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Ms Julie Owens MP
Chair
House Standing Committee on Economics
PO Box 6021
Parliament House
CANBERRA ACT 2600

31 May 2012

Our ref: JC/OG

By email: economics.reps@aph.gov.au

Dear Madam Chair

Tax Laws Amendment (2012 Measures No. 2) Bill 2012

Deloitte welcomes the opportunity to comment on the proposed amendments to the consolidated group rules as have been included in Schedules 2 and 3 of the Tax Laws Amendment (2012 Measures No. 2) Bill 2012 (**TLAB 2 2012**). These amendments relate to the operation of:

- The taxation of financial arrangements (**TOFA**) and consolidation interaction provisions – Schedule 2 of TLAB 2 2012
- The consolidation tax cost setting and rights to future income (**RTFI**) rules – Schedule 3 of TLAB 2 2012.

Our comments on the content of Schedule 2 of TLAB 2 of 2012 are set out in Appendix A to this submission.

At Appendix B, we attach our submission to Treasury of 3 May 2012 responding to the exposure draft (**ED**) legislation that preceded Schedule 3 of TLAB 2 2012. We note that our comments on the ED legislation as concerning the proposed amendments to the RTFI and residual tax cost setting rules remain largely intact. Consequently, we draw this submission to attention of the House Standing Committee on Economics as part of their review of Schedule 3 of TLAB 2 2012. We have also provided additional comment on the application of the prospective rules in Schedule 3.

In particular, we seek to emphasise the not inconsiderable concern of taxpayers, their advisors and the various professional bodies representing these groups, regarding the retrospective application of the amendments contained within both Schedules 2 and 3 of TLAB 2 2012. While discussed further in Appendices A and B, these concerns can be broadly summarised as follows:

- Schedule 2 – The retrospective application of the proposed changes to the TOFA and consolidation interaction provisions to 26 March 2009 is unfair to taxpayers who relied on the

existing tax legislation when making significant business decisions on acquisitions or deciding whether or not to make a transitional election to apply the TOFA rules to their existing financial arrangements. These taxpayers would have acted on the belief that they would be entitled to certain deductions which will not be available if the proposed changes were to apply retrospectively

- Schedule 3 – The unexpected 31 March 2011 cut-off date used throughout the application rules of the proposed changes to the consolidation tax cost setting and RTFI rules is unreasonably detrimental to taxpayers who acted prudently and did not claim in light of there being considerable uncertainty surrounding application of the RTFI and residual tax cost setting laws as were first enacted.

  Further, it would seem manifestly unfair to deny claims to taxpayers who lodged requests for private binding rulings, objections or requests for amended assessments well before 31 March 2011 but did not receive a ruling or were not issued with an amended assessment by this time. It is our view that these taxpayers should not be disadvantaged by circumstances clearly beyond their control.

* * * *

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Please contact us on (02) 9322 7749 if you have any queries on the submission.

Yours sincerely

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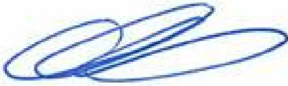

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Appendix A

Consolidation and TOFA

The proposed changes to the consolidation and TOFA rules as contained in Schedule 2 of the TLAB 2 2012 are proposed to apply retrospectively from 26 March 2009. We note that the proposed retrospective legislation will adversely affect a range of taxpayers who relied on the existing tax legislation when they were making significant business decisions, or deciding whether or not to make a transitional election to apply the TOFA rules to their existing financial arrangements.

Those taxpayers can be divided into two categories:

a) Head companies of consolidated groups who made a transitional election to apply the TOFA rules to their existing financial arrangements and had pre-TOFA acquisitions of joining entities with financial arrangements

b) Head companies of consolidated groups that have acquired entities with certain financial arrangement liabilities since the time that Division 230 started to apply to them (whether or not they made a transitional election).

Taxpayers that made transitional elections

As a result of the proposed changes, a taxpayer who made a transitional election based on the law prior to 25 November 2011 could be significantly worse off than a similar taxpayer who had not made a transitional election, for the reasons set out below.

As a result of the proposed changes, the head company of a consolidated group that acquires a joining entity with pre-TOFA financial arrangements that are liabilities is deemed to have received an amount equal to the accounting value of the liability at the joining time. Therefore, the head company would not be entitled to a deduction when the financial liabilities are closed out.

However, before these proposed changes were announced, the existing law had allowed the head company to be entitled to the deduction (on the basis that the tax cost in the financial liabilities assumed from the pre-TOFA joining entity would *not* be reset to their accounting value at the joining time). In that regard, many companies undertaking acquisitions before these changes were announced may have taken that deduction into consideration when pricing the acquisition, as well as when deciding whether or not to make a TOFA transitional election.

Therefore, the retrospective application of the proposed changes may result in an unfair outcome for taxpayers who had made a transitional election at the time on the belief that such a deduction would be available.

Taxpayers that made post-TOFA acquisitions

A consolidated group that is subject to the TOFA rules may have acquired entities with financial arrangement liabilities since the time that Division 230 started to apply to the group. This time could have been as early as 1 July 2009 if an election to early adopt the TOFA rules was made.

As noted above, the purchaser group may have priced acquisitions on the basis that they would be entitled to deductions on the settlement of certain financial arrangement liabilities assumed from the joining entities. If the proposed changes apply retrospectively, this may mean that acquisitions since 1 July 2009 (almost 3 years ago) may have been incorrectly priced to the extent of the tax benefit of any deduction that was anticipated.

Recommendation

We recommend that the commencement date for the final legislation be amended to 25 November 2011.

If, however, the Government proceeds with a commencement date of 26 March 2009, we recommend that affected taxpayers should be given the opportunity to revoke TOFA transitional elections within a reasonable timeframe.

Appendix B

Additional comment on the application of the prospective rules in Schedule 3

Further to our submission to Treasury of 3 May 2012, we wish to comment on the operation of the prospective rules which are proposed to apply from 30 March 2011.

