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Ms Julie Owens MP
The House Economics Committee
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Dear Ms Owens

Submission on the Tax Consolidation amendments contained in Tax Laws Amendment (2012 Measures No. 2) Bill 2012

Ernst & Young is pleased to provide this brief submission to the House Economics Committee on one aspect of the Tax Laws Amendment (2012 Measures No. 2) Bill 2012 (the "Bill"), which was introduced to Parliament on 24 May 2012.

We acknowledge and appreciate the consultation opportunities provided by the Government and Treasury to date in relation to the policy changes implemented in the Bill.

Consistent with our previous submissions to government on these measures, this submission also highlights some policy matters that should be considered in order to reduce some of the inequities associated with the proposed amendments, mindful of the revenue savings sought by the Government.

In summary, the policy matters considered in this submission are as follows:

1. Reverting back to the original residual tax cost setting rule (in section 701-55(6)) under the pre-rules will give rise to uncertain outcomes for taxpayers, and is unnecessary in light of the other integrity measures that have been introduced to overcome the perceived deficiencies of the 2010 amendments.

2. The broadened definition of "rights to future income" in the prospective rules, gives rise to an inconsistent and inequitable outcome for entities under the tax consolidation tax cost setting rules as compared with an asset acquisition.

3. Transitional relief (Interim rules treatment) should be extended to amendment requests, objections and ruling requests lodged before 30 March 2011, which were issued by the Australian Tax Office (ATO) after that date or are still outstanding.

4. The regulation impact statement in the Explanatory Memorandum to the Bill (at page 6), states that the compliance cost impact of the consolidation changes to be low. We comment on that proposition.

Our more detailed comments are below.

1. Residual tax cost setting rule under the pre-rules – section 701-55(6)

Item 2 of Schedule 3, Part 1 of the Bill has the effect that, in the pre-rules period, the treatment of residual assets introduced under Tax Laws Amendment (2010 Measures No 1) Act 2010 is repealed. The pre-rules then revert back to the original residual tax cost setting rule (enacted in 2002).

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We submit that consideration should be given to maintaining the residual tax cost setting rule in subsection 701-55(6) as amended by Tax Laws Amendment (2010 Measures No 1) Act 2010, rather than reverting back to the original residual tax cost setting rule, under the pre-rules.

We note that the 2010 version of subsection 701-55(6) is being applied under the interim rules and prospective rules and we believe that that the 2010 version of subsection 701-55(6) should also apply to the pre-rules to give effect to the intended policy and be consistent across all the periods.

The 2010 version of subsection 701-55(6) was introduced because it had universally been accepted that the original version of subsection 701-55(6) was problematic in its application as a general purpose residual rule to enable the tax cost setting amount for an asset to be taken into account under a provision in the income tax law that did not expressly recognise the "cost" of an asset. When subsection 701-55(6) was amended as part of 2010 law changes, paragraph 5.11 of the Explanatory Memorandum to Tax Laws Amendment (2010 Measures No 1) Act 2010 stated that "subsection 701-55(6) is amended to ensure that it gives effect to its policy intent". This was achieved by extending subsection 701-55(6) beyond cost to cover cost, outgoings or expenditure or an amount of a similar kind, such that the consolidation provisions better connected with the operational sections of the Income Tax Assessment Act that did not use the word "cost".

The Explanatory Memorandum to the Bill states at paragraph 3.27 that the 2010 amendments have had a broader impact than expected. As such, amongst other amendments, the original residual tax cost setting rule is restored.

We submit that, in relation to the pre-rules, the other amendments– particularly the proposed deemed goodwill treatment for certain assets (such as insurance contracts, customer relationship assets and certain rights to future income) should address the Government's concerns to prevent broader impacts than expected.

The proposed restoration of the original residual tax cost setting rule is therefore unnecessary as it will give rise to additional compliance burdens on taxpayers and also on the ATO.

2. Definition of "right to future income" in prospective rules – section 701-63(5)

In the prospective period under Schedule 3, Part 3 of the Bill, rights to future income are treated as retained cost assets.

Item 33 of Schedule 3, Part 3 has the effect that the definition of "right to future income" under the prospective rules is broader than the definition in the pre-rules and the interim rules. That is, rights to future income appear to be no longer limited to rights to receive an amount *for the performance of work or services or the provision of goods*.

The broader definition appears to be deliberate - see paragraph 3.109 of the Explanatory Memorandum to the Bill. This drafting is more wide-ranging than the approach taken in the exposure draft law released in April 2012. The broader definition means that contractual rights to future income will be treated as retained cost base assets, with the tax cost being based on the historical tax cost of the joining entity, rather than a value based on the purchase price of the joining entity.

