Ernst & Young Centre
680 George Street
Sydney NSW 2000 Australia
GPO Box 2646 Sydney NSW 2001

Tel: +61 2 9248 5555
Fax: +61 2 9248 5959
www.ey.com/au

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Review of Consolidation Rights to Future Income and Residual Tax
Cost Setting Rules
The Board of Taxation
c/- Sean Lee
The Treasury
Langton Crescent
PARKES ACT 2600
Email: taxboard@treasury.gov.au

Dear Board Members

Board of Taxation Review of Rights to Future Income and Residual Tax Cost Setting Rules

Ernst & Young welcomes the opportunity to respond to the Board of Taxation (Board) request for submissions for its Review of the tax consolidation Rights to Future Income (RFI) and Residual Tax Cost Setting (RTCS) Rules announced by Assistant Treasurer Mr Bill Shorten on 30 March 2011.

This submission provides some high-level comments in respect of the Board's review and also the issues raised in the Board's additional submission guidance which was released on 6 April 2011.

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

1. The RFI and RTCS rules provide appropriate tax outcomes for the tax cost of relevant assets for consolidated groups
2. The business acquisition model was not originally contemplated and should not apply retrospectively
3. The RFI and RTCS rules are necessary and provide outcomes comparable to asset acquisition scenarios
4. Assets clearly contemplated by RFI or RTCS rules should not be impacted by any retrospective changes
5. Unspecified concerns about the revenue make it very difficult to develop appropriate solutions
6. That said, we accept that targeted specific amendments are required for clearly unintended outcomes
7. The Board could address outstanding ATO interpretative issues in relation to RFI and RTCS rules as indicators of areas requiring clarification in the law
8. We comment on date of effect considerations and we recommend the Government announce transitional safeguards for existing transactions

Our detailed comments are set out below.

1. **RFI and RTCS rules provide appropriate tax outcomes for the tax cost of relevant assets for consolidated groups**

From a tax policy design perspective (equity, simplicity and certainty), the recently enacted RFI and RTCS rules provide appropriate tax outcomes for the tax cost of relevant assets for consolidated groups. Both the broader tax consolidation regime and the tax cost setting rules were significant and revolutionary tax reform developments for corporate groups in Australia, which unquestionably increased corporate tax revenues by eliminating the previous system of dealing with companies within corporate groups as separate entities, with the many resulting instances of loss duplication (leading to costs for the revenue) or of gain duplication (leading to inappropriate multiple revenue benefits) or inappropriate treatment of acquisitions of companies as distinct from asset acquisitions.

The focus of those reforms has been and should continue to be, on providing the most appropriate tax outcomes that reflect current income tax reform trends and developments. We are therefore most concerned with any attempts that may seek to apply historical tax treatments associated with business acquisitions of a bygone era, pre-consolidation thinking, to the tax consolidation system.

Broadly, the RFI rules and RTCS rules meet the objective of providing an appropriate basis for the recognition of the tax cost of relevant assets under the Income Tax Assessment Act (ITAA). The trend for business related income tax reforms over recent years has been for transactions to give rise to assessable or deductible amounts, rather than being treated on capital account or for blackhole expenditures to arise. This is most evident in the various Taxation of Financial Arrangements (TOFA) reforms as well as the reforms to blackhole expenditure rules in 2005. This trend is consistent with recent Australian cases, discussed below.

Those tax reform trends support the approach adopted for determining the tax reflex under the RFI rules and the RTCS rules under the ITAA.

Ernst & Young does not support the proposition that the RFI rules and RTCS rules as a whole are premised on the wrong policy basis.

2. **RFI and RTCS rules provide outcomes broadly comparable to asset acquisition scenarios**

We submit that outcomes arising through the application of the RFI rules or the RTCS rules are broadly comparable to those that would arise under an asset acquisition scenario. There are some differences in relation to the specific RFI rules, but those differences provide more appropriate targeted outcomes and greater certainty for both corporate groups and the revenue.