As a consequence of amendments contained within the prospective rules result it is apparent that the tax cost setting process is likely to result in many of the assets of a joining entity being treated on capital account as a consequence of their being deemed to have been acquired as part of the acquisition of a business that is a going concern. In addition, the treatment of the majority of RTFI assets as retained cost base assets should result in these assets being allocated minimal if any allocable cost amount under the tax cost setting process.

These results lead to a question about whether taxpayers should favour asset acquisitions over entity acquisitions as a means of reducing any potential exposure to adverse taxation outcomes, in turn leading to doubts over whether the consolidation rules achieve their intended result.

The amendments contained in the prospective rules were not announced on 31 March 2011, being the date on which the Assistant Treasurer announced the Board of Taxation review of the RTFI and residual tax cost setting rules, [1] but rather were only first announced on 25 November 2011.[2] Consequently, taxpayers would not have had regard to the consequences of the prospective rules in entering into transactions on or after 31 March 2011. Accordingly, it seems manifestly unfair to apply these rules from 31 March 2011 as is proposed in TLAB 2 2012.

Recommendation

We recommend that the commencement date for the prospective rules be amended to 25 November 2011.

Submission to Treasury of 3 May 2012

In light of the differences (both in format and substance) between the ED legislation that preceded Schedule 3 to TLAB 2 2012 and Schedule 3 to TLAB 2 2012 itself, please have regard to the following points when reviewing the content of the following submission:

Retrospective application of the amendments:

- Item 1– The reference to subitem 54(1) of the ED in recommendation 1 should now be read as a reference to subitem 51(1) of TLAB 2 2012
- Item 1 – The reference to subitem 53(3) of the ED in recommendation 1 should now be read as a reference to subitem 50(3) of TLAB 2 2012.

The pre-rules

- Item 2.1.1 – The reference to subitem 53(5) of the ED should now be read as a reference to Subitem 50(5) of Schedule 3 of TLAB 2 2012
- Item 2.1.3 – The reference to paragraph 701-63(2)(c) of the ED should now be read as a reference to paragraph 701-63(3)(c) of TLAB 2 2012
- Item 2.1.3 – The reference to subsection 701-63(3) of the ED should now be read as a reference to paragraph 701-63(4) of TLAB 2 2012

[1] Assistant Treasurer’s press release no. 045 of 2011.
[2] Assistant Treasurer’s press release no. 159 of 2011.

- Item 2.1.4 – The references to subsection 701-63(4) of the ED should now be read as references to subsection 701-63(5) of TLAB 2 2012
- Item 2.1.4 – The reference to subsection 701-63(5) of the ED should now be read as a reference to subsection 701-63(6) of TLAB 2 2012
- Item 2.1.4 – The reference to subsection 701-63(1) of the ED should now be read as a reference to subsection 701-63(2) of TLAB 2 2012
- Item 2.1.5 – This item is now irrelevant on the basis that subsection 701-63(6) has been amended to incorporate the provision of goods
- Item 2.1.6 – The references to paragraph 701-63(2)(b) of the ED should now be read as references to paragraph 701-63(3)(b) of TLAB 2 2012.

The interim rules

- Item 2.2.1 – This item is now irrelevant on the basis that subsection 701-55(5C) of TLAB 2 2012 now refers to section 716-410
- Item 2.2.2 – While the examples in the explanatory memorandum (**EM**) to TLAB 2 2012 illustrating the operation of subsection 701-63(4) have been updated, our comments querying the intended application of what is now paragraphs 701-63(4)(b) and (c) remain
- Item 2.2.3 – The references to subsection 701-63(4) of the ED should now be read as references to subsection 701-63(5) of TLAB 2 2012.

The prospective rules

- Item 2.3.6 – This item is now irrelevant on the basis that the EM to TLAB 2 2012 has been updated in accordance with our recommendation.

Application rules

- Item 2.4.1 – This item is irrelevant on the basis that subitem 51(3) of TLAB 2 2012 has been updated
- Item 2.4.2 – This item would appear to be irrelevant based on comments in paragraph 3.123 of the EM to TLAB 2 2012 to the effect that the tails of claims for deductions may not be allowed in subsequent income years.

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3 May 2012

Our ref: JC/JL/OG/ML

By email: consolidation@treasury.gov.au

Dear Sir/Madam

Tax Laws Amendment (2012 Measures No. 2) Bill 2012: Proposed amendments to the tax consolidation rules

Deloitte welcomes the opportunity to provide comments on the proposed consolidation amendments contained in Schedule 1 of the exposure draft (**ED**) legislation above, namely the rights to future income (**RTFI**) and residual tax cost setting rules.

We note that the proposed amendments contained in the ED legislation and related materials are largely unchanged from that outlined in the former Assistant Treasurer's announcement of 25 November 2011 although there are some important differences as highlighted in this submission.[3]

Our comments in the attached submission are divided into two sections:

- Issues arising from the retrospective application of the proposed amendments
- Technical issues arising from the ED.

All legislative references are to the *Income Tax Assessment Act 1997* unless otherwise stated.

[3] Assistant Treasurer's press release no. 159 of 2011.

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Yours sincerely

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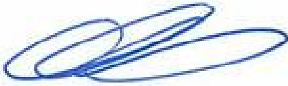

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1 Retrospective application of the amendments

At the outset, we highlight that we understand the government's revenue concerns with the rules as they currently stand. However, despite consultation between Treasury, the Australian Taxation Office (**ATO**) and members of various professional bodies, the cut-off date of 31 March 2011 that is used throughout the application rules in the ED will give rise to inequitable outcomes for many taxpayers who have sought to rely upon those rules. The main reason for this is that:

- Protection against the retrospective application of the changes contained in the ED legislation is limited to taxpayers who received a private binding ruling or written advice under an Advance Compliance Agreement issued before 31 March 2011[4]
- Where the joining time was before 12 May 2010, taxpayers will only be able to apply the comparatively more favourable interim rules where "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"[5].

