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By Email

Dear Steele

Submission: Consolidation exposure draft

Greenwoods & Herbert Smith Freehills welcome the opportunity to comment on the proposed tax consolidation amendments contained in *Treasury Laws Amendment (2017 Measures No. 9) Bill 2017* released in Exposure Draft form on 11 September 2017 (**ED**), together with the associated exposure draft Explanatory Memorandum (**EM**).

This submission does not address specific issues of relevance to life insurance companies, which we have submitted on separately.

Greenwoods & Herbert Smith Freehills is Australia's largest specialist tax advisory firm, with offices in Sydney, Melbourne and Perth. We advise ASX-listed and other large Australian businesses, SMEs as well as foreign investors and international financiers with interests in Australia.

1 Key Recommendations

Our key recommendations regarding the ED and attendant EM are as follows.

1.1 Part 1 – the deductible liabilities measure

(a) Adverse timing consequences for long term obligations

For the purposes of this submission, we accept the Board of Taxation's proposition that an amendment is required to the consolidation entry tax cost setting process to deal with liabilities of a joining entity that will be deductible after an entity joins a tax consolidated group (**TCG**). However, we have significant concerns regarding the timing impact of the proposed measure, which will create inappropriate or unfair outcomes for taxpayers where the reduction in the entry tax cost setting amount (**TCSA**) is allocated to assets that are realised over a short period of time, and the 'benefit' of the future deduction will not be realised for a long period of time.

In these circumstances, we submit that taxpayers should be given the option of excluding the deductible liability from step 2 of the entry TCSA (as currently proposed) or denying the subsequent deduction for the liability (with no reduction in step 2 of the entry TCSA).

Failure to address this may result in a distortion between asset and entity acquisitions.

Refer to 2.1 below for a more detailed explanation.

(b) Additional recommendations include the following:

- Removing the comment in paragraph 1.28 of the EM that '*this outcome does not change if, after the joining time, it is established that, in fact, the*

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liability does not give rise to a deduction'. If the taxpayer determines in calculating the entry TCSA that a liability is deductible in the future, but this determination is found later to be incorrect, consistent with the current operation of the law, the provisions must not restrict taxpayers from revising their entry TCSAs or alternatively, applying the error provisions in Subdivision 705-E (refer to 2.2 below).

- Specifically excluding liabilities relating to unearned revenue from the proposed amendments (refer 2.3 below).

1.2 Part 2 – deferred tax liabilities

We welcome the proposed amendment to remove deferred tax liabilities (**DTLs**) from an entity's entry and exit calculations (items 7 and 8 of the ED).

In particular, the inclusion of DTLs in an entity's exit TCSA under the current law represents a duplication of 30% of the difference between the accounting base and tax base of a leaving entity's assets.[1] It is also inconsistent with the economics of an exit transaction, the underlying policy of the exit tax cost setting rules, and the outcome that would arise under an asset disposal transaction.

The application of this proposed amendment to remove DTLs from an entity's exit TCSA should not be restricted in any way. It should be available to all subsidiary members that leave a TCG. Therefore, we submit that the proposed transitional rule in sub-item 9(3) of the ED be deleted.

If the proposed transitional rule is not removed, its current drafting will require complicated amendments to clarify its operation and onerous tracing issues will arise for taxpayers.

Refer 3 below for a detailed explanation.

1.3 Parts 3, 4 and 6

We also welcome the following measures contained in the package:

- the securitised assets measures contained in Parts 3 and 4 of the ED, which seek to ensure that there are no unintended entry and exit tax consolidation outcomes involving a originating entity under a securitisation arrangement; and
- the TOFA measures contained in Part 6 which correct the apparent omission between the interaction of TOFA and the tax consolidation rules in circumstances where intra-group financial arrangements commence to be recognised upon an entity leaving the tax consolidated group.