The RTCS rules

The RTCS rules (specifically amendments to s.701-55(6) and s.701-56) cover assets that would be dealt with under a provision of the ITAA that is not covered by s.701-55(1) to (5C) [which includes the RFI rules]. The RTCS rules are broad ranging provisions which are necessary to ensure there is a catch-all mechanism that enables the appropriate interaction and recognition of the tax cost setting amount of an asset by provisions in the ITAA that seek to deal with that asset.

The key interactions that arise under s.701-55(6) are the potential application of the general assessing provision (section 6-5) and the general deduction provision (section 8-1) in relation to what may be broadly described as "revenue assets". Various matters that need to be considered in relation to dealing with the tax cost setting amount of the asset, taking into account the effect of both s.701-55(6) and s.701-56, when applying the general provisions above, including:

(a) Whether a gross receipts/outgoings compared with net gain or loss approach should apply;

(b) Timing of recognition of any outgoing or any net gain or loss;

(c) Whether the loss or outgoing is of capital or capital in nature in relation to s.8-1.

The revenue versus capital characterisation issue in relation to s.8-1 is probably the most critical issue. The outcomes will be dependent on an application of relevant case law and relevant ATO guidance to the particular facts and circumstances of the tax consolidated group. There is no case law or ATO guidance which covers all situations which may arise for consolidated groups.

Various Australian High Court and Federal Court cases have held that the cost of acquiring business assets would be deductible or taken into account in calculating any gain or loss including:

- *Whitfords Beach v FCT* (1983) 14 ATR 247
- *Coles Myer Finance v FCT* (1993) 25 ATR 95
- *BP Australia v FCT* (1965) 112 CLR 386
- *National Australia Bank v FCT* (1997) 37 ATR 378
- *Tyco Australia V FCT* (2007) 67 ATR 63
- *XCO Pty Ltd v FCT* [1971] HCA 31

These cases parallel Australian cases which tend to the approach that corporate business gains are of a revenue rather than capital nature.

- *RFI rules*

The types of assets that fall within the scope of the RFI rules in s.701-90/s.716-405/s.716-410 of the Income Tax Assessment Act (ITAA) 1997 may be broadly described as contractual rights to income, under which future assessable income will be derived from the performance of work or services or the provision of goods (excluding trading stock). In the absence of the RFI rules, such rights would generally fall within the scope of the RTCS rules. However, the RFI rules assist in ameliorating many of the uncertainties relating to the general provisions as noted above, and thereby provide important integrity benefits for the revenue (regarding the regulation of the timing of deductions) and provide much needed certainty for consolidated groups (regarding the revenue versus capital debate).

The closest equivalent specific provision to the RFI rules in a non-consolidation context is s.25-95 of the ITAA 1997 for work in progress amounts, which provides a deduction for an amount paid to the extent that the amount can be identified as being in respect of partly performed work that will be recoverable within 12 months. S.25-95 provides an immediate deduction in contrast to the RFI rules where the deduction is spread over the lesser of the life of the contract or 10 years. Whilst the RFI rules may represent a broadening of scope of eligible items beyond short-term future recoverable work, the RFI rules significantly defer the timing of deductions in contrast to s.25-95. The mechanics of s.25-95 do not readily interact with the identification of an asset, with the consequence that a separate provision was required to properly recognise the tax cost setting amount of a relevant asset. Section 25-95 does not distinguish between an asset acquisition scenario and a business acquisition scenario. S.25-95, when originally introduced in 1998, was responding to issues that arose in relatively simple partnership arrangements as encountered in *Coughlan v FC of T* 91 ATC 4505 and *Crommelin v DC of T* 98 ATC 4790. It is appropriate that the RFI rules should have the capability to deal with a broader range of income rights that are likely to be encountered by corporate groups from a wide range of industries and sectors.

