in a manner that is thought to be not intended. In addition, the Board has been advised that the anomalies which potentially arise under the current

law were not foreseen and were only identified several years after the introduction of the consolidation legislation in 2002.

5.22 Recommendation 5.1 proposes to make a technical correction to the law to correct what is considered to be an unintended anomaly. In contrast, the recommendations in the other chapters of the Board report address issues that are more substantive in nature and require adjustments to the original policy design.

5.23 The Board has been advised that the difficulties identified in this chapter have arisen in practice and that, while these issues are not common, they are not rare one-off situations. More importantly, when the issues do arise, the impact is material and can, in some cases, be significant.

5.24 The Board has also been advised that taxpayers may have taken different positions under the current law. Therefore, the impact of retrospective changes (applying to joining and leaving events that have occurred since the primary legislative provisions were introduced) to the law on the following range of potential classes of taxpayers needs to be considered:

- taxpayers who were unaware of the anomalous outcomes that can arise and lodged tax returns on the basis that no anomaly arose – although the Board is not aware of any taxpayers in this category, a retrospective change to the law would be likely to confirm the position that these taxpayers have already taken;
- taxpayers who were aware of the anomalous outcomes that can arise but lodged tax returns on the basis of the intended policy outcome to avoid the anomaly – the Board has been advised that there are a number of taxpayers in this category and a retrospective change to the law would confirm the position that these taxpayers have already taken;
- taxpayers who were aware of the anomalous outcomes that can arise and altered the way in which they undertook a transaction to prevent the anomalous outcomes from arising – although the Board is not aware of any taxpayers in this category, a retrospective change to the law would have no impact upon these taxpayers;
- taxpayers who were aware of the anomalous outcomes that can arise and lodged tax returns on the basis of the current law – the Board understands that some taxpayers may be in this category and the impact of a retrospective change to the law would depend on the particular taxpayer's circumstances:
 - in the case of a taxpayer joining a consolidated group holding accounting liabilities without a referable accounting asset, a retrospective change to the law would remove an advantageous application of the law as currently enacted;

- in the case of a taxpayer leaving a consolidated group holding accounting liabilities without a referable accounting asset, a retrospective change to the law would remove an anomalous CGT liability; and
- taxpayers who were aware of the anomalous outcomes that can arise and consciously structured transactions to take advantage of the anomaly – although the Board is not aware of any taxpayers in this category, a retrospective change to the law would potentially remove an advantageous application of the law as currently enacted.

5.25 The Board has been advised that many taxpayers have already applied the law as it was thought that it should operate (or altered the way in which they undertook a transaction to prevent the anomalous outcomes from arising). Therefore, it is expected that a retrospective change would support the position taken by those who have lodged on the basis of how it was thought the law should operate.

5.26 Although there is a case for applying Recommendation 5.1 retrospectively, the Board is of the view that it is a question for Government to determine whether or not a change to the law should apply retrospectively. However, the Board considers that, except in highly unusual circumstances, retrospective changes to the law should not disadvantage taxpayers.

5.27 The Board acknowledges that, in this case, the issue is complicated by the fact that a retrospective change to the law would modify the tax cost setting calculations undertaken at the time an entity joins or leaves a consolidated group. Therefore, in a case of a taxpayer who has received a higher tax cost setting amount as a result of the anomaly in the current law, the benefit received may affect, for example, the calculation of gains and losses on the disposal of assets undertaken both before and after any date of announcement and may also affect annual tax returns for periods before and after the announcement date referable to revenue deductions arising in relation to relevant assets.

5.28 Therefore, if the Government decided to apply Recommendation 5.1 retrospectively, the Board considers that, where a taxpayer's entry tax cost setting amount is retrospectively reduced, any tax consequences that arose in respect of an asset before the date of announcement (which would have been worked out on the basis of the original higher entry tax cost setting amount) should be unaffected by the change. That is, the reduced tax cost setting amount would be used only for the purpose of determining tax consequences that arise in respect of the disposal of an asset on or after the date of announcement.

5.29 In addition, to protect taxpayers from being adversely affected by any retrospective changes to the law, consideration could be given to preventing the Commissioner of Taxation from amending prior year income tax assessments to

increase the amount of a tax liability. This is particularly important for any taxpayers in the first two categories mentioned above.

5.30 Further, taxpayers who have received rulings from the ATO, or who have disclosed relevant positions in Annual Compliance Arrangements with the ATO, could be protected from the adverse impact of any retrospective changes to the law, including any impact on tax consequences that arise in respect of assets after announcement but relate to joining or leaving events that occurred prior to that date.

CHAPTER 6: TAX COST SETTING FOR GOODWILL

6.1 During the course of conducting its *Review of the consolidation rights to future income and residual tax cost setting rules*⁶⁷, the Board considered an option to cap the tax cost setting amount for all assets in the consolidation regime at the greater of their market value or terminating value. This would extend the current treatment for revenue type assets in the tax cost setting process to all tax assets.

6.2 In its report on that review, the Board suggested that any excess allocable cost amount remaining after the tax costs of assets are capped could be deemed to be allocated to goodwill (if goodwill exists) or, alternatively, would result in a capital loss under CGT event L4⁶⁸ or L8⁶⁹.

6.3 The Board's preliminary view was that the adoption of this proposal may result in greater neutrality, in most circumstances, between consolidated groups that acquire a business (by acquiring the entity that carries on the business) and entities that acquire the assets of the business directly. However, it may not be the case in all circumstances – for example, where a purchaser, for commercial reasons, is willing or required to pay more than what would otherwise be the market value for the assets of the business.

VIEWS IN SUBMISSIONS

6.4 The general consensus in submissions received by the Board with regard to this issue was that capping the tax cost setting amount for all assets (and not just revenue assets) at the greater of their market value or terminating value would not result in greater neutrality and, in some cases (such as cases of progressive acquisitions), could result in inappropriate outcomes.

6.5 The submission from the Institute of Chartered Accountants in Australia noted:

... we do not consider that the Discussion Paper provides sufficient justification to warrant extending the capping rules to all reset cost base assets.