1.4 Part 5 – Churning

We submit the following:

- The churning rules should only apply where there is a dominant purpose of a controlling entity to achieve an uplift for the joined group in the tax cost of its underlying assets. This will ensure that the proposed rule does not apply to genuine commercial transactions.
- The policy intent of the proposed measure should be clarified in circumstances where there is no capital gain or loss triggered for the disposing entity (because the cost base / reduced cost base equals the capital proceeds) and the relevant shares are not *indirect real property interests*. If the policy intent is that the churning rules will not apply in these circumstances, then this should be clarified in the EM. Conversely, if the policy intent is for the churning rules to apply in these circumstances, then the ED will need to be amended.

[1] Based on a 30% tax rate.

- Where the churning rules apply, in addition to the 'switching off' of the joining provisions in relation to assets contained in proposed subsection 716-440(2) of the ED, the current section 715-375 (which resets the tax value of TOFA liabilities) should also be switched off.

Refer to 4 below.

1.5 Part 7 – Value shifting

We submit the following:

- The commencement date should be for arrangements which commence on or after the Bill is introduced into the House of Representatives. The current application date of 14 May 2013 corresponds to a media release which referred to recommendation 4.2 of the Board of Taxation's June 2012 report. As outlined in our previous submissions regarding these measures, Part 7 of the ED focuses on a converse situation to that which recommendation 4.2 applies.
- Given that the foundation of this measure is not based on the Board of Taxation review and therefore proper consultation has not been undertaken, the EM should be expanded to more thoroughly explain the policy intent of this measure.
- It needs to be made clear what type of liability the proposed paragraph 701-60A(3)(a) and 701-60A(4)(A) are referring, by describing the liability as 'not a debt'.

2 The deductible liabilities measure

2.1 Adverse timing consequences for long term obligations

We have significant concerns regarding the timing impact of the proposed measure, which will create inappropriate or unfair outcomes for taxpayers where the 'benefit' of the future deduction will not be realised for a very long period of time but the consequences of excluding the liability from the entity's entry TCSA will be realised in a short period of time.

For example, assume a joining entity has a deductible remediation liability payable in 10 years and trading stock. The tax cost of the entity's trading stock may be reduced under the entry tax cost setting process with that trading stock being realised (and the taxpayer being subject to taxable gains) within 12 months of joining a TCG, whereas the deduction for the remediation expenditure may not be realised for 10 years. A vastly different tax result occurs if the purchaser acquires the trading stock directly and has the vendor satisfy the liability compared to acquiring the entity and assuming the obligation to satisfy the liability at a later time.

We submit that taxpayers should be given the option of excluding the deductible liability from step 2 of the entry TCSA (as currently proposed) or denying the subsequent deduction for the liability (with no reduction in step 2 of the entry TCSA).

We understand this 'deduction denial' approach was not recommended by the Board of Taxation because of compliance difficulties in tracking items such as leave and warranty provisions.[2] However, in the case of large, long term obligations, it should not be difficult for taxpayers to track these liabilities. In addition, making this measure optional would enable taxpayers to determine whether it would be possible to track the liabilities on a reasonable basis and therefore decide which option they should pursue.

Examples of liabilities that this approach would be appropriate for include remediation obligations (that would not legally transfer with ownership of the relevant asset) and onerous long term contracts to buy goods or services.

[2] Refer to 2.40 of the Board of Taxation's June 2016 Report

2.2 Drafting amendments – incorrect determination

If a taxpayer determines that a liability is a 'deductible liability' and reduces the amount included in step 2 of its entry TCSA to this extent but this determination is found later to be incorrect, consistent with the current operation of the law, the proposed amendments must not restrict taxpayers from revising their entry TCSAs or applying the error provisions in Subdivision 705-E.

For example, if a taxpayer considers that a liability will be deductible in the future and therefore reduces the relevant entry TCSA under proposed subsection 705-70(1AB), and the Commissioner later successfully denies the deduction under a compliance review process, the taxpayer will suffer a double detriment as a result of the proposed amendment to exclude the amount from the entity's entry TCSA and the subsequent denial of the deductibility of the actual liability.