1.1 Appropriateness of the 30 March 2011 cut-off

We note that 30 March 2011 was the date on which the Assistant Treasurer announced the review by the Board of Taxation of the currently enacted RTFI and residual tax cost setting rules.[6] Protection from the changes in the ED is limited to taxpayers who were issued a private binding ruling before 31 March 2011. Furthermore, the interim rules apply in respect of pre-12 May 2010 joining times where the head company's latest notice of assessment or amended assessment that relates to the application of the RTFI or residual tax cost setting rules was served between 12 May 2010 and 30 March 2011. Taxpayers would not have expected that it would subsequently transpire that the announcement date of 30 March 2011 would effectively be a 'cut-off date' for the issue of any private binding rulings, or notices of assessment or amended assessment. If so, they would have been more proactive in applying for private binding rulings, or lodging requests for amended assessments or objections, as soon as the *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (**2010 Act**) received Royal Assent on 3 June 2010. Further, there are a number of reasons why taxpayers chose to defer any such courses of action as discussed below.

1.1.1 Time limit provided by legislation

The 2010 Act received Royal Assent on 3 June 2010 and applied retrospectively from 1 July 2002. In recognition of the fact that the typical 4-year period for amending assessments would have expired in some cases, item 4 of the 2010 Act provided that taxpayers would have 2 years from the date of Royal Assent to amend prior year notices of assessment. Accordingly, taxpayers would have had until 3 June 2012 to amend, or object to, prior year assessments.

In light of this additional period to amend, or object to, prior year assessments, many taxpayers did not seek to immediately lodge private binding ruling requests, objections or requests for amended assessments, preferring instead to take the time to obtain professional advice on the changes. Accordingly, taxpayers who continued to rely on the enacted law in good faith and based on time limits specified in the legislation are, in our view, unfairly penalised by the ED amendments.

1.1.2 Outstanding ATO guidance

There were six issues with the RTFI and residual tax cost setting rules that were raised with the ATO in October 2010 by members of the NTLG Consolidation Subcommittee. These were fundamental to determining the scope of the rules. Unsurprisingly, many taxpayers chose to await the outcome of

[4] ED legislation, Schedule 1, items 54(1) and (2).
[5] Ibid, item 53(3).
[6] Press release no. 045 of 2011.

ATO guidance on these issues (which had not been provided as at 31 March 2011) before seeking private binding rulings, or lodging objections or requests for amended assessments, since the issues were frequently critical to determining how the RTFI and residual tax cost setting rules applied.

1.2 Delays in ATO processing of requests for amended assessments or private binding rulings

Some taxpayers lodged requests for private binding rulings, objections or requests for amended assessments well before 30 March 2011 but the ATO did not issue private binding rulings or notices of amended assessments until after that date. In some cases, private binding rulings and notices of assessment remain unissued. It seems manifestly unfair that taxpayers should be penalised for something that they have no control over, particularly given that many will have invested considerable cost and effort in seeking professional advice and valuations, and preparing requests for rulings or amended assessments.

Recommendation 1

It is clear that the retrospective application of the proposed amendments to the RTFI and residual tax cost setting rules will have significant adverse implications for a number of taxpayers. Based on the above, we recommend that consideration should be given to amending the ED as follows:

- The protection afforded by item 54(1) should be conferred upon requests for private rulings or written advice under an Advance Compliance Agreement that were *lodged* rather than issued or given before 31 March 2011
- Where the joining time was before 12 May 2010, item 53(3) should permit the application of the interim rules where an objection or request for amended assessment was *lodged*, rather than served, between 12 May 2010 and 30 March 2011.

Focussing on the date of lodgment of a request for a private binding ruling, objection or a request for an amended assessment would ensure that taxpayers are not adversely affected under the proposed rules because of factors outside of their control (e.g. ATO processing times).

It will also recognise the fact that taxpayers will have invested considerable cost and effort in seeking professional advice, valuations, and preparing private binding ruling requests, objections or requests for amended assessments, that were lodged before 31 March 2011.

2 Technical issues arising from the exposure draft

2.1 The pre-rules

2.1.1 Treatment of revenue assets under the original rules

Subitem 53(5) of the ED establishes that subsection 701-55(6) as originally drafted will continue to apply to taxpayers for certain income years.

The explanatory memorandum (**EM**) to the *New Business Tax System (Consolidation) Bill (No. 1) 2002* provided very limited guidance on the interpretation of this provision. Paragraph 2.57 states:

> *In setting the cost for tax purpose of an asset to which provisions not covered in the discussion in paragraphs 2.53 to 2.56, the provisions apply as though the assets 'cost' is reset.*

The ATO subsequently took the view in TD 2004/D85 (withdrawn) that the fact that the tax cost of a work in progress asset may have been set at its tax cost setting amount (**TCSA**) at the joining time does not mean that payment for the work in progress has been made at that time or a later time by the head company of the group. Accordingly, the treatment of the TCSA of an asset as its cost suggests that subsection 701-55(6) would be relevant to assets in respect of which a net profit or loss approach is taken to determining assessable income or allowable deduction.

For example, paragraph 67 of TR 96/4, which is about valuing shares acquired as revenue assets, states:

> *If a taxpayer disposes of shares that are revenue assets, but are not trading stock, the gross receipt is not assessable, but any net profit is income according to ordinary concepts and, therefore, assessable under subsection 25(1): see Commercial and General Acceptance Ltd v. FC of T (1977) 137 CLR 373 at 382-383; 77 ATC 4375 at 4380; (1977) 7 ATR 716 at 721-722; FC of T v. Whitfords Beach Pty Ltd (1982) 150 CLR 355; 82 ATC 4031; (1982) 12 ATR 692; and Parsons at 307 and 431-432. It follows that if the disposal results in a net loss, that loss is deductible under subsection 51(1): see Ronpibon Tin NL and Tongkah Compound NL v. FC of T (1949) 78 CLR 47 at 57.*

Guidance on whether the TCSA of assets such as revenue assets that are within subsection 701-55(6) can be used in working out the net profit or loss on the realisation of those assets is required.

Recommendation 2

We recommend that the scope of the operation of subsection 701-55(6) in the pre-rules should be clarified, in particular that the TCSA of assets subject to that provision may be taken into account in working out a net profit that is assessable income under section 6-5 or a net loss that is an allowable deduction under section 8-1. This could be done by way of a note in the legislation or examples in the EM to the proposed bill.