However the drafting of this proposed rule is not limited to the residual asset rule and will impact assets that are specifically dealt with such as capital gains tax assets, trading stock etc for all purposes of the income tax law (except for the TOFA rules – see below).

There is an exception for an asset that is a financial arrangement which is covered by the TOFA 3& 4 rules, in proposed paragraph 701-63(5)(c). However, most small to medium size enterprises are not subject to the TOFA rules and therefore will be particularly exposed under this proposal.

The result under the proposed changes is that the tax cost of contractual right to future income assets is likely to be less than the value recognised for accounting purposes (which may give rise to deferred tax liabilities).

The tax cost setting amount for the head company is also likely to be less than the tax value that would be recognised if the transaction had been undertaken as a direct asset acquisition. This outcome conflicts with and is inconsistent with one of the stated objects of the proposed changes to the consolidation law of making the tax outcomes for consolidated groups more consistent with the tax outcomes that arise when assets are acquired outside the consolidation regime: see paragraph 3.13 of the Explanatory Memorandum to the Bill.

This disparity in cost base allocation will result in an inequitable outcome on a subsequent close-out or disposal of the relevant contract – that is, the acquirer under the tax consolidation rules will derive a greater taxable gain on the termination/disposal as compared with an asset acquisition, due to the limited cost base allocation that arises under the prospective rules.

We submit that it is inappropriate for the tax consolidation tax cost setting rules to limit a tax cost for contractual right to future income assets, for all purposes of the income tax law (except the TOFA rules). To that end, we submit that either:

- Subsection 701-63(5) under the prospective rules should be worded as per the original proposed wording in the exposure draft law (i.e. rights to future income should be limited to rights to receive an amount for the performance of work or services or the provision of goods); or

- If a broader definition of "rights to future income" is retained to capture specific types of contractual rights such as rights to income arising under an insurance or reinsurance contract, then that broader definition should be restricted in its application to the residual asset rule (subsection 701-55(6)) and should not be taken into account when applying the capital gains tax rules.

3. Transitional relief (interim rules treatment) should be extended

Item 50 of Schedule 3, Part 4 of the Bill, introduces transitional protection for some consolidated groups including, in sub-item (3), for the interim period.

We raise an issue on which we submitted in the earlier policy development phase, and also in response to the exposure draft law.

We are aware of a number of cases where consolidated groups sought amendments, objections or private binding rulings in relation to the right to future income and residual asset tax consolidation rules, after the enactment of Tax Laws Amendment (2010 Measures No 1) Act 2010 but before 30 March 2011. If those amendments, objections or rulings were not issued or allowed by the ATO by 30 March 2011, then those claims will not be eligible for the application of the interim rules.

We submit that groups that had lodged claims before 30 March 2011 should have the ability to have their claims considered, albeit under the more limited interim rules.

We submit, once again, that the Government reconsider its policy position on this matter. In our view, the interim rules provide the Government with the necessary integrity protections to eliminate claims that may be considered inappropriate from a policy perspective, or present an excessive cost to the revenue.

4. Compliance impact

The regulation impact statement in the Explanatory Memorandum to the Bill states that the compliance cost impact of the consolidation changes will be low (at page 6). Based on our work to date, we respectfully submit that the compliance cost impact of the consolidation amendments will not be low, for both taxpayers and the ATO.

For taxpayers, there will be a number of work streams required, including:

- Reviewing the legislative amendments to determine whether any past consolidation events arising from transactions/acquisitions/restructures will be impacted;
- If any consolidation events are affected, determining the immediate and go-forward impacts of the changes, which may include recalculation of tax cost setting amounts and flow-on impacts to revenue recognition and/or claiming of deductions; and
- Attending to the tax compliance (i.e. tax return amendment) and financial reporting requirements arising as a consequence of any changes.

In addition, taxpayers will need to invest time and resources in ensuring that their internal tax functions are in a position to administer the prospective rules going forward. For example, any acquisition under the prospective rules will likely require additional technical analysis (as compared with the pre-rules and interim rules) as taxpayers will be required to apply the business acquisition approach outlined in Item 31 of Schedule 4, Part, 4 which introduces the new section 701-56(2) to the residual tax cost setting rule.

We expect that the ATO will need to put in place a strategy for the management of the tax consolidation and TOFA changes. We expect that specific action plans will need to be implemented to govern the tax administration aspects of these developments, as well as investing resources to ensure that ATO officers are across the extensive legislative amendments.

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To discuss any aspect of this submission, please contact Colin Jones (02 948 4724) or Richard Czerwik (03 9288 8408) in the first instance.

Yours faithfully

Tony Stolarek
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