Under the current law, if step 2 of an entity's entry TCSA is reduced because a liability will be deductible in the future (under subsection 705-75(1)), and it is later determined that the item was not deductible and should not have resulted in a reduction of the entity's entry TCSA, the taxpayer can go back and amend its entry TCSA and its income tax returns to give effect to that amendment.[3] Alternatively, based on the factors in subsection 705-315(4), the TCG could potentially apply the error provisions in Subdivision 715-E to treat its original entry TCSA as correct and recognise a corresponding capital loss under CGT event L6.[4]

There is no basis for the reduction to step 2 under proposed subsection 705-70(1AB) to be any different in this regard.[5] Therefore, we submit that:

- this should be clarified in the EM; and
- the comment in paragraph 1.28 of the EM that '*this outcome does not change if, after the joining time, it is established that, in fact, the liability does not give rise to a deduction'* should be deleted.[6]

2.3 Unearned revenue

Unearned revenue is generally an obligation to provide a service to the counterparty in the future. Therefore, if the head company made a notional payment just after the joining time to the counterparty to discharge its liability, it would be characterised as a refund. It follows that the head company is unlikely to obtain a deduction for the payment (but would not be assessed on the unearned revenue on a derivation basis) and the relevant liability would not be reduced under proposed subsection 705-70(1AB).

The Board of Taxation noted that issues might arise in relation to unearned income that are similar to those that arise in respect of deductible liabilities, but emphasised that unearned income should be given further consideration.[7]

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[3] Subject to the 4 year statutory review period and the Commissioner's discretion to amend assessments after this time.

[4] Refer section 104-525.

[5] It is just that the reduction is likely to be greater than the 30% reduction under current law – based on a 30% tax rate.

[6] We expect this comment was inserted in the EM to clarify that the proposed rule does not require a taxpayer to continue to consider the quantum of the liability when it is later discharged in a similar way to the former CGT event L7 which required the amount paid to ultimately discharge the liability to be taken into account. However, this will cause confusion for taxpayers regarding the deductibility point.

[7] Paragraphs 2.77 and 2.78 of the April 2013 Board of Taxation Report.

Based on the current drafting, it is not clear whether the provisions are intended to apply to unearned income. For the avoidance of doubt, accounting liabilities that represent unearned income should be specifically excluded from the reduction in the proposed subsection 705-70(1AB).

3 Part 2 – Deferred tax liabilities

3.1 Item 8 – removal of DTLs from exit TCSAs

We welcome the proposed amendment to remove DTLs from an entity's entry and exit calculations (items 7 & 8 of the ED).

The inclusion of DTLs in an entity's exit TCSA under the current law represents a duplication of 30% of the difference between the accounting and tax base of a leaving entity's assets.[8] This can be illustrated by the following simple example:

- if a leaving entity holds no other assets or liabilities other than a depreciating asset with a market value and accounting value of $1,000 and a tax value of $800, and a DTL (attributable to the depreciating asset and arising after the entity joined the TCG) of $60;
- then, the exit TCSA for the leaving entity should equal $800, and the capital gain for the Vendor group should be $200.

Instead, the current law results in an exit TCSA of $740 ($800 less $60) and a capital gain for the Vendor group of $260.

The result under the current law is incorrect as it is inconsistent with the economics of the transaction, the underlying policy of the exit tax cost setting rules, and the outcome that would arise under an asset disposal. The removal of the DTL from an entity's exit TCSA corrects this result.

We understand that the basis for the Board of Taxation's recommendation that DTLs be excluded from an entity's exit TCSA was this duplication effect. As outlined in our previous submissions, there is no reason for implementation of this proposed amendment for exit TCSA's to be delayed any further. We submit that the proposed amendment to remove DTL's from an entity's exit TSCA should be implemented with effect from the date of the Budget announcement on 3 May 2016, in lieu of the start of the day on which the Bill is introduced into the House of Representatives in accordance with sub-item 9(2) of the ED.