...

67 Board of Taxation, *Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules* (May 2011).

68 A capital gain arises under CGT event L4 if, broadly, a joining entity has no reset cost base assets against which to apply excess allocable cost amount (section 104-515 ITAA 1997).

69 A capital gain arises under CGT event L8 if, broadly, the allocable cost amount allocated to a joining entity's reset cost base assets that are revenue assets is reduced (due to the capping rule), and the amount of the reduction cannot be allocated to other reset cost base assets (section 104-535 ITAA 1997).

The Institute does not consider that capping the tax cost setting amount for all assets will result in greater neutrality relative to a business acquisition. In particular, tax consolidation limits on tax cost setting for various assets do not precisely replicate the outcomes if the assets had been acquired under asset transactions. As a result, the Institute does not consider that the spreading mechanism causes inappropriate distortion of the tax outcomes.

6.6 The Corporate Tax Association submission noted:

The CTA is very strongly of the view that capping of asset tax values should not be extended to encompass assets held on capital account.

6.7 In particular, stakeholders raised concerns that capping the tax cost setting amount for all assets would result in a skewing of tax cost setting amounts in the case of progressive acquisitions – that is, where the membership interests in a joining entity are acquired progressively over a period of time. The submission from the Institute of Chartered Accountants in Australia noted:

Special rules would need to be developed to deal with creeping acquisitions. In a creeping acquisition it is inevitable that the perception of assets' market values might change from commencement of the progressive acquisition to the end.

6.8 The Pitcher Partners submission noted:

In creeping acquisitions, the proposed capping rule could result in significantly lower tax costs for CGT assets than would otherwise be appropriate. This could give rise to higher tax risks for purchasers that wish to acquire assets under a tax consolidation regime over a period of time (that is, under a creeping acquisition).

6.9 In addition to raising issues related to possible distortions in progressive acquisition cases, the Corporate Tax Association submission noted possible distortions that may arise with regard to rights to future income. The submission noted that:

As a result of the recently enacted provisions of paragraph 705-25(5)(d), ACA allocations (as compared to the relevant market value of assets) will be skewed where the assets of the joining entity are 'rights to future income' (other than a WIP amount asset). These ACA skewing distortions would be further exacerbated by market value capping.... The anomalies created by extending this capping rule as proposed by the BoT would be further exacerbated in situations where the joining entity had no goodwill, such that ACA was required to be allocated to a totally notional non-existent asset.

6.10 Most stakeholders raised concerns with regard to the Board's suggestion to allocate any excess allocable cost amount to goodwill (where goodwill exists). The Institute of Chartered Accountants in Australia noted:

... a resulting excessive allocation to goodwill ... would in practice mean that there would be no recognition for the relevant tax cost unless and until the consolidated group disposes of much or all of its business. The Institute considers this proposal could result in consolidated groups, selling off segments of the joining companies' assets, being denied an appropriate recognition for the relevant cost base allocated to goodwill because those goodwill disposal rules are quite restrictive.

6.11 If such a capping rule were to be introduced, one submission suggested that the tax cost setting amount allocated to goodwill should also be capped at the greater of its terminating value or market value, with any excess remaining to be allocated to goodwill or realised as a capital loss under CGT event L4 or CGT event L8, at the choice of the head company.⁷⁰ Another submission suggested that the excess tax cost setting amount should be treated as a capital loss akin to CGT event L4 or CGT event L8.⁷¹

THE BOARD'S CONSIDERATIONS

6.12 In the Board's view, where a consolidated group acquires a joining entity for a price that exceeds the net market value of the joining entity's non-goodwill assets, the excess price paid really is in the nature of goodwill. The Board remains concerned that, although the tax cost setting rules should produce this outcome, evidence suggests that, in practice, goodwill is sometimes allocated an insufficient tax cost.

6.13 In this regard, from a financial accounting perspective, where an amount has been paid for the acquisition of a business, over and above the value of its assets that are individually identified and separately recognised, this 'premium' has generally been treated as goodwill.

6.14 The tax treatment of goodwill was considered as part of the 1999 Review of Business Taxation. There, the discussion paper noted:

For accounting purposes, goodwill is defined in Australian Accounting Standard AASB 1013 *Accounting for Goodwill* as 'the future economic benefits from unidentifiable assets. Unidentifiable assets are those assets that are not capable of being both individually identified and specifically recognised.'

70 Deloitte.

71 Institute of Chartered Accountants in Australia.

...The accounting and economic concepts of goodwill, on which tax could be based, are logically similar.⁷²

6.15 In recommending at the time that the tax treatment of acquired goodwill be maintained, the Review of Business Taxation report noted:

From a practical perspective, acquired goodwill is normally purchased along with other assets (both tangible and intangible) of a business. As goodwill has no precise meaning, its acquisition cost is the residual amount remaining, consistent with the accounting treatment, after precise values have been allocated to other assets.⁷³

6.16 Maintaining the treatment of acquired goodwill meant that the consideration for it forms part of the acquirer's cost base and that cost is recognised for tax purposes only when the business that the goodwill is part of is disposed of. This is the tax position outside tax consolidation.

6.17 The Board has considered the operation of the consolidation tax cost setting rules in the context of determining the reset tax cost for goodwill.

6.18 In this regard, the tax consolidation regime applies an asset based model (as recommended by the Review of Business Taxation). A fundamental feature of the asset based model is that (unless otherwise specified) the tax costs of a joining entity's assets must be reset upon entry into consolidation.

6.19 The basic principle underlying the consolidation tax cost setting process is that where the tax costs of a joining entity's assets are reset, they are reset at an amount that reflects their respective share of the group's cost of acquiring the joining entity. There are broadly three main steps to work out the reset tax costs of a joining entity's assets.

6.20 First, the head company must work out the 'allocable cost amount' for the joining entity. The allocable cost amount is, broadly, the sum of the amount paid by the head company to acquire the membership interests in the joining entity plus the accounting value of the joining entity's liabilities (although several adjustments are made to this sum).

