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

22 May 2015

Dear Sir/Madam

EXPOSURE DRAFT LEGISLATION - TAX AND SUPERANNUATION LAWS AMENDMENT (2015 MEASURES NO. 4) BILL 2015: CONSOLIDATION

BDO welcomes the opportunity to provide a submission on the Exposure Draft Legislation: *Tax and Superannuation Laws Amendment (2015 Measures No. 4) Bill 2015: Consolidation* (Exposure Draft), and the accompanying *Explanatory Materials* (EM) released by Treasury for public consultation on 28 April 2015.

We make the submissions set out below in respect of the matters addressed in the Exposure Draft and EM.

Unless otherwise indicated, references to statutory provisions are references to the provisions of the *Income Tax Assessment Act 1997*.

Acquired liabilities

Our main concern is that the effect the proposed amendments in the Exposure Draft is to convert a revenue tax deduction into a capital loss. If this is the policy intention of the amendments this should be clearly stated in the EM so that affected taxpayers are fully aware of the outcome. We note that in the context of deductible liabilities for employee leave provisions the effect of the amendments will be to effectively counter the long standing treatment of employee leave provisions as a result of *TNT Skypak International (Aust.) Pty. Ltd. v. FCT* 88 ATC 4279 19 ATR 1067 and as agreed to by the Australian Taxation Office in Income Tax Ruling IT 2557.

Conversion of tax deductions to CGT cost base/capital loss

We understand the rationale for making adjustments in the Exposure Draft is to counter the double tax benefit that is perceived to be in the existing consolidation provisions. However, we are concerned that the proposed amendments in the Exposure Draft are not the correct way to deal with the perceived double tax benefit as it effectively results in the negating of a legitimate tax deduction by the head company of the consolidated group where a joining member of the group has deductible liabilities. The proposed amendments effectively convert deductable expenses into CGT cost base/capital loss.

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We understand the pure economic argument that a tax deduction and a CGT cost base/capital loss amount are equivalent and that the identities of the entities receiving the tax benefits for a particular cost is not relevant in macro-economic terms. However, in the real world, the treatment of an item as a revenue expense or a capital expense and the entity who receives the tax benefit of that expense are very important to the entities involved.

In the Appendix we show various examples that highlight the conversion of income tax deductions to CGT cost base/capital loss. In particular example 1 compared to examples 4 and 6.

The trade-off for this effective loss of a tax deduction is the tax effect (usually 30%) of the tax deduction being provided as an additional cost setting amount (by excluding the deductible liabilities from section 705-75) in the consolidation entry allocated cost amount (ACA) tax cost allocation process. This will usually result in a CGT cost base or capital loss of 30% of the deductible liability, the tax benefit of which could be deferred for what could be a long time, particularly in the common situation where, as a result of the entry ACA tax cost allocation, the additional tax cost is added to the CGT cost base of goodwill of the joining entity's business i.e. the tax benefit would not usually be realised until the business is disposed of by the consolidated group.

The justification for this treatment under the proposed amendments in the Exposure Draft appears to be that the vendor that sold the joining entity to the consolidated group would usually receive a capital loss or reduction of a capital gain as a result of disposing of shares in the joining entity that had tax deductible liabilities. This capital loss or reduced capital gain would usually be the after tax amount of the deductible liabilities (usually 70%). This combined with the 30% additional entry ACA appears to be the offset against the 100% loss of the tax deduction for the deductible liabilities.

No extra tax benefit when compared to non-consolidated group

We also note that in similar situations in a non-consolidated group, the current tax law gives a similar outcome to the situations under the current law for consolidated groups i.e. capital loss or reduced capital gain for the vendor that sells the shares and a full tax deduction for the company incurring the expense. See examples in the appendix and compare the overall effect in example 2 (current law outside a consolidated group) with that in examples 3 and 5 (current law within a consolidated group). These examples show how the current tax law applies in a similar fashion to both a consolidated and non-consolidated purchaser. This has been the situation since the introduction of CGT in 1985, so we query why change the law now only to the detriment of consolidated groups?