3.2 Sub-item 9(3) - proposed transitional rule

The application of the proposed amendment to remove DTLs from an entity's exit TCSA should not be restricted in any way. It should be available to all subsidiary members that leave a TCG. Therefore, we submit that the proposed transitional rule in sub-item 9(3) of the ED be removed.

As outlined in 3.1 above, this proposed amendment to exclude DTLs from exit TCSAs is necessary to correct a current anomaly in the law which arises because a DTL of an entity when it leaves a TCG represents a duplication of the difference between the accounting and tax bases of its assets. This duplication effect is only relevant to item 8 of the ED, which relates to the exit TCSA process. It is not relevant whether a DTL of an entity was included in its entry TCSA. Whether a DTL of an entity was included in its entry TCSA under item 7 of the ED is a completely different issue to the one contemplated by item 8 of the ED.

It appears that the proposed transitional rule for the application of item 8 of the ED is being used to, effectively, reverse the impact of the application of the current law for entry tax cost setting, which allows DTLs to be included (subject to the 're-iteration' process in the current subsection 705-70(1A)). This effectively results in a retrospective application of the proposed

[8] This is on the basis that the proposed amendment made by item 7 of the ED could not by definition have applied to these entites at the relevant joining time.

measure to exclude DTLs from an entity's exit TCSA in item 8 of the ED back to 1 July 2002. It is not appropriate for a proposed change to the law to be applied retrospectively by 15 years, where it represents a disadvantage to taxpayers. In most cases the iterative nature of the DTL calculation has resulted in a reduction in the DTL included at step 2 of the entry TSCA calculations where the tax cost of assets have been 'stepped up' to their fair value.

The proposed amendment for entry TCSAs is a completely different issue to the proposed amendment for exit TCSAs. The application of the proposed amendment to exit TCSAs should not be used to manipulate the outcomes arising from the correction of a different anomaly in the law (being DTLs on entry). Therefore, the proposed transitional rule should be removed.

The proposed amendments will also require onerous tracing. This is because item 8 only applies to the extent that the DTL that exists at the leaving time was taken into account in the entry TCSA at a joining time. The problem of tracking liabilities existing at the joining time has been recognised as very difficult practically and leading to high compliance costs. For example, this was recognised by the removal of CGT L7 and the amendment of section 711-45 in 2010.[9]

3.3 Conceptual difficulties in the currently proposed drafting

If the proposed transitional rule is not removed, its current drafting will require complicated amendments to clarify its operation, as explained below.

(a) Entity v asset approach

It is unclear whether the proposed transitional rule refers to a situation where a leaving entity had a DTL when it joined the relevant TCG (similarly to the current 'same liability' rule in subsections 711-45(8) to (10)) or whether taxpayers are required to trace the DTL attributable to a particular asset of an entity when it joined the TCG.

Using an entity approach would simply not work where a DTL was taken into account in an entity's entry TCSA when it joined a group but the assets giving rise to the DTL were transferred by the leaving entity to another member of the TCG prior to its leaving time.

A DTL represents a whole amount, made up of underlying sources. The underlying sources of a DTL relate to the differences between the accounting bases and tax bases of assets (and liabilities) of an entity at a particular point in time. In addition, it would be practically impossible to trace a DTL from the time an entity joined a TCG, to the time the entity leaves the TCG, unless the time frame between the two events was extremely short or if the assets and liabilities were extremely limited. Therefore, it would be very difficult to apply a rule like the 'same liability rule' in subsections 711-45(8) to (10) to a DTL.

If the proposed transitional rule did require some type of tracing of the underlying source of an entry DTL to the underlying assets of the entity (**underlying asset approach**), clarification would be required to make this clear. The proposed rule would need to state that where the leaving entity has a DTL at the leaving time attributable to a particular asset (or liability) of the leaving entity, this DTL is excluded from Step 4 of the exit ACA calculation if item 7 applied to a DTL attributable to that particular asset (or liability) (to exclude it from the entry TCSA) at an earlier joining time.

