2 May 2012

Principal Adviser
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: consolidation@treasury.gov.au

Dear Sir

Exposure Draft: Tax Laws Amendment (2012 Measures No.2) Bill 2012 (“ED”)
TOFA and Consolidation

We appreciate the opportunity to provide comments on the exposure draft which sets out proposed amendments to the tax consolidation and taxation of financial arrangements (TOFA) regimes.

The proposed amendments will have a significant adverse impact on many Australian corporate taxpayers. Major elements of the proposals operate retrospectively and on a basis which is inequitable as between taxpayers in like circumstances. In this regard, we do not endorse these changes. However, if retrospective amendments are regarded by the Government as unavoidable, the points made in this submission seek to clarify the scope and nature of the proposals.

We trust that the Government will give serious consideration to the broad concerns raised in relation to these proposed changes, as well as to our more specific comments on the proposed provisions.

Given the significance of the issues raised in this and other submissions, and given the very short time period since the release of the ED, we strongly recommend the release of a revised ED and a further period of consultation prior to the introduction of a Bill into Parliament.

Our comments are set out in the attached appendixes, as follows:

- Appendix A: Rights to future income (“RTFI”) and residual asset proposals (Sch 1 of the ED)
- Appendix B: Consolidation and TOFA interaction proposals (Sch 2 of the ED)

We encourage Treasury to work closely with the Australian Taxation Office (as with corporate taxpayers, professional bodies and advisers) in relation to the finalisation of the legislation and we hope that this process will enable the ATO to quickly and efficiently identify and formulate positions on the key interpretational issues which will exist in relation to the application of these amendments.

Should you have any questions or would like to discuss any of the above in further detail, please don’t hesitate to contact me on (02) 8266 7939

Yours sincerely

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Appendix A

Rights to future income and residual asset proposals (Schedule 1 of the ED)

1.0 Concerns in relation to the retrospective application of the proposals

The proposals operate on a retrospective basis in the following manner:

1. The repeal or limitation of measures introduced by Taxation Laws Amendment Act (2010 Measures No.1) ("TLAA (2010 No.1)") as affecting transactions which took place prior the introduction of TLAA (2010 No.1);

2. The limitation of measures introduced by Taxation Laws Amendment Act (2010 Measures No.1) ("TLAA (2010 No.1)") as affecting transactions which took place after the introduction of TLAA (2010 No.1) and before the Government announcement of 31 March 2011; and

3. The limitation of provisions which have been in place since 2002; including the removal of a specific tax cost base for certain contractual assets.

1.1 Wind-back of RTFI and residual asset rules under the pre rules

The retrospective wind-back of the RTFI and residual asset provisions introduced in TLAA (2010 No.1) will have a significant adverse impact for many companies. This will include companies in the following circumstances:

- Some entities have prepared and issued financial statements which include the impact of rights to future income ("RTFI") deductions in tax expense and current tax liability/asset. A subsequent reversal will force taxpayers to change their accounts, which has flow-on implications for investors who rely on the financial statements.
- Taxpayers may already have committed to investment decisions on the basis of a particular tax profile for an entity (including prior year RTFI deductions). If the law is retrospectively amended, this may materially impact the financial viability of the investment decision because the expected deductions are no longer available. Taxpayers may not be able to proceed with investments.
- Under consortium arrangements it is not uncommon for consortium members to share the income tax exposures of a bid vehicle /representative. If the law is retrospectively amended, this may adversely affect the viability of property and infrastructure deals as it may not be possible to recover this income tax refund from the other consortium members.
- The first time recognition of RTFI deductions may have given rise to profits which may have been distributed by corporate taxpayers as dividends. Prior decisions regarding dividend

policy (including franking percentages) may have been impacted by the availability of RTFI deductions.

- Taxpayers have incurred significant valuation and advisory fees in relation to the identification and quantification of RTFI deductions under the existing law.

1.2 Significant restriction of the RTFI deduction under the interim rules

The 25 November 2011 Press Release of the Assistant Treasurer included the following statements:

> *"Changes for the period between 12 May 2010 and 30 March 2011 will largely protect taxpayers who made business decisions on the basis of the current law before the Board's review was announced".*
>
> *"The transitional period changes will protect taxpayers who acted on the basis of the current law before the Board of Taxation Review was announced."*

And yet, the changes in proposed section 701-63(3) (and particularly paragraph (b) of that provision) under the interim rules, will in many cases operate to eliminate most of the deduction which was clearly available under the rules introduced in TLAA (2010 No.1).