2.1.2 Division 775

We note that issues were previously raised at the NTLG Consolidation Subcommittee in relation to the interaction between Division 775 and the currently enacted subsection 701-55(6).[7] For example, if a consolidated group acquires a joining entity that holds an 'in the money' forward foreign exchange contract under which the joining entity has an obligation to pay foreign currency. The settlement of that contract would give rise to forex realisation event 4 under subsection 775-55(1) as the consolidated group would cease to have an obligation to pay foreign currency.

A gain or loss under forex realisation event 4 is the difference between the "amount you paid in respect of the event happening" and the "proceeds of assuming the obligation or part of the obligation". It is doubtful that the TCSA of the forward foreign exchange contract under subsection 701-55(6) would be treated as an amount paid in respect of the event happening.

Although this issue was raised in the context of the currently enacted subsection 701-55(6), it would appear to be equally applicable to the version of that provision under the pre-rules. Furthermore, there are a range of other terms used under other forex realisation events which do not neatly interact with the treatment of the TCSA of an asset under subsection 701-55(6) as its 'cost'.

Recommendation 3

Consistent with previous consultation on the interaction between the consolidation rules and Division 775, Treasury should ensure that the TCSA of assets subject to subsection 701-55(6) can be appropriately taken into account in working out gains or losses under the various forex realisation events in Division 775. This is relevant for the pre, interim and prospective rules.

[7] October 2010 Minutes of the NTLG Consolidation Subcommittee, agenda item 5.1.

2.1.3 Treating non-deductible rights to future income as goodwill assets

Under paragraph 701-63(2)(c), non-deductible RTFI assets are to be treated as forming part of a goodwill asset. A non-deductible RTFI is defined in subsection 701-63(3) as a RTFI that is not a WIP amount asset. Paragraph 1.39 of the EM to the ED suggests that there will be limited scope to recognise the TCSA of an asset that is allocated to goodwill:

> *For the avoidance of doubt, the pre-rules will treat certain assets as forming part of the goodwill asset of an entity. A goodwill asset is a CGT asset. Taxation Ruling TR 1999/16 outlines how the CGT provisions apply to goodwill assets. Applying that ruling, the tax cost allocated to these assets will be recognised only when, broadly:*
>
> - *a subsidiary member leaves the group taking the goodwill asset with it;*
> - *the goodwill asset is sold; or*
> - *the goodwill asset ceases to exist.*

If a contract or agreement that constitutes a non-deductible RTFI is treated as forming part of a goodwill asset, this paragraph suggests that a consolidated group would not obtain any recognition of the TCSA of the RTFI except in the three scenarios specified above. Accordingly, when the contract or agreement is completed, we seek confirmation that no recognition of the tax cost (for example, as a capital loss) would be available at that time. If this is the intended outcome, we note that this would be significantly different to the position before the 2010 Act was introduced. The TCSA of contracts or agreements that constituted RTFIs would typically have been recognised as a tax loss (usually a capital loss) on the completion of those contracts.

If Treasury's intention is that the tax cost of non-deductible RTFIs should not give rise to a capital loss when the contract or agreement that constitutes that RTFI is completed, guidance is required on to what extent that cost is recognised if there is a disposal of a business or something less than a business by the consolidated groups. Taxation Ruling TR 1999/16 (**TR 1999/16**) considers whether there is a disposal of goodwill on the disposal of one of several businesses or on a disposal of something less than a business. Paragraph 74 of the ruling states:

> *If a business owner is carrying on one business and disposes of some part of the business, it is a question of fact whether the owner has disposed of a discrete business that a purchaser could conduct or has merely disposed of a business asset or a collection of business assets. This question is determined having regard to all of the circumstances (and not solely from the purchaser's perspective) including whether sufficient relevant assets are sold to enable the purchaser to carry on the business the vendor had carried on, whether the assets sold are accompanied or carry with them the legal right, privilege or entitlement to conduct the business and whether what is sold is sold as a self contained business. If a business owner disposes of part of their business, an important consideration is whether the effect of the transaction is to put the purchaser in possession of a going concern the activities of which the purchaser could carry on without interruption: see Full Supreme Court of Tasmania decision in Zeekap (No 56) Pty Ltd v C of SD (Tas) 99 ATC 4745 at 4747-8; (1999) 42 ATR 295 at 297-8.*

It is not clear how the principles of the ruling would be applied to determine if any of the TCSA of a RTFI that is deemed to form part of the goodwill asset should be recognised on the disposal of a business or something less than a business, particularly where the contract or agreement that constitutes the RTFI no longer exists.

Recommendation 4

We recommend that Treasury clarify its intention in respect of non-deductible RTFIs that are treated as forming part of a goodwill asset. We consider that the TCSA of non-deductible RTFIs should be recognised as a capital loss when the contract or agreement that constitutes the RTFI is completed.

However, if the intention is that the TCSA of the RTFIs will only be recognised when any of the three scenarios set out at paragraph 1.39 of the EM happens, further guidance is required on how that TCSA would be recognised when one of several businesses, or something less than a business, is disposed of.

This issue is also relevant to the interim rules.

2.1.4 Trade receivables

It is noted that a trade receivable may constitute a RTFI as defined in subsection 701-63(4). A trade receivable is a valuable right to receive an amount for the performance of work or services or the provision of goods. It also forms part of a contract or agreement and would be expected to have a market value of greater than nil. As to whether the trade receivable is or is not a Division 230 financial arrangement, it is noted that a "Division 230 financial arrangement" is defined in section 995-1 as a financial arrangement where "Division 230 applies in relation to your gains and losses from the arrangement". Although a trade receivable would be a financial arrangement, it would not be a Division 230 financial arrangement if the settlement terms are 12 months or less as the short-term arrangement exception in section 230-450 would apply.