6.21 Second, the allocable cost amount for a joining entity is reduced by the amount allocated to certain assets (called 'retained cost base assets') which retain their original tax cost. Examples of retained cost base assets are Australian currency, rights to Australian currency, rights to future income (other than work in progress amounts) and units in certain cash management trusts.

72 A Platform for Consultation, Building on a Strong Foundation, Review of Business Taxation Discussion Paper 2, February 1999.

73 A Tax System Redesigned, Review of Business Taxation Report, July 1999 – page 332.

6.22 Third, the remaining allocable cost amount is allocated to the remaining assets ('reset cost base assets'), including goodwill, based on their relative market value. However, for some assets (such as trading stock and other revenue assets) the reset cost is capped at the greater of market value and terminating value.⁷⁴

6.23 The Board notes that the consolidation provisions specifically address synergistic goodwill that accretes to an acquiring consolidated group when an entity joins the group.⁷⁵ Synergistic goodwill essentially reflects the future commercial benefits that may result from a synergy between businesses or assets of the acquired entity and the acquirer. The provisions ensure that synergistic goodwill is taken to be an asset of the joining entity for tax cost setting purposes.

6.24 The ATO has issued a Taxation Ruling⁷⁶ on the identification and tax cost setting of goodwill for the purposes of the consolidation regime. This Taxation Ruling clarifies that the goodwill attached to a business of a joining entity at the joining time includes:

- inherent goodwill attached to the business of the joining entity; and
- any synergistic goodwill accreting to the business of the joining entity because of its association with the acquiring entity's business or businesses.

6.25 The Taxation Ruling specifies that the value of goodwill can be determined using the residual value approach. Under that approach, when a subsidiary member joins a consolidated group, goodwill is identified and valued by working out the sum of the differences between:

- the market value of each business of the entity; and
- the market value of the net identifiable assets of each business of the entity.

6.26 The Board considers that the basic framework upon which the tax cost setting rules were formulated is sound. That is, all of the assets of a joining entity that becomes a member of a consolidated group would be allocated market value tax costs if:

- the allocable cost amount properly reflects the market value of the joining entity's assets;
- the market value of all assets is properly determined; and
- all of the assets were reset cost base assets which receive a market value allocation.

⁷⁴ The terminating value of an asset is, broadly, the joining entity's CGT cost base for the asset.

⁷⁵ Subsection 705-35(3) ITAA 1997.

⁷⁶ Taxation Ruling TR 2005/17: Income tax: goodwill: identification and tax cost setting for the purposes of Part 3-90 of the Income Tax Assessment Act 1997.

6.27 However, the Board notes that, due to the operation of certain specific adjustments under the tax cost setting rules and valuation issues, the outcomes that arise from applying the consolidation tax cost setting rules sometimes result in a skewing of the tax cost allocated to a particular asset. This skewing can result in the reset tax cost for a particular asset being more or less than its market value, depending on particular circumstances.

6.28 In this regard, this skewing arises partly because the allocation process relies on the market valuation of assets. The Board notes that the ATO has published a guide to provide assistance to taxpayers and their advisers (including valuers) on the processes to establish a market value for taxation purposes. The guide recognises a number of different valuation methods that can be used to determine the market value of an asset. The guide recognises that, although the tax law requires a specific market value for an asset to be determined, a valuation method may lead to a range of possible values for that asset. In these circumstances, the valuer is required to explain why the specific market value finally nominated has been adopted. The guide also outlines some valuation shortcut options that can be used for consolidation purposes in some circumstances. In this context, it is apparent that the operation of the tax cost setting rules means that there may be an unintended incentive for market values to be adopted that are consistent with the ATO guidelines but seek to maximise the value of assets that have their tax cost recognised in the short term, and minimise the value of assets (such as goodwill) that have their tax cost recognised in the longer term.

6.29 Skewing also arises because of the policy settings relating to the calculation of the allocable cost amount and retained cost base assets.⁷⁷ For example, under the policy settings for calculating the allocable cost amount, a reduction is made to reflect the anticipated tax benefit of future tax deductions in respect of losses transferred to the group by the joining entity. As this adjustment tends to exceed the commercial value of the future tax deduction, it potentially results in an excessive reduction to the allocable cost amount. This is disadvantageous to taxpayers as it effectively reduces the amount of the reset tax costs for the joining entity's assets.⁷⁸

6.30 In addition, under the policy settings for retained cost base assets, skewing arises if the joining entity's tax cost for the asset is different to its market value.⁷⁹ This may arise, for example, in the case of retained cost base assets that are contractual rights to future income (which will often have a retained tax cost that is less than market value).

77 As a further example, the modifications to the tax cost setting rules for some privatised assets (section 705-57 ITAA 1997) may also cause skewing.

78 Losses held by a joining entity can be transferred to the head company only if certain tests are satisfied and a choice is made the transfer the losses. In some cases, losses are not transferred to the group to prevent the reduction in the allocable cost amount.

79 The Board notes that, in its *Review of the consolidation rights to future income and residual tax cost setting rules*, the Board recommended that contractual rights to future income be treated as reset cost base assets. The adoption of this recommendation would have reduced the skewing that arises under the tax cost setting rules due to the treatment of retained cost base assets.

If insufficient tax cost is allocated to a retained cost base asset, the excess is allocated to the reset cost base assets according to their relative market values. This outcome can be disadvantageous to taxpayers if the allocable cost amount is allocated to an asset which has its tax cost recognised for tax purposes after the time that the right to future income asset comes to an end. However, to the extent that the allocable cost amount is allocated to an asset which has its tax cost recognised for tax purposes before the time that the right to future income asset comes to an end, taxpayers may receive an advantage as a result of this outcome.

6.31 Further, the Board notes that financial accounting treatment for acquired goodwill has changed since the 1999 Review of Business Taxation. Instead of amortising goodwill as an expense (over a period during which benefits are expected to arise but not more than 20 years), asset values are tested for impairment and written off against income only when impairment occurs. Further, goodwill is allocated to each of the acquirer's cash-generating assets, or groups of such assets, that is expected to benefit from the synergies of the combination that gives rise to the goodwill. If it is anticipated that certain assets are to be disposed of soon after a takeover, goodwill may not be allocated to them for financial accounting purposes.