The RTFI deduction rules introduced by TLAA (2010 No.1) clearly provided a deduction for the reset tax cost of RTFI contracts, notwithstanding the extent those contracts were cancellable. The limitation currently proposed will result in significant adverse outcomes for those companies who appropriately relied on the law as it stood. In addition to the outcomes listed at 1.1, the companies affected by this change are those companies that entered into transactions (and priced those transactions) based on the law which existed at time. For a number of companies that have considered the impact of the ED changes, this particular limitation (under section 701-063(3) of the interim rules) will eliminate most of the RTFI deduction for which they were entitled.

The following comment was made by the officer of a multinational group that had invested in Australia (through the acquisition of a company) during the interim period; who reflected the clear RTFI deductions in the pricing of this investment; and who recognised the clear RTFI deductions for the purposes of their accounts:

> *"We cannot believe this type of retrospective change would have been contemplated by a Government of Australia."*

The same comment will no doubt be repeated many times as groups in these circumstances work through the impact of this retrospective change.

1.3 Removal of CGT cost base for certain assets

Proposed section 701-63(2)(c) operates to remove the separate CGT cost base of (income producing) contractual assets (by deeming this cost base to be instead allocated to general goodwill). For the pre rules, this provision applies to all RTFI contracts except for WIP amount assets. For the interim rules, this provision applies to RTFI contracts to the extent the rights are contingent on renewal options or to the extent the contract is cancellable without penalty or compensation.

The taxpayer representative bodies have sufficiently canvassed how the retrospective repeal of a provision that has stood as law for 2 years carries with it significant elements of inequity and potential heightened views of sovereign risk; this is further compounded by retrospectively and adversely restricting the clear operation of a substantive law that has stood for 10 years. At no point in those ten years was de-recognition of CGT cost base for these assets raised as the subject of any possible amendment.

We also note that the deeming of such CGT contract assets to constitute goodwill is contrary to one of the stated intentions of these amendments more broadly, which is to treat such assets in the same way they would be treated outside of consolidation. This amendment would result in an anomalous adjustment to the normal operation of the CGT rules in the confined space of the consolidation regime.

The Board of Taxation report released in May 2011 identified a significant “unexpected” Revenue cost arising from the changes introduced by TLAA (2010 No.1); in particular, RTFI deductions, as well as deductions arising as a result of modifications to the residual asset rule (section 701-55(6)).This “unexpected” Revenue cost is referred to by the Assistant Treasurer (press release of 25 November 2011) as justification for the wind back of those measures.

However, there can be NO “unexpected” Revenue cost used as justification for the introduction of subsection 701-63(2)(c). These contracts are clearly CGT assets and should not be subject to the same proposed taxation treatment as other accounting intangible assets that are not “assets” for capital gains tax purposes. Taxpayers that have appropriately recognised the CGT cost base of these assets for the last 10 years now face the prospect of paying tax on gross proceeds should they come to sell those assets or a company holding those assets.

We would submit that, should the Government choose to proceed with this amendment, it clearly articulate the supporting policy imperatives. If the policy imperative is the need to realise a new amount of tax Revenue, then the Government should consider alternatives that might allow taxpayers to retain the CGT cost base of these assets until such time as the relevant contract or company holding the contract is sold outside the group.

If there is a need to defer a Revenue cost arising from capital losses generated on expiry of these contracts (where they are not otherwise sold outside the group), then consideration could be given to deferring the recognition of these capital losses over 5 years commencing from the year of enactment of this amending legislation.

2.0 “Pre Rules”

We make the following comments in relation to Schedule 1 Part 1 of the ED.

2.1 Specific deduction should extend to “accrued income” rather than just WIP

It has been acknowledged in discussions with Treasury that the limitation of the section 701-55(5C) deduction to work in progress (WIP) for the pre rules is not in accordance with the 25 November 2011 Press Release and will be expanded to include all rights to income which have accrued on contracts held by the joining entity at the joining time.

We welcome this acknowledgement.

2.2 Further EM guidance on application of the reinstated section 701-55(6)

The scope and application of the “original 2002” version of section 701-55(6) has not been thoroughly explored by taxpayers, the ATO or the courts. While it was the subject of technical discussion (principally through the tax consolidations subcommittee of the National Taxpayers Liaison Group) and was the subject of draft ATO Tax Determinations, further consideration largely ceased when the Government announced (in December 2005) that the provision would be clarified through legislative amendment.

However, the reinstatement of the “original 2002” version of section 701-55(6) will require a re-opening of this technical analysis and debate. In particular, taxpayers will no doubt seek to apply the reset cost of certain contractual assets to calculations of “profit” returned as assessable on an “emerging” or “net” basis.