Assuming the settlement terms of the trade receivable are 12 months or less such that the trade receivable is a RTFI, it must be considered if it is a WIP amount asset. Given that the trade receivable represents a recoverable debt, it would not constitute a WIP amount asset as defined under subsection 701-63(5) of the ED. Accordingly, the trade receivable would be a non-deductible RTFI that is treated as an asset forming part of goodwill. Pursuant to subsection 701-63(1), this treatment applies for the purposes of the consolidation rules.

On this basis, it would appear that all gains and losses in respect of trade receivables would be on capital account. This is in contrast to the current treatment of trade receivables. Trade receivables denominated in Australian currency would be retained cost base assets whose TCSA would equal their face value at the joining time. For the majority of taxpayers, no gain or loss would arise on realisation of receivables, or any gain or loss would be capital in nature. However, for some taxpayers, a gain on trade receivables may be ordinary income (for example, a debt factoring company may acquire an entity with trade receivables for an agreed discount or factoring charge). Furthermore, it is noted that gains or losses arising from foreign exchange movements on trade receivables that are denominated in a foreign currency would be on revenue account under Division 775.

The other issues highlighted at section 2.1.3 in respect of the treatment of non-deductible RTFIs are equally applicable here.

Recommendation 5

It is recommended that the definition of non-deductible RTFI should be amended to exclude trade receivables. There is no mischief arising from the current treatment of trade receivables. One way of achieving this might be to amend the definition of RTFI in subsection 701-63(4) to include a similar requirement to the currently enacted section 716-410, which requires that "it is reasonable to expect that an amount attributable to the asset will be included in the assessable income of the entity or any other entity after the joining time".

2.1.5 Rights to future income for the provision of goods

The pre-rules in the ED are more onerous than the retrospective rules set out in the announcement of 25 November 2011 in that they limit deductions to WIP amount assets (which can never be in respect of goods) as compared to the announcement which indicated that the reset tax costs of "Category 1 RTFI" would be deductible. In particular, paragraph 24 of the announcement states that the reset tax cost of a Category 1 RTFI would be deductible if it arose under an agreement, another entity had agreed to pay an amount to the joining entity under the agreement, and the amount can be identified as being in respect of goods or services that have been provided before the joining time by the joining entity where a recoverable debt has not yet arisen.

It appears that the definition of WIP amount asset in subsection 701-63(5) is intended to replicate the definition of a 'work in progress amount' in subsection 25-95(3). However, the WIP rules in section 25-95 deal with 'gross' amounts of income that are not derived at the time of acquisition. This explains the exclusion for goods from the definition of 'work in progress amount' as the goods would be dealt with separately (possibly via the trading stock rules or an ordinary general deduction for non-trading stock goods).

To the extent that subsection 701-63(3) will treat all RTFI assets, other than WIP amount assets as being non-deductible, it is evident that 'unbilled income' assets for goods already provided will be treated as goodwill of the joining entity. In addition to being inconsistent with the former Assistant Treasurer's announcement on the treatment of Category 1 RTFI, deemed goodwill treatment would preclude the head company from even contemplating the entitlement to a deduction for the cost of acquiring the unbilled income.

By way of example, if a head company acquires an unbilled income asset relating to the provision of items of trading stock by the joining entity, the head company would not be entitled to a deduction for that part of the TCSA that exceeds the cost of the trading stock supplied. Such an outcome would appear inconsistent with the policy behind the inclusion of a specific deduction for WIP amount assets as was discussed above but also with the outcome obtained under an asset acquisition.

The point raised above would be equally valid in relation to contracts for the future provision of goods. Any limitation to the head company's recourse to consider the availability of a deduction for the costs attributable to such contracts would seem almost prejudicial when, under the original rules, no such limitation would have existed.

Recommendation 6

The definition of non-deductible right to future income in the pre-rules should, consistent with the former Assistant Treasurer's announcement of 25 November 2011, not encompass 'unbilled income' assets arising from the supply of goods before the joining time.

Further, Treasury should also consider whether the pre-rules, as currently drafted, could be construed as being prejudicial to taxpayers as they apply to contracts for the provision of goods in general.

2.1.6 Accounting intangible assets treated as forming part of goodwill

Under paragraph 701-63(2)(b) of the pre-rules, an asset forming part of goodwill is defined as:

> *[A] customer relationship asset, know-how asset or another accounting intangible asset, that:*
>
> *(i) is not a CGT asset; and*
>
> *(ii) is not goodwill.*

It is unclear whether the reference to 'goodwill' is to accounting goodwill or goodwill as defined in TR 1999/16. In any event, it is unclear what the words 'not goodwill' add to this provision. If they were removed, the provision would simply treat customer relationship assets, know-how assets or other accounting intangible assets as forming part of a goodwill asset (regardless of whether or not they otherwise constitute goodwill).

The meanings of the terms 'customer relationship asset' and 'know-how asset' are also not clear. Given that the provision goes on to refer to 'another accounting intangible', this would appear to indicate that it is the accounting meanings of the terms that are relevant in interpreting the provision. However, this should be confirmed.

Recommendation 7

We recommend that Treasury consider whether the words 'not goodwill' are required. If so, clarification is required of the meaning of 'goodwill', that is, whether it is a reference to accounting goodwill or goodwill as defined in TR 1999/16.

We recommend clarifying (via the EM to the proposed bill) the meaning of the terms 'customer relationship asset' and 'know-how asset' in paragraph 701-63(2)(b).

2.2 The interim rules

2.2.1 Section 716-410

Paragraph 1.47 of the EM indicates that the interim rules are intended to restore the current RTFI and residual tax cost settings rules, including section 716-410.

It is noted that subsection 701-55(5C), as currently enacted, states:

> *If section 716-410 (rights to future amounts that are expected to be included in assessable income) covers the asset at the particular time, the expression means that section 716-405 may apply in relation to the asset after the particular time.*

However, the proposed subsection 701-55(5C) under the interim rules no longer refers to section 716-410 even though the latter provision is re-enacted under the interim rules. It is queried whether the intention was that subsection 701-55(5C) refer to section 716-410 given the note following subsection 716-405 of the interim rules, which reads:

> *Subsection 701-55(5C) deals with assets covered by section 716-410 (Rights to amounts that are expected to be included in assessable income after joining time).*

Contrary to the note, subsection 701-55(5C) does not refer to section 716-410, only to a RTFI, which is defined in subsection 701-63(4). We note section 716-410 covers assets which, amongst other things, are RTFIs.