This underlying asset approach would be inconsistent with the consequences of the consolidation 'single entity rule' effectively disregarding the taxation consequences of assets (and liabilities) and with the exit tax cost setting process which enables the tax consequences of an entity leaving a TCG to be based on the assets (and liabilities) of the leaving entity at the leaving time. Where assets have been 'freely'

[9] Refer Act No 56 of 2010.

transferred within a TCG over up to 15 years, without any contemplation that tracing would subsequently be required, it would be practically impossible to apply this asset tracing approach.

As outlined in 3.2 above, it appears that the proposed transitional rule is being used to reverse the impact of the application of the current law for entry tax cost setting, which allows DTLs to be included (subject to the re-iteration process in the current subsection 705-70(1A)). The proposed transitional rule appears to be an attempt to retrospectively remove the impact of current law, which allows DTLs to be included on entry (and therefore results in higher entry TCSAs allocated to the joining entity's assets). If this were the stated policy intention of the proposed law (we submit that it is not), this would require a tracing of the entry TCSA for assets when an entity joined a TCG and identification of a DTL component in those original TCSAs. This is a very different concept to considering the DTLs of an entity at exit. This 'benefit' from the entry DTLs would have to be attached to the entity's assets when it joined the TCG, similar to the former 'Pre-CGT factor rules in former 705-165[10] and the tagging approach for joining entities with an unrealised net loss balances under Subdivision 165-CC. This would require very complicated drafting of the kind in Division 715.

(b) Full v partial denial of DTL exclusion from exit TCSA where item 7 doesn't apply

Assuming an underlying asset approach, the exclusion of a DTL from Step 4 of an exit TCSA seems to apply to the entire amount of the DTL attributable to the particular asset at the leaving time (where item 7 of the ED did not apply to the DTL at the earlier joining time). That is, as currently drafted, the denial of the DTL exclusion is not limited ***to the extent that*** the quantum of the DTL (attributable to the particular asset) was included in step 2 of the entry TCSA because item 7 of the ED did not apply to the earlier joining time.

For example, if:

- an asset of the leaving entity had a DTL attributable to it of $10 when the entity joined the TCG which was included in step 2 of the entity's entry TCSA (item 7 of the ED did not apply); and
- the DTL value attributable to the asset at the leaving time was $15,

then the DTL value (relating to the asset) included in Step 4 of the exit TCSA would need to be $10 and not $15.

This is because the DTL attributable to an asset may increase because of an increase in the accounting base, which is not relevant to the exit tax cost setting, or because of additional tax depreciation which should not be taken into account anyway as it represents a duplication in the process.

(c) Full v partial denial where item 7 applies

Again, assuming an underlying asset approach, it needs to be made clear that the full amount of an entity's DTL attributable to an asset is excluded from step 4 of its exit TCSA if the DTL attributable to that asset was excluded from step 2 of its entry TCSA (under the application of item 7). That is, the amount of the DTL (attributable to the asset) that is 'excluded' from the exit TCSA should not be limited to the extent of the quantum of the DTL (attributable to the asset) that was excluded from its entry TCSA.

[10] Repealed by Act No 56 of 2010.

For example if:

- an asset of the leaving entity had a DTL attributable to it of $10 when the entity joined the group and which was not included in step 2 of the entity's entry TCSA (because of the operation of item 7 of the ED), and
- the DTL value attributable to the asset at the leaving time was $15,

then, the DTL value included in Step 4 of the exit ACA calculation in relation to this particular asset should be nil and not $5 (that is, $15 exit amount reduced to the extent of the entry amount of $10 excluded).

Again, this is because the DTL attributable to an asset may increase because of an increase in the accounting base, which is not relevant to the exit tax cost setting, or because of additional tax depreciation which should not be taken into account.