If the Government is going to remove the legislative clarification as to the operation of section 701-55(6), that analysis and debate would be “assisted” by any guidance which could now be included in the Explanatory Memorandum to accompany the amending Act. If nothing else, such guidance should set out the scope and application of section 701-55(6) as was intended when that provision was originally enacted.

2.3 Interaction with the Division 775 foreign currency rules

The gain or loss recognised for foreign currency assets upon forex realisation events under Division 775 are calculated with reference to either a “forex cost base” under section 775-85, or “forex entitlement base” under section 775-90. Section 775-90(c) reduces the forex cost base by “any amounts that you paid to acquire the right”. Section 775-85(a) provides that a “forex cost base” is the “money you paid or are required to pay to acquire the right”.

Further, a deduction arises under section 775-60(5) upon expiry of an FX option where: “The amount of the **forex realisation loss** is the amount you paid in return for the grant or acquisition of the option.”

It is submitted that none of these provisions operate to take into account the reset tax cost of an FX contract asset under the former s 701-55(6). The former section 701-55(6) simply provided that “the asset's cost ... [is] equal to its *tax cost setting amount”.

The narrow interpretation by the ATO of the former section 701-55(6) in the context of its interaction with other provisions was evident in the withdrawn draft determinations TD2004/D75 and TD2004/D85.

The consolidation interaction provision contained in section 715-370 will also need to be addressed. If left unchanged section 715-370 will effectively operate to reduce a Division 775 foreign currency loss to the extent it is not attributable to the foreign currency movement between joining time and settlement of the foreign currency contract. However, it cannot operate to increase a deductible Division 775 loss on a foreign currency asset as would be appropriate if, although an overall foreign currency loss, there was an inherent foreign currency gain on the asset at the joining time.

2.4 Deemed goodwill treatment for certain assets (new section 701-63)

2.4.1 Inappropriate retrospective application and future capital gains taxed on a “gross” basis

For the reasons noted above at 1.3, this provision (section 701-63(2)(c)) should not operate to treat as part of goodwill assets which are clearly separate CGT assets.

A number of companies have relied on obtaining at least a CGT cost base in RTFI contracts to support the non-recognition of a DTL and tax expense in their accounts. The removal of this CGT cost base on a retrospective basis could see these companies needing to recognise the DTL and take up a significant additional current year tax expense.

There are 4 sets of circumstances where a CGT cost base for these RTFI contracts should be expected to be utilised:

(a) to reduce a capital gain on direct sale of the contracts;

(b) to reduce a capital gain on sale of a subsidiary member that holds these contracts (including where the subsidiary no longer carries on the original business and therefore no longer may be said to hold any goodwill);

(c) to generate a capital loss on expiry of the contracts; and

(d) to take up as the retained cost base of these contracts if the relevant subsidiary joins another consolidated group under the prospective rules.

We submit that Treasury should consider alternative approaches to achieve the Revenue outcome targeted by this proposal, as mentioned at 1.3 above.

2.4.2 Mining information

A Division 40 deduction for mining information would seem precluded by the deemed goodwill treatment. It was acknowledged in discussions with Treasury that this result was unintended and would be revised.

2.4.3 Single goodwill asset might be problematic for groups carrying on multiple businesses

The provisions that deem goodwill to be a single asset of the head company (section 701-63(1)&(2)) could preclude groups that carry on multiple businesses from recognising a separate cost base for goodwill in respect of each business. At law, a separate goodwill asset will generally be attributable to each separate business and consideration should be given to reflecting this approach in the proposed deeming rules.

Treasury may wish to consider specific aggregation and disaggregation rules allowing clear tracing of any individual components of goodwill to the underlying business and providing for realisation of that goodwill on sale of the relevant underlying business. This would overcome the possible difficulty with common law analysis of goodwill, where for example, part of a business is disposed of only and a common law analysis may not support any realisation of the goodwill, but that part includes the relevant deemed goodwill RTFI assets. Such difficulties could also arise on cessation of a part of a business which might cause elements of deemed goodwill to cease to exist.

2.4.4 Deemed goodwill asset will change intra-group accounting

The provisions that deem goodwill to be a single asset of the head company (section 701-63(1)&(2)) will mean that where a subsidiary member of a tax consolidated group has recognised CGT cost base for these assets, those subsidiaries will now recognise a DTL whilst the head company of the

tax consolidated group will recognise a DTA (as the head company will not have an accounting asset for the deemed goodwill).

This will reduce the tax cost setting amount of the subsidiary member's shares in an exit ACA process and may create a CGT Event L5 exposure, without, as discussed above, any clarity on the ability to recognise an offsetting capital loss for the tax cost in the deemed goodwill.