Reconsider these measures

We suggest that the acquired liabilities measure be excluded from the Exposure Draft and the issue be reconsidered by looking for an alternative measure that does not result in the effective conversion of income tax deductions into CGT cost bases or capital losses

Alternative Measures

We have looked at a number of alternative measures that could be considered, however we note that that each has their own problems as outlined below.

Repeal section 71-45(5)

One alternative that could be considered is that rather than, in effect, disallowing the deduction for the head company for the deductible liabilities introduced by a joining entity to the head company's consolidated group, a simpler approach could be to amend the consolidation exit ACA by repealing

section 711-45(5).

The repeal of section 711-45(5) would result in deductible liabilities that leave with leaving member of a consolidated group not being excluded from the liabilities in step 4 of the exit ACA. The result of this is that a reduction of the CGT cost base of the vendor's shares in the leaving entity.

This would leave the purchaser to claim the deductible liabilities when there are incurred.

Exclude deductible liabilities from Step 2

Another alternative would be to just exclude deductible liabilities from step 2 of the entry ACA. This was considered as 'option 3' by the Board of tax but it was discounted because it was thought it would give rise to many distortions to the cost setting amounts. The Board of tax did not outline what these distortions are but we understand the main concern is that the effective assumption of the deductible liabilities is a real cost of acquiring the underlying assets of the joining entity and if they are excluded from the ACA process the real cost will not be available to push down to the tax cost of the assets of the joining entity.

Optional alternative

The taxpayer could be given the option to either apply the acquired liabilities measure in the Exposure Draft or to exclude the deductible liabilities from step 2 of the entry ACA. We see there are problems with both these alternatives but if the Government is committed to go ahead with amendments to counter perceived extra tax benefits, taxpayers should be given the option to choose to either bring the deductible liabilities in as assessable income as per the Exposure Draft or to reduce the ACA by the amount of the deductible liabilities. This would allow the taxpayers to decide which would be the best alternative given their particular circumstances.

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Should you have any questions, or wish to discuss any of the comments made in the above submissions, please do not hesitate to contact Lance Cunningham on 02 9240 9736 or lance.cunningham@bdo.com.au or Matthew Wallace on 02 9240 9760 or matthew.wallace@bdo.com.au.

Yours sincerely

Lance Cunningham

BDO National Tax Director

Matthew Wallace

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Appendix

Example 1
Business Sale

Year Ended 30 June X1 - Vendor

XXX starts business on 1 July X0. The only entries raised for the year ended 30 June X1 are:

Dr	Land	100
Cr	Share Capital	100
Dr	Expense	100
Cr	A/L Provision	100
Dr	DTA	30
Cr	ITE	30

There is an accounting loss in X1 of $100. The taxable income is nil (s 26-10).

Year Ended 30 June X2 - Vendor

On 1 July X1, the land is sold to a tax consolidated group for $30 cash and the assumption of the annual leave provisions (tax effected) CGT consideration received is $30 (assumption of liability not included – section 116-55 does not apply):

Dr Annual Leave provision 100
Cr Land 100

Dr Bank 30
Cr DTA 30

There is no profit or loss in X2. The taxable income is nil (s 26-10). There is a capital loss of $70

Year Ended 30 June X2 - Purchaser

When the business is acquired, the following entries are raised:

Dr Land 100 (CGT cost base $30 – section 110-45(2) applies)
Cr Annual Leave provision 100

Dr DTA 30
Cr Bank 30

During the year ended 30 June X2, the only entry is to pay out the annual leave:

Dr Annual Leave provision 100
Cr Borrowings 100

Dr Income Tax Provision 30
Cr DTA 30

There is no accounting profit or loss in X2. There is a tax loss of $100 (s 26-10). There will be a capital gain of $70 when land is subsequently disposed of (assuming no change in market value of land).