A more distant relation to the RFI rules, which is also relevant to consider, is subsection 27H(2) of the ITAA 1936 which operates to provide an effective deduction for the undeducted purchase price of an annuity. Under s.27H(2) the undeducted purchase price of an annuity (excluding any residual capital value) is effectively deducted over the life of the annuity, capped by the amount of the annuity income derived in a particular year of income. Again, this provision has some similar design features to the RFI rules, and is underpinned by a policy that seeks to provide a reasonable basis for deducting the purchase cost of an assessable income stream. Section 27H does not distinguish between an asset acquisition scenario and a business acquisition scenario.

Sections 25-95 and 27H deal with situations where there is an actual payment of an amount in relation to work-in-progress amounts or in relation to an annuity, respectively, whereas the RFI rules notionally recognise the tax cost setting amount of the income right asset as a result of a subsidiary member joining a tax consolidated group. It is a fundamental design feature of the tax consolidation rules that the tax cost setting amount of an asset should be appropriately recognised by provisions in the ITAA that seek to deal with that asset.

3. Business acquisition model was not originally contemplated and should not apply retrospectively

The terms of reference for the Board's review require a consideration of outcomes that arise for relevant assets under a business acquisition model. Ernst & Young questions whether a business acquisition model was contemplated when the proposed amendments were announced and also whether a business acquisition model is compatible with the tax consolidation rules as they were originally introduced.

When the proposed amendments to the tax cost setting rules were announced by the Government on 1 December 2005, there was no express mention that the proposed amendments (in relation to relevant assets) would be confined to providing the same tax outcome as would arise under a business acquisition in contrast to an asset acquisition. The Assistant Treasurer's Press Release stated:

> "Third, a modification will be made to ensure that the tax cost of a joining entity's assets determined under the tax cost setting rules is used by the head company of a consolidated group or MEC group for the purpose of applying all other provisions in the income tax law. In addition, the head company will be taken to have incurred expenditure to acquire a joining entity's assets equal to their tax cost setting amount at the joining time."

The tax consolidation tax cost setting rules adopt a variety of approaches in relation to determining the tax status or character of reset assets held by subsidiary members, ranging from an "entry history rule" approach to a notional acquisition of asset (in contrast to whole of business) approach. The approaches can vary depending on the type of asset, the circumstances of the entity and sometimes mixed approaches may apply to different aspects of the same asset–however, the entry history rule is the predominant approach. The current approach can be seen as a hybrid of various policy underpinnings.

However, a whole of business acquisition approach is not currently a feature of the tax cost setting rules.

The Board's current Post Implementation Review of Certain Aspects of the Tax Consolidation Regime includes consideration of the merits of an asset acquisition approach[1]. Whilst, we are broadly supportive of such a proposal, the understanding was that any such change would be prospective and would involve detailed adjustments yet to be developed for the purpose of the application of the tax cost setting rules, in order to alleviate some current inequitable outcomes that can arise for mining rights and privatised assets under the existing approach. In our view, considerable detailed analysis of the consequences of adopting an asset acquisition approach is required, to ensure that unintended consequences do not arise from such a fundamental design change to the consolidation rules.

It is clear that the asset acquisition approach is not ready for an immediate application to tax consolidation retrospectively.

4. <u>Assets contemplated by RFI or RTCS rules should not be impacted by any retrospective changes</u>

Ernst & Young is keen to address the Government's concerns regarding the types of assets that were not contemplated when the rules were introduced. However, it is important that the Board's review and any subsequent Government response, should not adversely affect those assets that were clearly contemplated when the law was enacted.

Whilst it is unclear what scenarios were unintended, it is clear which assets were clearly contemplated as being within the scope of the rules.

The Supplementary Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No. 1) Act 2010 (TLAA 2010) includes clear examples which illustrate that the RFI rules apply to:

- Rights to future income under a long-term construction contract;
- Rights to receive trailing commissions;
- Rights to future income under a land development agreement; and
- Rights to unbilled income for the supply of gas.

Examples in the Explanatory Memorandum clearly illustrate that the amended RTCS rules apply to:

- Consumable stores;
- Assets held on revenue account;
- Traditional securities; and
- Trade receivables.