Recommendation 8

It is recommended that Treasury clarify whether proposed subsection 701-55(5C) should, in line with the currently enacted version of that provision, specifically refer to section 716-410 rather than a RTFI.

2.2.2 Non-deductible rights to future income

Under subsection 701-63(3) of the interim rules, a non-deductible RTFI is defined as:

> *(a) a right of the entity under a contract or arrangement, to the extent that the value of the right is contingent on the renewal of the contract or arrangement; or*

(b) a right of the entity under a contract or arrangement entered into by the entity with another entity, to the extent that the other entity can unilaterally cancel the contract or arrangement without paying compensation or a penalty.

The examples provided in the EM do not seem to match the wording used in the provision.

Example 1.1 indicates that an ability to cancel a contract in 'extraordinary and unexpected circumstances' will not result in the treatment of the contract as a non-deductible RTFI. However, this exception is not apparent from the wording of the provision.

Examples 1.2 and 1.3 both indicate that a RTFI will only be a non-deductible RTFI to the extent that it is not guaranteed. Again, the concept of 'guaranteed' that is used in the examples is not reflected in the wording of the provision.

In addition to the above, we note that many contracts for the performance of work or services, or the provision of goods, may contain clauses permitting cancellation subject to the satisfaction of certain conditions. While example 1.1 reflects one such condition – extraordinary and unexpected circumstances (or force majeure) – and example 1.5 reflects another condition – that cancellation does not cause the entity to breach liquidity requirements – there are a range of other conditions that are not covered by the EM. For example, the ability to cancel a contract may be subject to a material breach of its terms by either party, or one of the parties becoming insolvent or entering into receivership.

Finally, we query how paragraph 701-63(3)(b) will apply to a unilaterally cancellable RTFI where the right has been valued taking into account the risk of cancellation. The provision appears to contemplate the ability to treat part of the value of a unilaterally cancellable RTFI as deductible via the inclusion of the words "to the extent". However, it is unclear how this provision is intended to apply, particularly where the risk of potential cancellation is inherent in the value of the right.

Recommendation 9

We recommend that the wording of subsection 701-63(3) be updated to reflect that a RTFI will not be a non-deductible RTFI to the extent that it can only be conditionally cancelled, for example, on the occurrence of extraordinary and unexpected circumstances, a material breach of its terms, or one of the parties becoming insolvent or entering into receivership.

An example should also be included in the EM to illustrate the intended effect of the words "to the extent" as they appear in paragraph 701-63(3)(b).

2.2.3 Rights to receive an amount for the provision of trading stock

Subsection 701-63(4) precludes a right to receive an amount for the provision of trading stock from constituting a 'right to future income' and therefore, precludes taxpayers from obtaining deductions under section 716-405 for the cost setting amount of such rights.

We understand that the purpose of the trading stock 'carve-out' in existing subsection 701-90(1) was to prevent the value of trading stock the subject of the right (which would be separately recognised under the tax cost setting process) from being double counted as a deduction by the head company (i.e. amounts deductible under the trading stock rules would not also be deductible under section 716-405).

Following the introduction of the 2010 Act, the operation of this 'carve-out', however, was potentially broader than intended as it could have been read to exclude the entirety of the right to an amount from the provision of trading stock irrespective of the relative value of the trading stock compared with the total value of the right itself.

In light of the decision to repeal section 701-90 in favour of subsection 701-63(4), the opportunity has arisen for Treasury to clarify the intended scope of the trading stock 'carve-out'.

Recommendation 10

We recommend that an example be included in the EM to the proposed bill that illustrates that the trading stock 'carve-out' in subsection 701-63(4) excludes only the value of the trading stock to be provided under contract and not value referable to the right itself.

2.3 The prospective rules

2.3.1 Business acquisition approach to the residual tax cost setting rule

We understand that under the prospective rules the intention is that pursuant to subsection 701-55(6), the TCSA can be used for the purposes of any other provision not already mentioned, for example, the ordinary income provision section 6-5. However, the EM to the ED could be read to suggest that the TCSA is only relevant for the CGT provisions in these cases. Therefore, we recommend that the EM to the ED be updated to make it clear that the TCSA will also be relevant in determining net profits (assessable under section 6-5) arising from the disposal of assets that are on revenue account.

It is noted that item 36 of the ED introduces new subsection 701-56(2) which treats the head company as having acquired each of the relevant assets of the joining entity at the joining time as part of acquiring the business of the joining entity as a going concern. Furthermore:

- Proposed subsection 701-56(1) specifies that new subsection 701-56(2) applies in relation to each asset that would be an asset of an entity at the joining time, assuming that the single entity rule did not apply
- Proposed subsection 701-56(1A) specifies that new subsection 701-56(2) applies only to the extent necessary for the purposes of the residual tax cost setting rule in subsection 701-55(6) to determine whether a provision of the income tax assessment acts are to apply in relation to each of those assets on and after the joining time.

At paragraph 1.63 of the EM it is suggested that by applying a business acquisition approach to the residual tax cost setting rule, assets acquired by a consolidated group as a result of acquiring an entity will generally be taken to be on capital account. It is further suggested that this will ensure that the tax costs allocated to assets will be recognised only when a CGT event happens to the asset rather than giving rise to immediate revenue deductions.

Further, paragraph 1.67 of the EM specifies that the definition of a CGT asset (under subsection 108-5(1)) effectively includes assets that are not taxed under the CGT provisions, with specific reference made to revenue assets.

Consequently, it would be helpful to clarify (perhaps by way of examples in the EM to the proposed bill) that whilst the head company is treated as acquiring a business as a going concern, this does not preclude, for the purposes of subsection 701-55(6), a cost, outgoing etc. equal to the TCSA being allocated to revenue assets in respect of which a net profit will be assessable under section 6-5 or a net loss will be deductible under section 8-1.