Overall Tax Result:

Vendor:	Tax loss	$0
	Capital loss	$70
Purchaser	Tax loss	$100
	Capital gain	($70)
Total		$100

Tax Loss equals the economic loss on the annual leave expense and is appropriately dealt with on a revenue basis

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Example 2
Company Sale – no consolidated group

Year Ended 30 June X1 - Vendor

XXX starts business on 1 July X0. The only entries raised for the year ended 30 June X1 are:

Dr	Land	100
Cr	Share Capital	100
Dr	Expense	100
Cr	A/L Provision	100
Dr	DTA	30
Cr	ITE	30

There is an accounting loss in X1 of $100. The taxable income is nil (s 26-10).

Year Ended 30 June X2 - Vendor

On 1 July X1, the company is sold for $30, being its current worth (100 – 100 + 30). There is a $70 capital loss made on sale (100 - 30).

Year Ended 30 June X2 - Purchaser (not consolidated)

When the shares are acquired the CGT cost base of the shares is $30.

The land has a CGT cost base of $100. When the annual leave provision is paid out, there will be a $100 tax loss (s 26-10).

If the land is sold for $100, assuming there is no increase in market value of the land, there will be no capital gain or capital loss on disposal of the land.

If the shares were sold for $30, assuming no increases in the market values, there would be no capital gain or loss.

Overall Tax Result:

Vendor:	Tax loss	$0
	Capital loss	$70
Purchaser	Tax loss	$100
	Capital loss	$0
Total		$170

The tax treatment of the annual leave expense is appropriately dealt with on a revenue basis.

Example 3
Company Sale – Current Consolidation Rules

Year Ended 30 June X1 - Vendor (not consolidated group)

XXX starts business on 1 July X0. The only entries raised for the year ended 30 June X1 are:

Dr	Land	100
Cr	Share Capital	100
Dr	Expense	100
Cr	A/L Provision	100
Dr	DTA	30
Cr	ITE	30

There is an accounting loss in X1 of $100. The taxable income is nil (s 26-10).

Year Ended 30 June X2 - Vendor

On 1 July X1, the company is sold for $30, being its current worth (100 – 100 + 30). There is a $70 capital loss made on sale (100 – 30).

Year Ended 30 June X2 - Purchaser (consolidated group)

When the shares are acquired, the ACA is as follows:

Step 1: 30
Step 2: 70

The land has a tax cost of $100. When the annual leave provision is paid out, there will be a $100 tax loss (s 26-10).

If the land is sold for $100, assuming there is no increase in market value of the land, there will be no capital gain or capital loss on disposal of the land.

Overall Tax Result:

Vendor:	Tax loss	$0
	Capital loss	$70
Purchaser	Tax loss	$100
	Capital loss	$0
Total		$170

When compared to example 2, this shows that the current consolidation rules have the same result as a similar situation outside the consolidation context.

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Example 4

Company Sale – Proposed Consolidation Rules

Year Ended 30 June X1 - Vendor (not Consolidated Group)

XXX starts business on 1 July X0. The only entries raised for the year ended 30 June X1 are:

Dr	Land	100
Cr	Share Capital	100
Dr	Expense	100
Cr	A/L Provision	100
Dr	DTA	30
Cr	ITE	30

There is an accounting loss in X1 of $100. The taxable income is nil (s 26-10).

Year Ended 30 June X2 - Vendor

On 1 July X1, the company is sold for $30, being its current worth (100 – 100 + 30). There is a $70 capital loss made on sale (100 – 30).

Year Ended 30 June X2 - Purchaser (consolidated group)

When the shares are acquired, the ACA is as follows:

Step 1: 30
Step 2: 100

The land has a tax cost of $130. There will be a $100 taxable income equal to the annual leave provision. When the annual leave provision is paid out, there will be a $100 tax deduction (s 26-10).

The net result is that the vendor will get a $70 capital loss and the subsequent sale of the land by the purchaser will attract a $30 capital loss (assuming no change in the market value of the land).

Overall Tax Result:

Vendor:	Tax loss	$0
	Capital loss	$70
Purchaser	Tax loss	$0
	Capital loss	$30
Total		$100

The effect of this is that a revenue deduction is converted into a capital loss

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Example 5
Company Sale – Out Of Consolidated Group (Current Rules)

Year Ended 30 June X1 - Vendor (consolidated Group)

XXX starts business on 1 July X0 as part of a tax consolidated group. The only entries raised for the year ended 30 June X1 are:

Dr	Land	100
Cr	Share Capital	100
Dr	Expense	100
Cr	A/L Provision	100
Dr	DTA	30
Cr	ITE	30

There is an accounting loss in X1 of $100. The taxable income is nil (s 26-10).