6.32 As a result of this change in accounting treatment, some consolidated groups sought to divide goodwill into other identifiable assets for tax cost setting purposes. However, recent changes to the law⁸⁰ to restrict the application of the tax cost setting rules to assets that are recognised for taxation purposes (as recommended by the Board in its *Review of the consolidation rights to future income and residual tax cost setting rules*) significantly address this concern.

THE BOARD'S VIEW

6.33 The Board's underlying concern is to ensure that the acquired goodwill of a joining entity is properly identified and is allocated a tax cost based on its relative market value.

6.34 Having examined the issue, the Board considers that the basic framework upon which the tax cost setting rules were formulated, together with the Taxation Ruling on the identification and tax cost setting of goodwill for the purposes of the consolidation regime, are sound. Therefore, the introduction of a capping rule for all reset cost base assets is unnecessary and would add to the existing skewing that arises under the tax cost setting rules.

6.35 In this regard, the Board notes that, in practice, skewing already arises under the consolidation tax cost setting rules. This skewing results in the tax costs allocated to assets being more than market value in some circumstances. However, in other

80 Section 701-67 ITAA 1997.

circumstances, the tax costs allocated to assets may be significantly less than market value. In some cases this can give rise to favourable outcomes for taxpayers (by bringing forward the time that tax costs are recognised).⁸¹ In other cases the skewing gives rise to unfavourable outcomes for taxpayers (by deferring the time that tax costs are recognised).

6.36 The Board also notes that a primary difficulty with the tax cost setting rules is that they rely on a market valuation of assets. Even though the market values of assets are determined in a manner consistent with the ATO guide relating to market valuations for taxation purposes, this does give rise to integrity concerns as market valuations may vary within a range and are difficult to challenge. However, it is not apparent that there is any viable alternative to the existing approach, without changes to the fundamental structure of the consolidation regime.⁸²

6.37 As capping the tax cost setting amount for all reset cost base assets would add to the skewing that arises under the tax cost setting rules, the Board agrees with views in submissions that this proposal should not proceed. Therefore, the Board does not recommend any changes to the tax cost setting rules.

6.38 The Board notes that the income tax law was changed in 2012 to restrict the application of the tax cost setting rules to assets that are recognised for taxation purposes (as recommended by the Board in its *Review of the consolidation rights to future income and residual tax cost setting rules*). This change significantly addresses the Board's concerns about the proper identification of the goodwill asset. The impact of this change should be monitored before making any further changes to the consolidation tax cost setting rules for allocating the allocable cost amount to a joining entity's assets (including goodwill).

Recommendation 6.1

The Board recommends that:

- a) no changes be made to the tax cost setting rules in relation to the treatment of goodwill of a joining entity; and

81 In this regard, the Board understands that it is not uncommon after a corporate takeover for the acquirer to sell off unwanted assets (perhaps to pay down some of its debt). If the sale price is less than the reset tax cost for these unwanted assets, the acquirer will make a tax loss as a result of the disposal of the assets.

82 If this continues to be a concern, the Board's *Post Implementation Review into Certain Aspects of the Consolidation Regime* report to the Assistant Treasurer in June 2012 recommended at paragraph 2.74 that the Government evaluates the state of the consolidation regime within five years of the implementation of the recommendations contained in the report, to assess the extent to which problems and issues continue to arise that may point to on-going structural problems with the regime.

b) the 2012 changes to the income tax law which restrict the application of the tax cost setting rules to assets that are recognised for taxation purposes be monitored before any further changes are made to the tax cost setting rules in relation to goodwill.

CHAPTER 7: CGT ISSUES

7.1 The Board's review identified some CGT issues during the course of its post-implementation review of certain aspects of the consolidation regime relating to:

- the interaction between the CGT rollover rules and the consolidation regime; and
- the operation of CGT event J1.

INTERACTION BETWEEN THE CGT ROLLOVER RULES AND THE CONSOLIDATION REGIME

7.2 The Board's 2012 Discussion Paper broadly identified the following four anomalous outcomes that can occur when entities join a tax consolidated group following a rollover. Most of these issues identified are more prevalent where small to medium sized groups (SME groups) are restructured:

- Issue 1: owned profits of the joining entity may not be picked up when an entity is rolled into a tax consolidated group following a restructure.
- Issue 2: the tax consolidation provisions rely on the CGT cost base rules contained in each of the rollover provisions, which may not provide an appropriate cost base for step 1 purposes of the tax cost setting process.
- Issue 3: where the joining entity has a goodwill asset (or other asset) with value, this can inappropriately skew the tax cost setting process under a restructure.
- Issue 4: the interposition of a new holding company under a restructure using certain CGT rollovers can result in the old group ceasing to exist and may require a new group to be formed. This can result in exit calculations, CGT event L3 capital gains and inappropriate entry calculations.

7.3 The Board's 2012 Discussion Paper sought stakeholder comments on the Board's proposal to introduce systemic rules dealing with CGT rollovers of entities into consolidated groups.

Views from submissions

7.4 Stakeholders who responded to this issue generally agreed with the Board's identification and analysis of the issues and strongly supported the solutions suggested by the Board in this regard.

7.5 The Corporate Tax Association noted the following:

The CTA is very supportive of the thrust of the BoT's proposal to simplify and, wherever possible, standardise consolidation outcomes associated with corporate restructures that are facilitated by way of CGT rollover relief. As identified by the BoT, the current differential and anomalous outcomes can create very significant and inequitable adverse results for taxpayers

7.6 The submission from BDO noted:

As observed in Chapter 7 of the Discussion Paper, there is considerable divergence in the tax treatment under the consolidation measures between the different methods of transferring ownership interests in an entity using one of the available CGT rollovers. Similarly, as observed in that chapter, there are material differences in the interaction of the "scrip for scrip" rollover provisions in Subdivision 124M and the Consolidation measures. Depending upon whether the "common or significant stakeholder" provisions (s124-782) apply, the "restructure" measures (s124-784B) apply or neither of those measures apply. Such divergent treatment offends against the tax policy criteria of equity and neutrality.