(d) Other

Finally, assuming an underlying asset approach, it also needs to be clarified that the transitional rule would not apply to deny a TCG from excluding a DTL (relating to an underlying asset) from a leaving entity's exit TCSA in the following circumstances:

- if the tax cost of the relevant asset was set under a joining event, but there was no DTL attributable to the asset; and
- if the tax cost of the relevant asset was never reset because the asset was directly acquired or created by the TCG, or the entity that held the asset at the relevant joining time was not subject to entry tax cost setting.[11]

3.4 Lack of consultation or Government announcement on proposed transitional rule

Neither the Board of Taxation nor the announcement by the Government in the 2016-17 Federal Budget on 3 May 2016 contemplated this proposed transitional rule. Therefore, it has not been properly consulted upon and has not been expressly agreed to by the Government.

The Board of Taxation's April 2013 report discussed under the heading 'The Board's Considerations' the mismatches on entry (inclusion of DTLs on entry has the effect of reducing the future tax liability when the asset is sold)[12] and on exit (the terminating value included at step 1 does not reflect the value of the DTL relating to the asset, but the DTL on exit included at step 4 has the effect of reducing the tax costs of the membership interests in the leaving entity)[13]. However, the recommendation[14] did not refer to any proposed transitional rule.

The 2016-17 Budget Paper No. 2 provided:

> 'The Government will amend the consolidation regime's treatment of deferred tax liabilities by removing adjustments relating to deferred tax liabilities from the consolidation entry and exit tax cost-setting rules. This change will apply to joining and leaving events under transactions that commence after the date amending legislation is introduced in Parliament. This measure is estimated to result in an unquantifiable gain to revenue.'

We understand that the proposed unquantifiable gain to revenue referred to in the paragraph immediately above, was the benefit to the revenue (and cost to taxpayers) of DTLs being excluded from entry TCSA calculations. This would result in lower entry TCSAs allocated to assets and therefore higher taxable gains on disposal of those assets (or on disposal of the subsidiary member).

[11] Because it was a head company, an eligible tier-1 company or a chosen transitional entity.

[12] Refer paragraph 3.13 of the Board of Taxation April 2013 report.

[13] Refer paragraph 3.14 of the Board of Taxation April 2013 report.

[14] Refer recommendation 3.1 in paragraph 3.22 of the Board of Taxation April 2013 report.

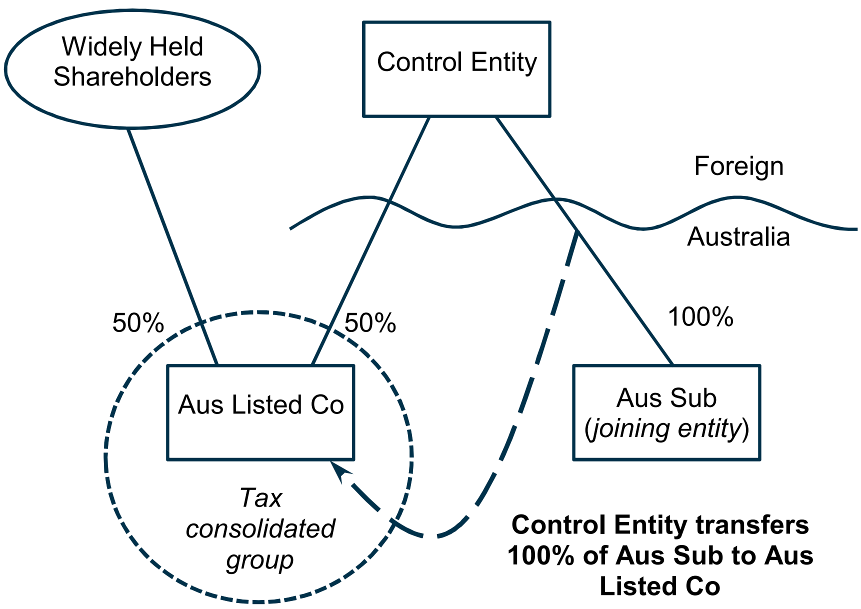
Given that this proposed transitional rule has not been subject to consultation and has not even implicitly been agreed by the Government, it clearly should not be included in the proposed measures.