Perhaps an example along the following lines can be included in the EM (which is drawn from Example 5.2 of the EM to the 2010 Act:

> *Head Co acquired 100% of Joining Co on 1 July 2012 and Joining Co became a member of the Head Co tax consolidated group on that date. Joining Co carries on an active consumer product distribution business. In addition, Joining Co has a significant share portfolio where it regularly switches between investments to maximise dividend yields and any profit made on the sale of its*

shares constitutes ordinary income. The shares are therefore held as revenue assets, as defined in section 977-50.

As required by subsection 701-56(2), Head Co is treated as having acquired each of the assets of Joining Co as part of acquiring the business of Joining Co as a going concern. In the current circumstances Head Co allocates tax cost setting amounts to each of the assets of Joining Co. As the share portfolio constitutes CGT assets which are revenue assets, the tax cost setting amounts allocated to Joining Co's share portfolio are to be used for the purposes of both the capital gains tax provisions (via subsection 701-55(5)) and the ordinary income provisions (via subsection 701-55(6)).

Consequently, when shares in the portfolio are disposed of, the taxable amount for both CGT and for ordinary income purposes (i.e. net profit purposes) should reflect the tax cost setting amount allocated. As a consequence of the anti-overlap rule in section 118-20, the profit amount will be fully assessed under the ordinary income provisions.

The operation of the rules in this fashion ensures that where an asset, being a revenue asset as defined in section 977-50, is disposed of, the net profit assessable as ordinary income takes into account the amount of tax cost allocated to that asset pursuant to subsection 701-55(6). If this were not the case, the gross proceeds received upon the disposal of the revenue asset (rather than the net profit) would be the taxable sum.

The tax outcome in the above example is consistent with the tax outcome that would have arisen if Head Co had acquired the business of Joining Co, which included the share portfolio. The cost to Head Co of acquiring the shares would be able to be offset against the sale proceeds on disposal of the shares (pursuant to the net profit approach).

Recommendation 11

It is recommended that an example such as the one set out above be included in the EM to the proposed bill.

In addition, it is recommended that the legislation recognises that where the relevant asset is a revenue asset (as defined at section 977-50) of a joining entity and remains so when part of the tax consolidated group, there is a TCSA for the purposes of subsection 701-55(6).

2.3.2 Rights to future income treated as retained cost base assets

The proposals in relation to 'other contractual RTFI' have the potential to result in the tax system favouring business acquisitions over entity acquisitions causing tax inefficiency. This is particularly apparent for businesses that hold rights to accrued revenue where the rights do not constitute WIP amount assets. The tax consolidation rules should provide for a TCSA for such assets consistent with a business acquisition model.

It is noted at paragraph 1.73 of the EM to the ED that under the prospective rules, a RTFI (other than a WIP amount asset) will be a retained cost base asset, with a TCSA equal to the joining entity's terminating value for the asset.

Furthermore, at paragraph 1.74 of the EM, reference is made to the Assistant Treasurer's announcement of 25 November 2011 specifying that the prospective rules will treat other contractual rights to income (such as a right that arises under an insurance contract or a reinsurance contract) as retained cost base assets.

We understand that the amendments to implement these changes are still being considered and are not in the ED.

In this regard, we recommend that significant consultation be entered into in respect of these potential changes, given the risk that they may inadvertently and inappropriately penalise taxpayers and create a preference for taxpayers to acquire assets rather than entities.

By way of example, a head company taxpayer may have acquired a joining entity with RTFIs (not being WIP) that constitute CGT assets expected to be regularly realised. In such circumstances, a taxpayer may be fully assessed on the amounts received on realisation of the rights notwithstanding that market value consideration was paid for the rights via the acquisition of the joining entity.

An example of such a scenario is deferred management fees (**DMF**) (also referred to as exit fees or departure fees) in respect of retirement village arrangements. The contractual arrangements are described in Taxation Ruling TR 2002/14 (**TR 2002/14**) as follows:

> *39. Under some occupancy agreements, deferred management fees are calculated, on a per annum basis, as a percentage of a resident's original entry price. The deferred management fee is usually subject to an upper limit (e.g., 2.5% of the original entry price for each of the first ten years that the resident occupies the village dwelling - i.e., a maximum of 25% of the original entry price). However, the village operator cannot properly demand payment of the fee until the resident ceases to reside in the accommodation unit to which the contract relates. ...*
>
> *40. Under other occupancy agreements, deferred management fees are calculated as a percentage of the entry price that is to be paid by the replacement resident. In this situation, the amount of the deferred management fee payable by an outgoing resident cannot be ascertained with certainty, nor can the village operator properly demand payment of the fee until the amount payable by the new resident has been determined.*

DMF payable on exit would typically not constitute WIP amount assets. Furthermore, pursuant to TR 2002/14, DMFs are treated as ordinary assessable income derived when the relevant occupancy agreement comes to an end and the village operator becomes entitled to demand payment of the fee from an outgoing resident.

While it is not expected that DMF would constitute a RTFI under proposed subsection 701-63(4) as it is not in respect of the performance of work, it may constitute "any other right to income that arises under a contract".

If DMF were viewed as being subject to the proposed rules outlined in paragraphs 1.73 and 1.74 of the EM, the consequence is likely to be that no TCSA will be allocated by the head company of a tax consolidated group on the acquisition of a joining entity with DMF rights of considerable value, given that the terminating value of the DMF rights is generally likely to be nil.

Consequently, when the DMF rights are crystallised (which can occur immediately after the joining time, and on a regular basis), the head company will be assessed on the full amount of the DMF received. This is notwithstanding that the consideration paid for the joining entity is reflective of the market value of the DMF rights at the joining time (generally being the accrued amount of the DMF).

The above would clearly be an inequitable and illogical result. In this regard, it is noted that in the circumstances where the head company acquired the DMF rights as part of a business acquisition of a retirement village operation (rather than the acquisition of a joining entity), it would clearly be possible to allocate tax costs to the DMF rights based upon the market value consideration paid.