We strongly endorse the solutions to this issue addressed in pages 51 to 53 of the Discussion Paper.

7.7 The Pitcher Partners submission noted:

In general, we believe that tax consolidation should not result in taxing points where there has been a rollover and there has been no change in the economic underlying ownership of the asset being rolled over.

We also believe that tax consolidation should not produce different results where the tax consolidated group utilises one rollover as opposed to another rollover (where the commercial outcomes are identical). We believe that this gives rise to taxation anomalies and this [sic] complex tax planning.

Accordingly, we believe that this is an important issue for the Board to address in seeking to ensure that larger SME groups are provided with an opportunity to consolidate for tax purposes. Furthermore, we believe that the use of these alternatives would greatly simplify how tax consolidation interacts with the tax cost setting process for SME groups.

7.8 The submission from CPA Australia noted that similar issues can arise with MEC groups.

The Board's considerations

7.9 The Board understands that the primary concern of taxpayers is that it would be reasonable if a wholly-owned group of entities that has not consolidated could restructure so that it is in a consolidatable form without tax consequences and with appropriate tax costs for its assets.

7.10 Some of the current CGT rollovers allow for the restructure of entities within a wholly-owned group prior to joining a tax consolidated group. The following table from the Board's 2012 Discussion Paper lists the various rollover provisions under the ITAA 1997 that are available for these purposes.

Rollover	Generally applies to the following consolidation cases
Subdivision 122-A	Individual or trustee interposes a 100 per cent holding company over another company.
Subdivision 122-B	Partnership interposes a 100 per cent holding company over another company.
Subdivision 124-G	Joint owners interpose a 100 per cent holding company over another company.
Subdivision 124-H	Joint owners interpose a 100 per cent holding company over a unit trust.
Subdivision 124-M	Acquisition of an 80 per cent or more interest in a company through the issue of scrip
Subdivision 126-B	Acquisition of a wholly owned group company from a non-resident entity.

7.11 The underlying policy rationale for most of these rollovers is that there is no change in the ownership of the underlying assets. However, although the rollovers have a common objective of deferring CGT, other outcomes that arise under the rollovers (such as the cost base allocated to assets subject to the rollover) differ. The Board understands that significant issues arise if these outcomes are changed.

7.12 As the CGT rollovers were developed and introduced at different times, they reflect the policy considerations relating to particular features of transactions that were prevalent at the time each particular rollover was introduced. There does not appear to be one single policy intent underpinning all aspects of the range of rollovers available. The features or requirements of each rollover are different.

7.13 For example, the Board understands that the rollover under Subdivision 124-G (joint owners interpose a 100 per cent holding company over another company) was introduced in 1988 in response to a request from a particular taxpayer and in relation to a particular type of business restructure that involved the interposition of an entity between an existing holding entity and its shareholders. Subdivision 124-M (acquisition of an 80 per cent or more interest in a company through the issue of scrip)

was introduced as part of the Ralph reforms⁸³ to improve the efficiency of the capital markets in Australia.

7.14 Given the history of the various CGT rollovers, it difficult to draw a single policy conclusion about the rollovers collectively in order to develop a more systemic solution.

7.15 There was general agreement in submissions with regard to the Board's identification of the issues and strong support for the introduction of the systemic solutions suggested by the Board. However, during further discussion with stakeholders, it became apparent that a range of complex issues would need to be resolved if CGT rollover outcomes were to be changed. Therefore, the Board considers the interaction between the CGT rollover rules and the consolidation regime raises significant policy questions.

7.16 In the Board's 2012 Consolidation Report, the Board recommended⁸⁴ ongoing simplified formation rules for small to medium sized corporate groups that have an aggregated turnover of less than \$50 million in the prior income year to assist them with entering the consolidation regime.

7.17 Under these simplified rules, eligible groups forming consolidated groups could, among other things, elect to retain the existing tax costs of assets for all subsidiary members of the consolidated group which is formed.

7.18 The Board also recommended that the Government should investigate whether rules should be introduced to enable small to medium sized corporate groups to apply a 'stick approach' to long-term majority owned subsidiaries when they become wholly-owned by a consolidated group after formation time.

7.19 The rationale underlying these recommendations is that small to medium sized groups that are growing would be able to consolidate at an appropriate time without significant tax consequences. The \$50 million turnover threshold was chosen because data suggests that corporate groups with a higher turnover are already able to enter consolidation without the need for special formation rules.

7.20 The Board notes that, if these recommendations are implemented, the CGT rollover issues become significantly less prevalent for small to medium sized corporate groups.

7.21 Nevertheless, the Board acknowledges that it is inevitable that some corporate groups will fail to consolidate before reaching the \$50 million turnover and therefore

83 A Tax System Redesigned, Review of Business Taxation Report, July 1999 - Recommendation 19.3.

84 Board of Taxation, Post-Implementation Review into Certain Aspects of the Consolidation Regime (June 2012), Recommendation 6.1.

will still be disadvantaged due to the various outcomes that arise under the different CGT rollovers.

7.22 If the Government does not agree to the recommendations in the Board's 2012 Consolidation Report, the Board considers it would be beneficial for further consideration to be given to how systemic rules relating to the interaction of the CGT rollover rules and the consolidation regime could be implemented.

Recommendation 7.1

The Board recommends that if the Government does not agree to Recommendation 6.1 in the Board's 2012 Consolidation Report, further consideration be given to how systemic rules relating to the interaction of the CGT rollover rules and the consolidation regime could be implemented.

Application date of any changes

7.23 The Board considers that, if the income tax law is amended to introduce systemic rules relating to the interaction of the CGT rollover rules and the consolidation regime, 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 CGT events that happen after the date amending legislation is introduced (rather than the date of announcement).