2.4.5 List of "accounting intangibles" in the EM

The list of accounting intangibles in the EM (para 1.41 and 1.68) includes a number of assets which might be CGT or Division 40 assets (eg. assets covered by copyright protection). A note should be included in the EM clarifying that deemed goodwill treatment will not apply to assets to the extent they are covered by Division 40 or by the CGT provisions.

2.4.6 Treatment of deferred tax assets

If the Government intends that section 701-63(2)(b) cover a deferred tax asset (as an intangible asset recognised for accounting purposes which is not recognised for tax purposes) then this is an example of where a comment in the EM to this effect would provide useful guidance on the scope (and types of assets) covered by this provision.

2.4.7 Exclusion for assets which are not CGT assets

The 25 November 2011 Press Release proposed deemed goodwill treatment for assets which are "not otherwise recognised for tax purposes". It is suggested that this would be a more appropriate criteria for deemed goodwill treatment rather than simply non-CGT assets. Examples of assets which might not be CGT assets, but which might be recognised for tax purposes could include mining information (as discussed above), and certain instruments recognised under TOFA rules (eg. repurchase agreements). It is noted that any Revenue concerns should be protected by the specific exclusion of s40-880 deductions arising from the application of section 701-55(6)).

2.4.8 Joining company having no other goodwill

The acquisition of a company joining a consolidated group may take place at a discount to the net book value of its underlying assets. In this case, there is clearly no "goodwill" actually acquired as part of the joining entity's assets. If Government intends that section 701-63(1) can still apply in these circumstances to deem a tax cost of goodwill to arise in respect of, for example, a non-deductible RTFI contract held by that joining entity, then this would be useful guidance to include as a note or example in the EM.

Here also specific aggregation and disaggregation and tracing rules may be helpful as there will be no goodwill at common law.

2.5 Scope of RTFI definition

2.5.1 Further EM guidance on the scope of the RTFI definition

During the period after the introduction of TLAA (2010 No.1), some uncertainties were raised in relation to the scope of the RTFI definition – in particular, the references to the "performance of work or services or the provision of goods". We understand that the guidance provided in the EM which accompanied TLAA (2010 No. 1) (and, in particular, the distinction drawn between "active" and "passive" contracts) has been acknowledged as not necessarily supported by the legislation.

It would be useful if the Government could include additional comment and examples in the EM to accompany the proposed amending legislation. Examples might include the types of contracts included in the EM to TLAA (2010 No.1) with the addition of:

(i) a chattel lease (which should fall within the RTFI definition);

(ii) an actively managed property lease or occupancy agreement, such as a shopping centre lease (which should at least partly fall within the RTFI definition); and

(iii) a property lease or occupancy agreement under which no active services are provided (which should not fall within the RTFI definition).

2.5.2 No required expectation of future assessable income for RTFI assets

The current definition of RTFI in section 701-63(4) is defined without a requirement (as previously existed in section 701-410) that there be a reasonable expectation of an amount of future assessable income being derived. Without this exclusion, trade debtors and service receivables (which have previously been reflected as assessable income) might be inappropriately included under the RTFI definition.

3.0 "Interim Rules"

We make the following comments in relation to Schedule 1 Part 2 of the ED.

3.1 Scope of the exclusion for cancellable contracts

We refer to the comments at 1.2 above on the impact of the retrospective nature of the change contained in section 701-63(3)(b) of the interim rules.

If the proposed exclusion is retained, we recommend that the wording used in the EM examples in relation to the application of section 701-63(3)(b) be reviewed to ensure it is consistent with the wording of the provision.

We refer to example 1.3 at para 1.54 of the draft EM and suggest that a contract which is only cancellable upon payment of a cancellation fee is not a contract which “the other entity can unilaterally cancel ... without paying compensation or a penalty”. Some contracts might make reference to an amount payable on termination of a contract and describe this amount as a “penalty”. There is no difference in substance, and should be no difference in tax treatment, between a contract which sets out a fee or penalty which is payable on termination, and a contract which is silent on the matter but in respect of which, under contract law, would involve the payment of some penalty or compensation on termination.

Relevantly, in valuing such a contract, a valuer would assess the likelihood of the contract being cancelled and, based only on the probability of this happening and appropriate additional discounting for the time expected to elapse before that income would arise, calculate the value attributable to the possibility of the payment of the fee. It is not commercially realistic to suggest that the full amount of a cancellation fee would be reflected in the value of an RTFI contract. This is further reason to conclude that it is not appropriate for such contracts to be treated as cancellable for the purposes of proposed section 701-63(3).

3.2 Deemed goodwill treatment for certain assets (section 701-63)

The comments above at 2.4 are similarly applicable in relation to the operation of section 701-63 in the interim rules.