4 Part 5 – Churning

4.1 Dominant purpose test

We consider the type of transactions that the proposed churning rule was intended to address were ones that should be addressed through the use of the general anti-avoidance rules in Part IVA. Given the difficulties in applying the general anti-avoidance rule in a tax consolidation context, we accept the Government's decision that a specific measure is required. However, we are concerned that the proposed measure could unintentionally apply to genuine commercial transactions.

For example, referring to the diagram below, if Aus Sub was transferred under Aus Listed Co under a genuine commercial arrangement voted on by Widely Held Shareholders, and the shares in Aus Sub were not an indirect real property interests, then, as drafted, the churning rules would apply to prevent Aus Listed Co from resetting the tax costs in the assets of Aus Sub:



We submit that the churning rule should only apply where there is a dominant purpose of the 'control entity' of achieving an increase in the tax costs of the assets for the joined group (i.e. the Aus Listed Co tax consolidated group) in relation to the underlying assets of Aus Sub. Where the dominant purpose of the transaction is a commercial one then the churning rule should not apply.

4.2 No capital gain or loss

The proposed law should be clarified as to whether the policy intent is for the churning rules not to apply where Division 855 would apply but for there being no capital gain or capital loss.

For example, if the capital proceeds for a transfer of the shares in Aus Sub equalled the cost base and reduced cost base, the churning rules would not apply as currently proposed. However, if the capital proceeds was $1 more than the cost base or $1 less than the reduced cost base then the churning rules would apply. Further, the capital proceeds in respect of the shares can change in the event that a dividend is paid by the joining entity before the disposal (the payment of a dividend should have the effect of reducing the market value of the joining entity).

4.3 Resetting of Division 230 financial arrangement liabilities

Where the churning rules apply, in addition to the 'switching' off' of the joining provisions in relation to assets contained in proposed subsection 716-440(2), current section 715-375 (which resets the tax value of TOFA liabilities) should also be switched off. Otherwise, a misalignment will arise in respect of the treatment of Division 230 financial arrangements that are liabilities, as compared to Division 230 financial arrangements that are assets.

There is currently no misalignment in the law nor is there any basis for there to be any difference in the treatment of TOFA assets and TOFA liabilities. This is simply a drafting oversight in the ED.

4.4 Arbitrary nature of the proposed rule

We understand the gateway provisions to the churning rule are arbitrary provisions designed to ensure the rule does not apply in circumstances where there has been a genuine change in the underlying ownership of the relevant entity or entities. For completeness, we note that the use of such an arbitrary rule and the use of 'all or nothing' consequences, can lead to seemingly arbitrary and/or anomalous outcomes.

For example:

- Under the facts at example at 4.1 above, if Control Entity held 49% of Aus Listed Co the churning rules would not apply, but if Control Entity held 50% or more the churning rules would apply. The Widely Held Shareholders are indirectly disadvantaged where the churning rules apply and there would otherwise have been a step-up in the tax cost of the assets of the Aus Sub.
- As a new example, a consolidated group is owned 90% by a foreign entity (the 'control entity') which acquires 100% of a joining entity from the foreign entity for cash consideration in two tranches, where under the earlier tranche (say, 99%) the shares in the joining entity satisfied the principal asset test contained in the existing section 855-30, but under the later tranche giving rise to the joining event they did not. In this case the churning rules would apply notwithstanding that the control entity would have been subject to CGT on the disposal under the earlier tranche (in this example being 99% of the transaction value). This is an anomaly as CGT has been paid on 99% of the overall capital gain (assuming that the cost base and market values were constant across both tranches).