Year Ended 30 June X2 - Vendor

On 1 July X1, the company is sold for $30, being its current worth (100 – 100 + 30). An exit ACA is done:

Step 1: 100
Step 4: 0 (711-45(5))

There is a $70 capital loss made on sale (100 – 30).

Year Ended 30 June X2 - Purchaser (consolidated Group)

When the shares are acquired, the ACA is as follows:

Step 1: 30
Step 2: 70

The land has a tax cost of $100. When the annual leave provision is paid out, there will be a $100 tax loss (s 26-10).

Overall Tax Result:

Vendor:	Tax loss	$0
	Capital loss	$70
Purchaser	Tax loss	$100
	Capital loss	$0
Total		$170

Example 6
Company Sale – Proposed Consolidation Rules

Year Ended 30 June X1 - Vendor (consolidated group)

XXX starts business on 1 July X0. The only entries raised for the year ended 30 June X1 are:

Dr	Land	100
Cr	Share Capital	100
Dr	Expense	100
Cr	A/L Provision	100
Dr	DTA	30
Cr	ITE	30

There is an accounting loss in X1 of $100. The taxable income is nil (s 26-10).

Year Ended 30 June X2 - Vendor

On 1 July X1, the company is sold for $30, being its current worth (100 – 100 + 30). An exit ACA is done:

Step 1:	100
Step 4:	0 (711-45(5))

There is a $70 capital loss made on sale (100 – 30).

Year Ended 30 June X2 - Purchaser (consolidated group)

When the shares are acquired, the ACA is as follows:

Step 1:	30
Step 2:	100

The land has a tax cost of $130. There will be a $100 taxable gain equal to the annual leave provision. When the annual leave provision is paid out, there will be a $100 tax deduction (s 26-10).

Overall Tax Result:

Vendor:	Tax loss	$0
	Capital loss	$70
Purchaser	Tax loss	$0
	Capital loss	$30
Total		$100

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Example 7
Owned Company – Current Consolidation Rules

Year Ended 30 June X1 - Owned Company

XXX starts business on 1 July X0. The only entries raised for the year ended 30 June X1 are:

Dr	Land	100
Cr	Share Capital	100
Dr	Expense	100
Cr	A/L Provision	100
Dr	DTA	30
Cr	ITE	30

There is an accounting loss in X1 of $100. The taxable income is nil (s 26-10).

Year Ended 30 June X2 - Owned Company

On 1 July X1, the company is consolidated by its current holding company. There are no tax issues for the company.

Year Ended 30 June X2 - Head Company

When the head company consolidates, the ACA is as follows:

Step 1:	100
Step 2:	70
Step 3:	0

The land has a tax cost of $170. When the annual leave provision is paid out, there will be a $100 tax deduction (s 26-10).

Overall Tax Result:

Head Company	Tax loss	$100
	Capital loss	$70
Total		$170

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Example 8
Owned Company – Proposed Consolidation Rules

Year Ended 30 June X1 - Owned Company

XXX starts business on 1 July X0. The only entries raised for the year ended 30 June X1 are:

Dr	Land	100
Cr	Share Capital	100
Dr	Expense	100
Cr	A/L Provision	100
Dr	DTA	30
Cr	ITE	30

There is an accounting loss in X1 of $100. The taxable income is nil (s 26-10).

Year Ended 30 June X2 - Owned Company

On 1 July X1, the company is consolidated by its current holding company. There are no tax issues for the company.

Year Ended 30 June X2 - Head Company

When the head company consolidates, the ACA is as follows:

Step 1:	100
Step 2:	0
Step 3:	0

The land has a tax cost of $100. When the annual leave provision is paid out, there will be a $100 tax deduction (s 26-10).

Overall Tax Result:

Head Company	Tax loss	$100
	Capital loss	$70
Total		$170