Interposing a new holding company

7.24 The Board's 2012 Discussion Paper outlined an anomaly in the way the tax consolidation provisions interact with the CGT rollover rules when a new holding company is interposed above an existing tax consolidated group (see Issue 4 of Chapter 7).

7.25 Under a Subdivision 124-G rollover (joint owners interpose a 100 per cent holding company over another company), the new interposed holding company can choose that the consolidated group is to continue to exist.⁸⁵ The consolidated group is then taken to not have ceased to exist when the original head company ceased to qualify as the head company.⁸⁶ This choice is only available for Subdivision 124-G rollovers. However, Subdivision 124-G requires that the original head company has at least two shareholders in order for the provisions to apply.

7.26 The choice to have the consolidated group continue to exist is not available for all rollovers – for example the Subdivision 122-A rollover (individual or trustee interposes a 100 per cent holding company over another company) and the Subdivision 124-M rollover (acquisition of an 80 per cent or more interest invested in a company through

85 Subsection 124-380(5) ITAA 1997.

86 Subsection 703-70(1) ITAA 1997.

the issue of script) in a closely held entity scenario.⁸⁷ Under these rollovers, the old consolidated group is taken to cease to exist and a new group is required to be formed. This results in exit calculations being required which, in turn, can give rise to capital gains under CGT event L5 (and in some circumstances, possible capital gains under CGT event L3), when there has not been a change in the underlying ownership of the tax consolidated group. Entry tax cost setting calculations would then also be required for the newly formed group.

7.27 Rule 3 of Chapter 7 of the Board's 2012 Discussion Paper suggested that where a new holding company is interposed over an existing consolidated group under a restructure, the old tax consolidated group should be taken to continue to exist with the new holding company being taken to be the new head company of the old group.

Views from submissions

7.28 As noted above, stakeholders who responded to the issues relating to the interaction of the CGT rollover rules and the consolidation regime generally agreed with the Board's identification and analysis of the issues and strongly supported the solutions suggested by the Board in this regard.

7.29 Submissions which provided comments specifically in relation to the interposition of a new holding company over an existing consolidated group included the Pitcher Partners submission, which noted the following in this regard:

Rule 3: Interposition of a head company

In our view, this proposition is critical for SMEs. The chapter highlights the significant anomalies that occur by interposing a head company using one rollover as compared to another. It also noted that the issues can be avoided by simple tax planning – that is rolling down the assets to a subsidiary after consolidating for tax purposes.

We believe that this one of the easier fixes in the legislation, given that there is already an existing provision that allows for seamless interposition of a head company – that is sections 703-65 to 703-80.

7.30 The Corporate Tax Association submission also noted that it agreed with the Rule 3 approach.

The Board's view

7.31 The Board understands that, even if the Board's recommendations in its 2012 Consolidation Report are implemented, this issue would remain a significant impediment for corporate groups.

⁸⁷ Under subsection 124-795(3) ITAA 1997, a scrip for scrip rollover (Subdivision 124-M) is not available if a Division 122 rollover or Subdivision 124-G rollover can apply to an event.

7.32 Therefore, the Board recommends that Rule 3 should be introduced, so that where a new holding company is interposed over an existing tax consolidated group under a restructure⁸⁸, the old tax consolidated group should be taken to continue to exist with the new holding company being taken to be the new head company of the old group without any exit or entry tax cost setting calculations being required.

7.33 The Board notes that this outcome is already available in the case of some existing CGT rollovers.⁸⁹ However, taxpayers who are unable to use one of those existing rollovers are unable to interpose a new holding company without significant tax consequences.

Recommendation 7.2

The Board recommends that the income tax law be amended so that, where a new holding company is interposed over an existing tax consolidated group under a restructure, the old tax consolidated group is taken to continue to exist with the new holding company being taken to be the new head company of the old group without any exit or entry tax cost setting calculations being required.

Application date of any changes

7.34 The Board considers that, if this recommendation is implemented, the changes should apply prospectively. Given that the changes do not require significant further development, the changes could apply to CGT events that happen after the date of announcement.

CGT EVENT J1

7.35 The Board's 2010 Consolidation Position Paper identified concerns about the appropriateness of the outcomes that arise under CGT event J1 in certain circumstances where CGT assets which have been rolled over between members of a wholly-owned group are subsequently transferred out of the wholly-owned group.

7.36 Since the introduction of the tax consolidation regime, and the removal of the availability of rollover relief under Subdivision 126-B for resident companies within wholly-owned groups from 1 July 2003, CGT event J1 has had limited application.

7.37 However, CGT event J1 is still relevant where a rollover was undertaken between resident companies before 1 July 2003 and a consolidated group has not been formed,

88 A 'restructure' for the purposes of Chapter 7 of the Board's 2012 Discussion Paper and for the purposes of this chapter is an event which effectively does not involve a change to the underlying ownership of the relevant entity and its assets. Subdivision 124-M ITAA 1997 contains rules to determine when an arrangement is a restructure. These rules could be extended for the purpose of implementing the Board's recommendation.

89 Subdivisions 124-G and 124-M ITAA 1997.

or where a rollover involving a foreign resident member of a wholly-owned group is undertaken (which is still permissible under Subdivision 126-B).

7.38 While the issues relating to CGT event J1 are not prevalent, the Board understands that where they do arise the adverse implications are potentially significant (or are inhibiting restructures and/or transactions).

7.39 The Board also understands from stakeholders that the potentially adverse implications relating to CGT event J1 can also increase the practical compliance burden for certain taxpayers, to ensure that they do not inadvertently trigger the CGT event.

7.40 In addition to submissions received, the Board held a workshop with stakeholders to discuss the specific issues related to CGT event J1.

Eligible tier-1 company leaves a MEC group

7.41 The Board acknowledged in its 2010 Consolidation Position Paper that the consolidation pooling rules may give rise to double taxation when an eligible tier-1 company leaves a consolidated group with assets that were rolled over prior to the entity joining a consolidated group.⁹⁰

7.42 The pooling rules apply when an eligible tier-1 company leaves a MEC group and indirectly capture some or all of the deferred capital gains or capital losses made on rolled over assets when an eligible tier-1 company leaves a MEC group. CGT event J1 may also apply to include the deferred capital gain or capital loss in taxable income.