3.3 Scope of RTFI definition

The comments above at 2.5 are similarly applicable in relation to the operation of section 701-63 in the interim rules.

3.4 Timing of RTFI deductions if part of a contract term is treated as cancellable

If an RTFI contract is limited by section 701-63(3)(b), then the period over which the RTFI deduction is allowed under section 716-405 should be based on a corresponding limited period.

Take as an example, a contract which has a specified term of 8 years, but which may be cancelled at any time by a party giving 6 months notice (without penalty or compensation). Section 701-63(3)(b) would have the effect that only that part of the contract value which relates to the first 6 months would be eligible for an RTFI deduction. However, section 716-405 would, as it currently stands, require the deduction be taken over the 8 year specified contract term.

Section 716-405 should be amended to allow a deduction in these circumstances over the period which is not excluded by section 701-63(3)(b).

4.0 “Prospective Rules”

We make the following comments in relation to Schedule 1 Part 3 of the ED.

4.1 Scope of the deduction for WIP

WIP will typically be an asset which would form part of a broader contractual asset. The current definition of “WIP asset amount” could be interpreted as being the whole value of a contract under which work has been partly completed. One approach might be to consider refining the wording and perhaps including the equivalent of the current section 701-90 "deemed separate asset" rules - ie. to clarify that the other rights under a contract (of which WIP represents part of the value) will be treated as a separate asset.

Also the word “*income*” appears to be missing from before “*year in which the joining time occurs*” in section 701-55(5C) under the prospective rules as compared to the same provision under the pre rules.

4.2 Business acquisition approach

A number of issues are listed below in relation to the deemed "business acquisition" approach to the characterisation of assets:

- The wording used in the ED is not consistent with the wording of the 25 November 2011 Press Release. It should not be necessary to deem the head company to have acquired the assets as part of a business or to include the words "as a going concern". It should only be necessary to require that the characterisation of assets be determined with regard to the acquisition of all of the assets of the joining entity(ies) at the same time. In this regard, we note that the Board of Taxation’s RTFI Report and the Government’s 25 November 2011 announcement did not specifically contemplate the case where a corporate group may acquire only one entity which holds a single asset but which does not carry on a business. The asset of this joining company might constitute a revenue asset or asset in the nature of circulating capital. If the tax characterisation outcomes upon consolidation are to mirror those outcomes of a direct asset purchase, a “deemed business” overlay in these circumstances would not be appropriate and would likely result in a preference for asset acquisitions rather than company acquisitions.

- The use of the word "despite" in proposed section 701-56(1B) is ambiguous.

- See also above points (under pre rules) in relation to non-CGT assets.

4.2 Exclusion for assets which are not CGT assets

The 25 November 2011 Press Release proposed that the tax cost setting provisions would not apply to assets which are "not otherwise recognised for tax purposes". It is suggested that this would be a more appropriate criteria rather than simply non-CGT assets.

5.0 Application

We make the following comments in relation to Schedule 1 Part 4 of the ED.

5.1 Cumulative "mechanics" of the Application provisions

We note that item 52 defines the pre, interim and prospective rules as follows:

> ***interim rules*** means Part 3-90 of the *Income Tax Assessment Act 1997* as amended by Part 2 of this Schedule.
>
> ***pre rules*** means Part 3-90 of the *Income Tax Assessment Act 1997* as amended by Part 1 of this Schedule.
>
> ***prospective rules*** means Part 3-90 of the *Income Tax Assessment Act 1997* as amended by Part 3 of this Schedule.

The appropriate application of the interim rules requires that the ITAA 97 is first amended by Part 1 of Schedule 1 before it is amended by Part 2 of Schedule 1. Similarly, the appropriate application of the prospective rules requires that the ITAA 97 is first amended by Part 1 of Schedule 1 and then by Part 2 of Schedule 1 before it is amended by Part 3 of Schedule 1.

It does not seem clear that the mere sequential placement of Parts 1, 2 and 3 will necessarily achieve the necessary cumulative outcomes required. We would have thought that the relevant definitions should be amended as follows:

> ***interim rules*** means Part 3-90 of the *Income Tax Assessment Act 1997* as amended by Part 1 of this Schedule and then by Part 2 of this Schedule.
>
> ***pre rules*** means Part 3-90 of the *Income Tax Assessment Act 1997* as amended by Part 1 of this Schedule.
>
> ***prospective rules*** means Part 3-90 of the *Income Tax Assessment Act 1997* as amended by Part 1 of this Schedule and then by Part 2 of this Schedule and then by Part 3 of this Schedule.