We note also that the position of a right of a retirement village operator to deferred management fees was previously covered by Example 5.10 of the Explanatory Memorandum, but was excluded in the Supplementary Explanatory Memorandum, for the following reasons:

> "2.20 Example 5.10 of the Explanatory Memorandum no longer applies and has not been replicated. That example concerned a right of a retirement village operator to deferred management fees. This depends on the terms of the contract between the operator and the retirement village resident.
> 2.21 As there are many different contractual arrangements offered by retirement village operators, the basis on which deferred management fees may arise also varies widely.
> 2.22 Whether a right to deferred management fees is an asset covered by subsection 701-90(1) will depend on the facts (including the terms of the particular contract) in each case."

It is quite clear from the above, that a right of a retirement village operator to deferred management fees, should be considered for the purpose of the RFI rules, subject to a consideration of the particular contractual arrangements of each case.

[1] October 2010 Position Paper: Position 2.1

Assets that are the same or closely related to the abovementioned assets that were clearly contemplated by the Government in the currently enacted RFI rules and RTCS rules and considered in the explanatory memorandum commentary and its examples should not be retrospectively impacted by any changes to the RFI or RTCS rules.

Board's review should be mindful of long-standing interpretations of assets for consolidation purposes

The Assistant Treasurer's press release on 30 March 2011, states that "tax deductibility may be argued for types of assets that were not contemplated when the [RFI and RTCS] rules were introduced."

We highlight for the Board that the meaning of "asset" for the purpose of the tax cost setting rules, has been the subject of considerable development since the inception of the tax consolidation rules, which includes a range of guidance from the ATO, including: Taxation Ruling TR 2004/13 "Income Tax: the meaning of an asset for the purposes of Part 3-90 of the Income Tax Assessment Act 1997", TR 2005/10 "Retained cost base assets consisting of Australian currency or a right to receive a specified amount of such currency" and TR 2005/17: "Goodwill: identification and tax cost setting for the purposes of Part 3-90 of the Income Tax Assessment Act 1997", as well as various guidance in the ATO's Consolidation Reference Manual. Consequently, when assessing whether assets were contemplated for the purpose of the RFI and RTCS rules which were announced on 1 December 2005, regard should be given to such work.

More importantly, the Board should ensure that any recommended developments to either the RFI and/or RTCS rules are compatible with the principles that are applied for the recognition of assets for the purpose of the tax cost setting rules.

We accept that to the extent that certain assets are demonstrably beyond the scope contemplated by the RFI and RTCS rules, these fall into a different category and the law should be clarified.

As well, if the revenue cost of the measures governing assets within the scope contemplated by the RFI and RTCS rules is in excess of that anticipated, and can be demonstrated as discussed below, there is scope to consider appropriate prospective policy adjustments.

5. **<u>Without detail of the revenue concerns it is difficult to develop appropriate solutions</u>**

The Assistant Treasurer's announcement on 30 March 2011 stated that there "is some evidence that the rights to future income and residual tax cost setting rules may have a substantially greater revenue impact than anticipated." However, there is no information as to:

- the quantum of the revenue concerns raised;
- the extent to which the concerns relate to the RFI rules compared to the RTCS rules; and
- whether the revenue concerns are referable to specific categories of assets within either the RFI or RTCS rules. In this regard the Assistant Treasurer's announcement on 30 March 2011 does indicate that in relation to the RFI rules, "tax deductibility may be argued for types of assets that were not contemplated when the rules were introduced", however, there is no indication of such assets.

When TLAA 2010 was introduced in February 2010 the expected cost to revenue from the RFI and RTCS measures was stated in the Explanatory Memorandum to be as follows:

> ***Financial impact***: These amendments, other than those in Part 20, are expected to have a small but unquantifiable cost to revenue.