7.43 However, as stakeholders have highlighted previously⁹¹, there is no clear solution to address these concerns. The Board's 2012 Discussion Paper sought further stakeholder views on a potential solution.

7.44 The Pitcher Partners submission to the Board's 2012 Discussion Paper acknowledged that:

Addressing the issues with CGT event J1 can (in itself) be quite difficult, simply due to the operation of other provisions that interact with the tax consolidation provisions (such as pooling under the MEC provisions).

...

Noting that the issues with CGT event J1 are complicated and difficult to resolve, we believe the Board should consider whether it is better to simply make

⁹⁰ Position 4.10.

⁹¹ In response to the Board's 2009 *Post-implementation review into certain aspects of the consolidation regime* Discussion Paper (2009 Consolidation Discussion Paper) and the Board's 2010 Consolidation Position Paper.

suggestions to resolve 'some' of the issues with CGT event J1 (being those that are able to be corrected) rather than trying to resolve all of the issues.

7.45 The Board has considered examples raised by stakeholders and found that many of the examples highlighted issues with the MEC pooling rules (which is outside the scope of the Board's review) rather than with CGT event J1.

7.46 At the same time, the Board understands that stakeholders currently do not see a strong need to move away from the current pooling rules. While there were adverse implications in some cases, the Board is of the view that the extent of the problem is not prevalent enough to justify amendments which will unnecessarily add further complexity to the current rules.

Recommendation 7.3

The Board recommends that no changes be made to the operation of the MEC group pooling rules to address concerns that arise when an eligible tier-1 company leaves a MEC group with assets that were rolled over prior to being brought into the group by a joining entity.

Subsidiary member leaves a MEC group

7.47 When a subsidiary member that is not an eligible tier-1 entity, leaves a MEC group, the capital gain or loss on the disposal of the membership interests is calculated using the tax cost setting rules that apply when an entity leaves a group.

7.48 CGT event J1 may also apply to include a capital gain or loss made on the rolled over asset. As noted above, CGT event J1 was modified when the consolidation rules were introduced such that it does not apply in respect of a company in receipt of a rolled over asset which leaves a consolidated group. However, as only consolidated groups are referred to, the modification does not apply to MEC groups.

7.49 Consequently, where such a subsidiary member (that is not an eligible tier-1 entity) leaves a MEC group, the capital gain or loss on the rolled over asset may be included in taxable income twice.

7.50 In its 2010 Consolidation Position Paper⁹² the Board noted that it considers that CGT event J1 should not apply when subsidiary members leave a MEC group with assets that were rolled over prior to the entity joining the group.

92 Position 4.9.

7.51 Stakeholders who responded to the Board's 2010 Consolidation Position Paper and to the Board's 2012 Discussion Paper in respect of this issue supported the Board's position.

7.52 The Board understands that the Government is seeking to rectify this oversight. The Government's *Improvements to the Calculation and Collection of Income Tax Liabilities from Consolidated Groups* June 2010 discussion paper noted⁹³:

There are a number of provisions in the income tax law that specifically apply to consolidated groups for the purposes of calculating and collecting the group's income tax-related liabilities. In some cases, the provisions do not expressly refer to MEC groups, or to the head company or provisional head company of a MEC group, causing confusion as to their application to MEC groups.

The amendments will clarify that these provisions apply to MEC groups for the purposes of calculating and collecting their income tax-related liabilities in the same way that they apply to consolidated groups.

7.53 The Board recommends that the Government seek to rectify the duplication of capital gains and capital losses made on the disposal of rolled over assets when a subsidiary member that is not an eligible tier-1 entity leaves a MEC group. Any change should only relate to disposals that are subject to an exit calculation under Division 711.

7.54 The Board notes that these amendments are currently on the Government's forward work program for tax measures and considers that they should be progressed as soon as practicable.

Recommendation 7.4

The Board recommends that the income tax law be amended to rectify the duplication of capital gains and capital losses made on the disposal of rolled over assets when a subsidiary member that is not an eligible tier-1 entity leaves a MEC group. Any change should only relate to disposals that are subject to an exit tax cost setting calculation.

Application date of any changes

7.55 The Board considers that, if this recommendation is implemented, the changes should apply prospectively. Given that the changes do not require significant further development, the changes could apply to CGT events that happen after the date of announcement.

93 At paragraphs 45 - 46.

Head company of a consolidated group leaves the group

7.56 Both the Board's 2009 Consolidation Discussion Paper and the 2010 Consolidation Position Paper raised concerns that it is unclear how CGT event J1 applies where the membership interests in a subsidiary are rolled over to the head company of a consolidated group that is owned by a non-resident and the head company subsequently leaves the wholly-owned group.

7.57 In Position 4.11 of the Board's 2010 Consolidation Position Paper, the Board noted that CGT event J1 should apply to rolled over membership interests when a non-resident owner disposes of its interests in the head company. The Board also asked for assistance from stakeholders to determine how the cost base of the membership interests in the subsidiary member should be calculated or to suggest an alternative method that can be used to determine the capital gain or capital loss on the disposal of those membership interests (including for a partial disposal of the membership interests).

7.58 The Board considered the solution put forward in the joint submission by the Corporate Tax Association and the Minerals Council of Australia in response to the Board's 2010 Consolidation Position Paper. The submission suggested:

...trigger a CGT event J1 deemed market value disposal and reacquisition in respect of certain key assets that were held by the joining entity at the joining time and continue to be owned by the consolidated group.

Such an approach would satisfy the CGT event J1 policy objectives, but would avoid the complexities and anomalies associated with a deemed 'leaving' and then a deemed 'joining' by the previously rolled over entity.