5.2 *Protection for joining times pre 12 May 2010*

The application provisions contained in Part 4 of Schedule 1 are particularly complex and somewhat uncertain as they relate to joining times pre 12 May 2010. We have set out below a table which summarises our interpretation of the relevant application provisions:

Joining Time	Lodgment of Tax Return	Latest Amended Assessment	Rules Applicable	Reference
Pre	Pre	None	Original 2002 rules**	Item 53(5)
Pre	Pre	Pre	Original 2002 rules**	Item 53(5)
Pre	Pre	Interim	Interim rules**	Item 53(3)
Pre	Pre	Post	Pre rules	Item 53(2)
Pre	Pre	Taxpayer merely seeks an amendment (after enactment of the ED provisions?)	Note *	Item 53(2)
Pre	Interim	None	Interim rules**	Item 53(3)
Pre	Interim	Interim	Interim rules**	Item 53(3)
Pre	Interim	Post	Pre rules	Item 53(2)
Pre	Post	None	Pre rules	Item 53(2)
Pre	Post	Post	Pre rules	Item 53(2)
* this circumstance is covered by Item 53(6). The application of 53(6) is unclear.				
** it is uncertain whether, if a taxpayer amends a tax return currently falling under one of these categories, the applicable rules will revert to the Pre rules?				

5.2.1 *Pre-12 May 2010 joining time - assessment subject to the interim rules*

An assessment will be subject to the interim rules where:

- Under Item 53(3)(a) – "the joining time is before 12 May 2010" and "the head company's latest notice of assessment, for the income year, that relates to the application of subsection 701-55(5C) or (6) of the original 2010 rules in respect of the joining entity, was served on the head company by the Commissioner on or after 12 May 2010 and on or before 30 March 2011; or

Treasury is asked to provide further guidance or examples on what is meant by "the head company's latest notice of assessment, for the income year, relates to the application of subsection 701-55(5C) or (6) of the original 2010 rules".

For example, we assume that, if an amended assessment is issued for a head company in respect of a joining year, but the amendment relates to a completely separate provision (eg. additional R&D deductions) these words would not be activated (ie. notwithstanding that the amended assessment will show a taxable income (or loss) based on items included in the original tax return relying on the application of section 701-55(5C) or (6)).

Other relevant examples where we believe further guidance might be required (in either the provisions or in the EM) are set out below:

Example 1

A head company lodged, in December 2010, a 2010 income tax return which covered a company joining the group in January 2010. A first year RTFI deduction is claimed in that tax return pursuant to sections 701-55(5C) and 716-405. The same head entity may then have lodged a 2011 income tax return in December 2011 containing the second year deduction for the same RTFI asset that was reflected in the 2010 income tax return.

Please confirm that the claiming of a second year RTFI deduction under section 716-405 in the 2011 tax return lodged in December 2011 should not be treated as giving rise to a notice of assessment that "relates to the application of subsection 701-55(5C) or (6) of the original 2010 rules" (and should therefore not operate to prevent the application of the interim rules to the 2010 assessment).

Example 2

The same facts as above, except that the head company does not include an RTFI deduction in the relevant 2010 tax return when lodged (in December 2010). But the head company does claim a deduction for the reset tax cost of consumable stores in that tax return – pursuant to the application of section 701-55(6) and section 8-1. The head company subsequently (in February 2011) lodges an application for amendment in respect of the 2010 income tax return to claim the RTFI deductions. It would seem that, if the ATO process this application after 30 March 2011 and issue an amended assessment, the head company would have a notice of assessment that "relates to the application of subsection 701-55(5C) or (6) of the original 2010 rules" issued post 30 March 2011 and the head company would thereby lose the protected application of the interim rules to the original 2010 assessment (and any subsequent assessment).

However, if the head company withdraws the application for amended 2010 assessment before it is processed and makes no subsequent request for 2010 amended assessment, the original 2010 assessment would seem to be covered by the interim rules. Accordingly, the tax cost of the RTFI assets of the joining entity are reset under the interim rules (even if the head company did not make an actual RTFI claim in the 2010 year).

There would then seem to be nothing to preclude that head company from claiming RTFI deductions under section 716-405 under the interim rules in subsequent years.

Example 3

Same facts as above, except that an RTFI deduction (but not a deduction for consumable stores) is claimed in the relevant 2010 tax return when lodged by the head company (in December 2010).

In May 2012 (prior to the enactment of the provisions contained in the ED), the head company lodges a request for amendment of the 2010 assessment to claim a deduction for consumable stores. The ATO issue an amended assessment allowing this deduction in June 2012 (also prior to the enactment of the provisions contained in the ED). The issue of this amended assessment would then seem to represent a notice of assessment that "relates to the application of subsection 701-55(5C) or (6) of the original 2010 rules" issued post 30 March 2011 and the head company would thereby lose the protected application of the interim rules to the original 2010 assessment (and any subsequent assessment).