We understand that there is a concern regarding excessive value being placed on other contractual rights, however this can be adequately addressed in drafting using concepts existing in the current ED that apply in the interim rules.

Recommendation 12

Other contractual rights to income (non-RTFI) should continue to be reset cost base assets under the prospective rules, potentially with a cap on the TCSA (with any excess amount being reallocated to other reset cost base assets).

The drafting of any proposed tax cost setting capping rules for 'other contractual rights to future income' could exclude:

- the value of the right "to the extent that the value of the right is contingent on the renewal of the contract or arrangement" (i.e. as per proposed paragraph 701-63(3)(a))
- the value of the right to the extent that "the other entity can unilaterally cancel the contract or arrangement without paying compensation or a penalty" (i.e. as per proposed paragraph 701-63(3)(b)).

This would effectively cap the TCSA at the value of the accrued income at the joining time and provide for a more equitable outcome.

2.3.3 Subsection 701-56(2)

Subsection 701-56(2) requires that the head company be treated:

> *[A]s having acquired each of those assets at the joining time as part of acquiring the business of the joining entity as a going concern.*

It is queried whether the words "as a going concern" are required. In this regard, we note that the Board of Taxation, in its report arising from its *Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules* made the following recommendation:[8]

> *The Board proposes that the residual tax cost setting rules be modified so that, for the purpose of applying the rules to the reset tax cost for an asset, the consolidated group is taken to acquire the asset at the joining time as part of a business acquisition.*

No reference was made to an acquisition of a business as a going concern.

Recommendation 13

It is recommended that Treasury consider whether the words "as a going concern" are required.

2.3.4 Objective of the prospective rules

Paragraph 1.63 of the EM indicates that the objective of the prospective rules is to:

> *[I]ncrease certainty for taxpayers by making the tax outcome for consolidated groups more consistent with the tax outcomes that arise when assets are acquired by entities outside the consolidation regime.*

It is queried what purpose the use of the adverb "more" serves in the above passage. The ED itself does not, prima facie, appear to provide any statutory context to explain if a degree of consistency rather than complete consistency is being sought.

Recommendation 14

It is recommended that Treasury consider whether the words "more consistent" in paragraph 1.63 and other sections of the EM should be replaced with the word 'consistent'.

[8] Paragraph 6.11.

2.3.5 Assets for the purposes of Part 3-90

The effect of section 701-67 is that the consolidation rules will not apply to assets that are not CGT assets. However, this appears to be inconsistent with the then Assistant Treasurer's announcement of 25 November 2011, which states, at paragraph 55, that assets held by a joining entity will have their tax costs set only if those assets are "recognised for taxation purposes". Paragraph 56 then states that assets recognised for tax purposes are "primarily" CGT assets. Accordingly, the announcement clearly contemplates that assets recognised for tax purposes are not limited to CGT assets.

Recommendation 15

It is recommended that Treasury amend section 701-67 to clarify which assets besides CGT assets obtain recognition for tax purposes.

2.3.6 Examples of assets that are not CGT assets

Paragraph 1.68 of the EM refers to examples of assets that are not CGT assets. It is queried whether it is appropriate for the EM to unequivocally state that all of the assets listed in this paragraph are not CGT assets. For example, the paragraph states that unregistered trademarks are not CGT assets. However, the ATO, in Taxation Ruling TR 92/3[9] and Income Tax Ruling IT 2660[10], takes the view that trademarks are considered to be property. On this base, trademarks would fall within the definition of a CGT asset in section 108-5, which would contradict the statement in the EM that they are not CGT assets.

Paragraph 1.68 also states that databases are not CGT assets. However, a database may be an example of application software.[11] Software is a form of property under the ordinary meaning of the word (as it is not a defined term). Accordingly, a database could fall within the definition of a CGT asset in section 108-5, which would contradict the statement in the EM that it is not a CGT asset.

Recommendation 16

It is recommended that paragraph 1.68 be reworded to refer to examples of assets that "may not be" CGT assets.

Further, we recommend that paragraph 1.41 of the EM be reworded along the same lines to remove references to examples that would constitute CGT assets in their own right (e.g. databases and trademarks as were discussed above).

2.4 Application rules

In addition to our comments at section 1 of this submission, please note the following issues.

2.4.1 Amendments relating to private rulings

Subitem 54(3) would appear to prevent a taxpayer from amending an assessment to give effect to a private ruling, which is clearly contrary to the purpose of item 54.

Recommendation 17

We recommend subitem 54(3) be removed.

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[9] Taxation Ruling TR 92/3, paragraph 66.
[10] Income Tax Ruling IT 2660, paragraph 12.
[11] Taxation Ruling TR 93/12 Income Tax: computer software, paragraph 12.

2.4.2 The treatment of claim tails

Subitem 53(3) of the ED establishes that the interim rules apply where either one of two sets of prescribed circumstances exist. Where such circumstances exist for a taxpayer and the taxpayer determines that they have acquired a RTFI (other than a non-deductible RTFI), proposed section 716-405 in the interim rules provides for a deduction(s) for the TCSA of the RTFI. This outcome is achieved via the operation of proposed subsection 701-55(5C) in the interim rules which treats proposed section 716-405 as applying after the joining time. These deductions will be recognised over the lesser of 10 years or the term of the relevant contract or agreement. Accordingly, an initial application of subsection 701-55(5C) that is subject to the interim rules may give rise to deductions for income years after 31 March 2011. Notwithstanding this, it appears that the deductions would continue to be available despite the more restrictive application of subsection 701-55(5C) under the prospective rules as well as the repeal of sections 716-405 and 716-410. That is, the tail of the claim would continue to be deductible based on the interim rules.

While the above treatment appears to be clear on the face of the law, it would be useful to include an example in the EM to the proposed bill confirming that this is the case.

Recommendation 18

We recommend that an example be included in the EM to the proposed bill that illustrates that the tail of a claim that gives rise to a deduction under proposed section 716-405 of the interim rules will continue to be deductible under that provision for income years that arise after 31 March 2011.