7.59 The Board understands that under this proposition:

- the market value in respect of the underlying assets of a subsidiary at joining time (not the shares of the subsidiary holding the asset that has been subject to the rollover) would be used in determining the deemed market value disposal;
- the taxing point, based on a deemed disposal and reacquisition at the above market value, would be triggered at the break-up time; and
- the key assets referred to could be limited to assets, other than monetary assets and excluded classes of assets (for example, trading stock, plant).

7.60 With regard to the limitation of the proposal to key assets, the joint submission by the Corporate Tax Association and the Minerals Council of Australia further noted that:

Further, it is submitted that, pragmatically, a deemed disposal / reacquisition of underlying assets should not apply in respect of:

(i) trading stock, because it is assumed that normally these assets are turned over regularly, such that any deferred gain would likely have already been subject to tax (for similar reasons, there are arguments that CGT event J1 treatment should also not apply to other assets held on revenue account); and

(ii) depreciating assets of the joining entity because the suppressed tax value would already have resulted in reduced depreciation deductions and any deemed disposal and reacquisition would trigger a balancing adjustment – but also a subsequent increase in depreciation deductions.

7.61 The Board is aware that, rather than CGT event J1 problems, the issues that arise in this regard are broader MEC group issues outside the scope of the Board’s review. With the lack of data, it would also be difficult to determine which assets the proposition could apply to.

7.62 The Board is also mindful that the effort to implement a solution and the added complexity of a solution would be disproportionate to the tax collected.

7.63 In light of the above uncertainties and potential complexities, the Board recommends that the Government should continue to monitor situations where a head company of a consolidated group that is owned by a non-resident leaves the group. If it becomes apparent that the outcomes that arise under the current law are giving rise to integrity risks, the Government could then consider implementing amendments along the lines suggested by the Corporate Tax Association and Minerals Council of Australia.

Recommendation 7.5

The Board recommends that the Government should continue to monitor situations where a head company of a consolidated group that is owned by a non-resident leaves the group.

APPENDIX A: LIST OF BOARD'S RECOMMENDATIONS

Recommendation 2.1

The Board recommends that the income tax law be amended so that:

a) where an entity that has deductible liabilities is acquired by a consolidated group, the head company includes the amount at step 2 of the entry tax cost setting rules for those deductible liabilities in assessable income at the following times:

- where the deductible liability is a current liability for accounting purposes, the assessable income is brought to account over the 12 month period following the joining time; and
- where the deductible liability is a non-current liability for accounting purposes, the assessable income is brought to account over the 48 month period following the joining time;

b) integrity rules be considered where a subsidiary exits with group with a non-current liability, or a group is liquidated, within the 48 month period; and

c) in the case of an entity that is acquired progressively, the assessable amount reflects the acquired component of the deductible liabilities included at step 2 of the entry tax cost setting rules using a shortcut method to work out the acquired component.

Recommendation 3.1

The Board recommends that the income tax law be amended so that adjustments relating to deferred tax liabilities in the entry and exit tax cost setting rules are removed from those rules.

Recommendation 4.1

The Board recommends that the income tax law be amended so that the adjustment which applies if the head company's accounting value of a liability is different to the joining entity's accounting value of the liability (the subsection 705-70(1A) adjustment) is removed from the entry tax cost setting process.

Recommendation 4.2

The Board recommends that the income tax law be amended so that the adjustment for unrealised gains and losses on liabilities (the section 705-80 adjustment) is removed from the entry tax cost setting process in full acquisition cases. In addition, in the case of the adjustment for unrealised gains and losses that have accrued to the head company before the joining time, further consideration should be given to whether the

section 705-80 adjustment mechanism can be replaced with a mechanism that reduces the amount at step 2 of the allocable cost amount by the owned amount of the deductible liability.

Recommendation 5.1

The Board recommends that the income tax law be amended so that, in principle:

- where an anomalous outcome arises because an asset is recognised under the consolidation tax cost setting rules and a related liability is not an accounting liability, the related liability should be recognised for tax cost setting purposes to the extent that is necessary to address the anomaly; and
- where an anomalous outcome arises because an asset is not recognised under the consolidation tax cost setting rules and a related liability is an accounting liability, the related liability should not be recognised for tax cost setting purposes to the extent that is necessary to address the anomaly.

Recommendation 6.1

The Board recommends that:

- a) no changes be made to the tax cost setting rules in relation to the treatment of goodwill of a joining entity; and
- b) the 2012 changes to the income tax law which restrict the application of the tax cost setting rules to assets that are recognised for taxation purposes be monitored before any further changes are made to the tax cost setting rules in relation to goodwill.

Recommendation 7.1

The Board recommends that, if the Government does not agree to Recommendation 6.1 in the Board's 2012 Consolidation Report, further consideration be given to how systemic rules relating to the interaction of the CGT rollover rules and the consolidation regime could be implemented.

Recommendation 7.2

The Board recommends that the income tax law be amended so that, where a new holding company is interposed over an existing tax consolidated group under a restructure, the old tax consolidated group is taken to continue to exist with the new holding company being taken to be the new head company of the old group without any exit or entry tax cost setting calculations being required.

Recommendation 7.3

The Board recommends that no changes be made to the operation of the MEC group pooling rules to address concerns that arise when an eligible tier-1 company leaves a

MEC group with assets that were rolled over prior to being brought into the group by a joining entity.

Recommendation 7.4

The Board recommends that the income tax law be amended to rectify the duplication of capital gains and capital losses made on the disposal of rolled over assets when a subsidiary member that is not an eligible tier-1 entity leaves a MEC group. Any change should only relate to disposals that are subject to an exit tax cost setting calculation.

Recommendation 7.5

The Board recommends that the Government should continue to monitor situations where a head company of a consolidated group that is owned by a non-resident leaves the group.

APPENDIX B: LIST OF SUBMISSIONS

SUBMISSIONS IN RESPONSE TO THE BOARD'S DISCUSSION PAPER

BDO (Australia) Limited

Corporate Tax Association

CPA Australia

Deloitte

Financial Services Council

Greenwoods & Freehills

Property Council of Australia

Pitcher Partners

The Institute of Chartered Accountants in Australia