5.2.2 Pre 12 May 2010 joining time - protected application of the original 2002 rules

Subitems 53(5) and (6) provide protected application of the original 2002 rules in the following circumstances:

> *(5) Despite subitems (2), (3) and (4), those provisions are the original 2002 rules if the head company's latest notice of assessment, for the income year, that relates to the application of subsection 701-55(6) of the original 2002 rules in respect of the joining entity, was served on the head company by the Commissioner before 12 May 2010.*
>
> *(6) Subitem (5) does not apply if:*
>
> > *(a) the head company of the group requests an amendment of the assessment and the amendment relates to the application of subsection 701-55(6) of the original 2002 rules in respect of the joining entity; or*
> >
> > *(b) the amendment of the assessment:*
> >
> > > *(i) would relate to an asset of a kind mentioned in paragraph 701-63(2)(b) of the pre rules; and*
> > >
> > > *(ii) would not be consistent with the outcome that arises under the pre rules for assets of that kind.*

Treasury is asked to provide further guidance or examples on what is meant by "relates to the application of subsection 701-55(6) of the original 2002 rules". We provide the following example to illustrate potential unintended outcomes:

Example 4

A head company lodged, in December 2008, a 2008 income tax return which covered a company joining the group in January 2008. The joining company has a number of RTFI assets.

Aware of the various Government statements relating to clarification of section 701-55(6), the company decided to not claim any deduction for assets potentially reset under section 701-55(6) in the relevant tax return. Neither did it claim a capital loss in that year for the reset CGT cost base of any RTFI contracts that expired in that same year post joining time.

Similarly, in its 2009 tax return, lodged in December 2009, the company claimed no RTFI deduction or capital loss in respect of expired RTFI contracts.

In November 2010 (ie. after the enactment of TLAA (2010 No.1)) the head company lodged an application to amend the 2008 and 2009 tax returns to claim RTFI deductions. These applications have still not been processed by the ATO.

It would seem that, unless the head company had any other asset in respect of which it applied section 701-55(6) in the 2008 tax return as lodged, it is not protected by subitem 53(5).

Whereas, if, for example, the head company returned a profit on close out of a hedge contract in its 2008 tax return, the tax cost of which had been reset under section 701-55(6), subitem 53(5) would apply. And, it is suggested that the subsequent request for amendment to claim RTFI deductions lodged in November 2010 would not trigger the exclusion in subitem 53(6)(a) because the amendment relates to the application of sections 701-55(5C) and 716-405 (rather than to section 701-55(6)). On this basis, the original 2002 rules would apply. The important outcome of the application of these rules is that the RTFI assets would retain a separate CGT cost base (rather than losing that cost base through the application of section 701-63).

While this protection mechanism is welcomed, it should not be based on a requirement that the head company actually applied section 701-55(6) in respect of an assessment issued pre 12 May 2010. Given the relevant Government announcements, many companies at that time prudently refrained from applying this provision in the expectation that they would subsequently amend the relevant assessment once the law was clarified (and others incurred significant time in obtaining detailed valuations and advice in order to substantiate their positions which then resulted in their also being “out of time”).

5.3 Protected tail deductions

Treasury is asked to confirm whether RTFI "tail deductions" are intended to be protected if the relevant assessment covering the joining time is subject to the interim rules. As they stand, it would seem that the intention of the provisions in Item 53 is to protect tail deductions claimed in subsequent years. This outcome should be made very clear in the provisions or at least through the EM.

Subitem 53(1) provides as follows:

The provisions specified in subitem (2), (3), (4) or (5) apply to an assessment of the head company of a consolidated group or MEC group for an income year in respect of an entity (the joining entity) that becomes a member of the group at a time (the joining time).

It is noted that there is nothing in subitem 53(1) that limits the relevant assessment to be the one for the income year in which the relevant joining time has occurred. On the contrary, the use of the terms “an assessment” in the first line and “a time” in the last line of this provision would suggest such a limitation is not imposed.

5.4 Protection for private rulings

Sub-item (3) of item 54 would render ineffective the protection otherwise provided by a private ruling where, (as would be usual subsequent to the issue of the ruling) a taxpayer lodges a request for amendment to give effect to a positive private ruling. The relevant protection should absolutely not be removed in these circumstances.