In May 2010, following a process of further consultation on the proposed RFI rules and RTSC rules, those rules were subject to some changes that were accompanied by a Supplementary Explanatory Memorandum, which provided the following guidance on the expected financial impact:

> *Financial impact*: The explanatory memorandum to the Bill states that the amendments in Schedule 5 to the Bill, other than Part 20, have a small but unquantifiable cost to revenue. Since the Bill was introduced, more information has become available which impacts on the financial impact of the amendments in Schedule 5.
>
> First, it has become apparent that the amendments in Part 1 (use of the tax cost setting amount) will have a significant but unquantifiable cost to revenue. Amendments 8 to 12 will reduce that revenue impact. However, the revenue impact will still be significant.

The capacity of Ernst & Young to make useful input is limited by the Board's review being conducted by reference to an unknown (to us) starting base and unspecified (to us) existing revenue concerns. Without more information, it is difficult to ascertain the extent of any changes required and to consider the extent of policy adjustments which may be required.

We are concerned about the risk that an information vacuum might result in a blunt, ill-directed policy response to these rules.

6. <u>We accept the need for targeted specific amendments to deal with unintended outcomes</u>

As stated at the outset, the existing RFI rules and RTCS rules provide an appropriate basis for the income tax recognition for the tax cost of relevant assets that are expected to produce assessable income for a consolidated group. When considered on a systemic basis, taking into account that in an acquisition scenario, vendors would have been immediately assessed in relation to the disposal of their shares in the relevant subsidiary that joins a consolidated group, the RFI and RTCS rules provide an appropriate tax reflex, in the context of revenue that will arise from such assets.

To the extent that unintended consequences can be reliably be identified, Ernst & Young would support targeted specific amendments, in order to limit the uncertainty that may accompany any broad ranging (principle based drafting) changes. This is a critical consideration for consolidated groups that have been seeking to finalise their positions, since the proposed changes were announced on 1 December 2005.

The Board's additional submission guidance invites comment on "other asset types" including:
- Customer contracts;
- Insurance policies;
- Non-contractual customer relationships; and
- Goodwill.

The treatment of customer contracts and insurance policies should in our view be analysed consistently with long-standing practices of the financial markets sector and the ATO in relation to purchases of portfolios of financial assets such as loan portfolios, securitisation portfolios etc. The ATO has accepted a profit-emerging or net profits approach in such cases – see for example ATO Interpretative Decision ATO ID 2009/63 "Income Tax: Assessable Income: securitisation arrangement - profit emerging basis of returning assessable income" and the cases cited in it, and the broadly similar treatment of the treatment of long-term construction contracts.

We think it is necessary for Australia's financial services tax system at minimum, and corporate tax system, to provide effectively for acquisitions of companies carrying on financial services activities including banking, insurance, funds management etc. Acquisitions of such companies, with their pools of financial assets and continuing customer contracts and revenue streams, need to be treated unambiguously for tax purposes.

7. Board could address outstanding ATO interpretative issues in relation to RFI and RTCS rules

We are uncertain whether the Board intends to consider any issues of detail in addition to the broad strategic issues relating to the RFI and RTCS policies. We note that there are six interpretative issues in relation to the RFI rules and RTCS rules raised with the Australian Taxation Office (ATO) in October 2010 through the National Tax Liaision Group Consolidation Subcommittee (NTLG). The ATO has yet to determine its position on any of those issues to date. The issues were:

a) Asset characterisation of the reset tax cost setting amount arising from subsection 701-55(6)
b) What is the scope of the terms "provision of goods (other than trading stock)" in subsection 701-90(1)?
c) What is meant by the terms "right (including a contingent right)" in section 701-90(1)?
d) What is the scope of the terms "provision of goods" in section 701-90?
e) Will a section 40-880 deduction be available for the reset tax cost base allocated to a non-contractual customer intangible of a joining entity?
f) What is meant by the terms "the performance of work or services" in subsection 701-90(1)?

The issues above cover some threshold, fundamental matters in relation to the application of the RFI rules and RTCS rules.