5 Part 7 – Value shifting

5.1 Commencement date

If the amendment is to become law, the amendment should only apply to arrangements which commence on or after the Bill is introduced into the House of Representatives. This is because the proposed amendment does not appropriately correspond with any announcement in the 14 May 2013 Federal Budget. Part 1 of Budget Paper 2 of the 14 May 2013 Federal Budget provides the following:

> 'The law will be amended to ensure that …….consolidated groups cannot access double deductions by shifting the value of assets between entities.'

The accompanying media release[15] issued that day refers to recommendation 4.2 of the Board of Taxation's June 2012 report where the media release provides that the Government agrees to this recommendation.

[15] Media release No. 68 from David Bradbury, Assistant Treasurer dated 14 May 2013.

Recommendation 4.2 deals with the disposal of encumbered assets, i.e. assets held by a leaving entity whose market value has been reduced due to the intra-group creation of rights over the asset.

Recommendation 4.2 states:

> 'The Board recommends that integrity rules should be designed to address any double benefit which arises when an encumbered asset, whose market value has been reduced due to the intra-group creation of rights over the encumbered asset, is sold by a consolidated group, whether directly or indirectly.'

That is, Recommendation 4.2 relates to the tax cost setting amount of an asset of a consolidated group that consists of a liability owed to it by a leaving entity.

5.2 Uncertainties as to policy intent and operation of the proposed amendments

Given that the foundation of this measure is not based on the Board of Taxation review and therefore proper consultation has not been undertaken, the EM should be expanded to more thoroughly explain the policy intent of this measure and to include real life examples.

In addition, the application of proposed subsections 701-60A(3) and (4) of the ED requires that the corresponding liability is 'not a debt'. We expect that section 701-60A is only intended to provide a TSCA (for the purpose of step 3 of the exist TCSA and for the purpose of the leaving entity determining the tax cost of the asset once the single entity rule ceases to apply) for other rights, for example onerous leases over assets. However, this is not entirely clear from the ED or the EM.

The ED should be amended to ensure that in addition to a monetary debt, a 'debt' for the purpose of proposed subsections (3) and (4) includes a 'present indebtedness' of the kind described at paragraph 10c) of TD 2005/45. That paragraph provides:

> '10. For a 'present indebtedness' liability, subsection 711-40(1) provides that the step 3 amount is the market value of the corresponding asset. For instance, where:
>
> ……
>
> c) the leaving entity has prepaid the member of the old group for goods or services that have not been provided at the leaving time: the old group has a 'liability owed' to the leaving entity to provide the goods or services and the right to receive them is the 'corresponding asset' of the leaving entity. The step 3 amount is the market value of that asset.'

This will ensure that the proposed amendment will not apply to a 'present indebtedness' liability.

Where, for example, prior to the leaving time the leaving entity pays another member of the group for goods which have yet not been delivered to the leaving entity as at the leaving time, the leaving entity has an enforceable right (i.e. an asset) against the relevant member of the group to provide the goods and the relevant member of the group has an obligation to provide the goods (i.e. a liability).

The market value of the leaving entity will reflect that it holds a right as against a member of the consolidated group to require it to deliver the goods.

From the perspective of the leaving entity, assuming it does not join another tax consolidated group, where the tax cost in the right is less than market value (which is possible under the ED if the obligation of the member of the group is not a 'debt'), then the delivery of the goods and hence the extinguishment of the right after the leaving time may give rise to a capital gain for the leaving entity under CGT event C2.

If, consistent with our submission regarding paragraph 10c) of TD 2005/45, the payment before delivery were recognised as giving rise to a ‘debt’ owed by the member of the group to the joining entity, which after the leaving time is discharged upon delivery of the goods, then appropriate outcomes should arise for both the continuing group and the leaving entity.

* * *

We are happy to discuss this submission further, should you wish to do so.

Yours sincerely

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