5.5 Significant compliance cost - multiple ACA calculations required for the same joining

To the extent cost bases and future tail deductions are not protected, taxpayers will likely need to redo the same ACA calculations, perhaps on multiple occasions. For example, a head company with a joining time pre 12 May 2010 may have adopted CGT treatment for various RTFI contracts. The head company may then have lodged (and had processed) an amendment request between 12 May 2010 and 30 March 2011 claiming RTFI deductions for at least part of the reset tax cost base of these RTFI contracts. To the extent the "tail" and cost base positions are not protected, the taxpayer will need to redo the joining time ACA calculation to re-allocate the cost base of the RTFI contracts to goodwill.

The proposed changes in Schedule 2 (discussed in Appendix B) will also require taxpayers to redo prior year ACA calculations.

All of these changes will involve a significant additional compliance cost for taxpayers.

6.0 Penalties and interest

It is suggested that the removal of penalties and interest should apply broadly. In our view any taxpayer who has an assessment which is affected by the amendments should be protected from the imposition of interest and penalties where the Bill "affects" the taxpayer. This protection should apply notwithstanding the ATO and the taxpayer may have different views as to whether the amount was (subject to the amendments proposed in this Bill) otherwise deductible, as the taxpayer will be precluded from applying the current law to defend their position.

For example, the protection should include taxpayers who submitted a claim after the December 2005 Press Release (which announced the clarification of the residual asset cost base rule) and who are now required to amend such claims to base them only on the "old" section 701-55(6). The provision should also protect those taxpayers who are impacted by the amendment proposed in subsection 6 of Item 53 that prevent a taxpayer from amending an income tax return where the amendment relates to an asset mentioned in 701-63(2)(b) of the pre-rules and would not be consistent with the outcome that arise under the pre-rules.

7.0 Amendment period

Item 4 of the ED "Amendment of assessments" proposes to provide the ATO with an unlimited ability to seek amendments to prior year assessments within a 2 year period post enactment of these measures. This is contrary to the 25 November 2011 Press Release which stated that this 2 year window would only apply for taxpayers and that the ATO would be limited to the normal (4 year) amendment period.

Appendix B

Tax consolidation and TOFA interaction proposals (Schedule 2 of the ED)

The measures proposed in Schedule 2 of the ED apply on a retrospective basis. Furthermore, the measures do not give taxpayers an opportunity to reconsider certain tax and commercial decisions and elections that were made based on the law as it stood prior to the retrospective amendments proposed by Schedule 2.

In particular, the measures are stated to apply to Division 230 financial arrangements of a relevant head company and can apply to joining/consolidation events that occurred prior to the relevant tax consolidated group starting to apply the TOFA provisions in relation to its financial arrangements.

This means that the Schedule 2 measures apply to taxpayers who made a TOFA transitional election (to turn pre-TOFA financial arrangements into Division 230 financial arrangements (that is, arrangements to which Division 230 applies)).

TOFA transitional elections were made in prior income years for a variety of reasons (including compliance efficiency and simplicity) and certainly with no knowledge of the measures announced in Schedule 2.

Many taxpayers therefore now find themselves potentially prejudiced because:

- taxpayers have no ability to reconsider their prior TOFA transitional election in light of the measures announced in Schedule 2 (and it is quite possible that taxpayers might not have made the transitional election had the Schedule 2 measures been known at the time); and

- in any case, the law does not allow taxpayers to redo entry tax consolidation allocable cost amount (ACA) calculations undertaken many years ago and which would now be potentially different by virtue of the measures announced in Schedule 2 (particularly in relation to adjustments for future tax deductions and deferred tax balances associated with TOFA liabilities).

This is inequitable.

In our view the Schedule 2 measures should not be retrospectively applied to any joining time that arose prior to 25 November 2011, being the earliest time that the proposal was announced. Alternatively, if the Government proceeds with making the Schedule 2 measures retrospective then appropriate ‘transitional measures’ should be introduced which would:

1. Give taxpayers the opportunity to reconsider a TOFA transitional election which was made prior to the announcement of the Schedule 2 measures (and on the basis of the law as it then stood); and/or

2. At the very least, provide a clear and simple mechanism to facilitate the amendment of tax consolidation calculations affected by the Schedule 2 measures. For instance, a safe harbour which would allow taxpayers to substantiate a position without completely revising entry ACA calculations.

In addition, in respect of proposed Item 104B(2) and (4), and its application to assets, we request that consideration be given to the application of the policy to “chosen transitional entities” (under section 701-5 and section 701-15 of the Income Tax (Transitional Provisions) Act 1997) where the tax cost of affected assets are not set. Specifically, it would seem inappropriate for affected entities to have to work out a tax cost setting amount for relevant financial assets at the time of joining solely for purposes of working out transitional balancing adjustments or Subdivision 230-G balancing adjustments.