As well, it appears that there may be some anomalous outcomes arising in relation to some related amendments contained in TLAA 2010 in relation to:

- The interaction of the RTCS rules (specifically section 715-370) in relation to reset foreign currency denominated assets in relation to the operation of Forex Realisation Event 3, 4 or 5; and
- Whether paragraph 701-56(3)(d), which excludes the tax cost setting amount for an asset to be taken into account under the project pool rules in Subdivision 40-I, is an unintended outcome in the context of the operation of section 701-56 (which otherwise applies to provisions that are dependent on the inherited history of the relevant expenditure).

It would be appropriate for the BOT review to consider those issues, in order to minimise uncertainty and misunderstanding as to the application of the RFI and RTCS rules.

8. Date of effect considerations

Ernst & Young is strongly of the view that any changes to restrict the application of the RFI rules or RTCS rules should only apply on a prospective basis. This should only be from the date of any Government announcement. The announcement of the BOT review of the RFI and RTCS rules, has been accepted by the business community in good faith, as an impartial objective review, and should not be treated as a defacto pre-determined Government announcement.

When the RFI rules and the RTCS rules were enacted in June 2010 to apply on a retrospective basis from 1 July 2002, this was justifiable based on a 1 December 2005 Government announcement which indicated that the amendments would apply on a retrospective basis, which was reconfirmed on various occasions, most notably by the incoming Labor Government on 13 May 2008.

A) Compliance and reporting issues following the 2010 amendments

Consolidated groups undertaking merger and acquisition transactions have justifiably taken into account either the proposed law or the enacted law in pricing transactions, determining positions for income tax returns and also in respect of their disclosures and impacts on financial positions and financial statements and in disclosures to financial markets. It would be inequitable to reverse the operation of the RFI rules or the RTCS rules on a retrospective basis.

Any retrospective changes will require transitional provisions that would protect positions adopted in tax returns, amended assessments and private binding rulings by consolidated groups prior to any government announcement. The government will also need to alleviate the likely significant compliance costs of requiring consolidated groups to again review tax consolidation positions and then amend assessments potentially back to 1 July 2002. In addition, consolidated groups would need to be compensated for the previous compliance costs that were incurred in implementing the previously enacted law.

The costs associated with consequential necessary transitional relief as well as the impacts of any reputational risk, are significant factors that compel the need for only prospective potential restrictions to the RFI rules or RTCS rules effective from the date of any Government announcement.

B) <u>Transactions undertaken since the 2010 amendments</u>

There are a number of consolidated groups that are currently undertaking merger and acquisition transactions, some of which have been concluded and others are locked in and being closed, where the tax law has affected the price paid for acquisitions.

The 30 March announcement does not provide any safeguards for transactions underway where the application of the relevant tax consolidation rules may impact the relative value and financial position of the parties. In our view consolidated groups which have bona fide operated on existing tax law and have factored that tax law into the pricing of actual transactions should be protected.

We want to ensure that we do not have a repeat of the turmoil that followed the former Liberal Federal Government's hasty announcement of proposed changes to the scrip for scrip rules for consolidated groups announced on 12 October 2007, which was followed by numerous further government announcements (including announcements by the subsequently elected Labor Government) to minimise the unintended consequences of the proposed changes.

We would strongly recommend that the Government give immediate consideration to announcing transitional relief to provide greater certainty for existing transactions. One approach would be to adopt the types of transitional measures used for the scrip for scrip rules for consolidated groups, which formed the basis of the then Assistant Treasurer's announcement on 13 May 2008.

The government is clearly aware that both the Board's review and also the resulting government decision on this matter, will need to be taken speedily. There is a risk is that, until this issue is resolved, merger and acquisition transactions may be delayed or potentially abandoned pending the clarification of the rules.

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We would welcome the opportunity to discuss this submission further with the Board. If there is any aspect of this submission which the Board would like more information, please contact Colin Jones (02 9248 4724) or Andrew Woollard (03 8650 7511) or Tony Stolarek (03 8650 7654) or Richard Czerwik (03 9288 8408) in the first instance.

Yours faithfully

Tony Stolarek
Tax Centre for Excellence and Tax Policy Services