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Review of Rights to Future Income and Residual Tax Cost Setting Rules
The Board of Taxation
c/- The Treasury
Langton Crescent
PARKES ACT 2600

21 April 2011

Our ref: JC/JL/OG

By email: taxboard@treasury.gov.au

Dear Sir/Madam

Review into the consolidation rights to future income and residual tax cost setting rules

Deloitte welcomes the opportunity to provide comments on the review of the Board of Taxation (**the Board**) into the rights to future income (**RTFI**) and residual tax cost setting rules.

We note that, notwithstanding the additional guidance provided by the Board, it is difficult to pinpoint the exact areas of concern that have prompted this review. The press release issued by the Assistant Treasurer on 30 March 2011[1] highlights that due to uncertainty in the scope of the RTFI rules, tax deductibility may be argued for types of assets that were not contemplated when the rules were introduced, thereby resulting in a substantially greater revenue cost than was anticipated.

Details of the assets in question and a better understanding of where the main risks to the revenue rest as between the RTFI rules and the residual tax cost setting rule, subsection 701-55(6), would have enabled us to make more targeted comments on the scope of those rules and how that scope might be appropriately limited.

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

- Date of effect of any proposed changes
- Appropriate policy framework to determine the scope of the rules
- Comparison of outcomes under the rules with those under direct business acquisitions
- Potential changes to refine the scope of the rules
- Alternative options.

[1] Press Release No. 045 of 2011

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

In summary, the key recommendations in our submission are as follows:

- Based on the original policy intention of the provisions, the Board should not recommend the retrospective application of any amendments to the RTFI and residual tax cost setting rules
- If the Board does recommend that retrospective amendments be made to these provisions, the Board needs to clearly identify the scope of any carve out from the RTFI rules and such a carve out should only apply to those items to which the provisions were never originally intended to apply. Examples are goodwill, passive income not derived as part of an entity's ordinary business operations, and customer relationships
- The Board should recommend that the tax cost setting amount allocated to the nine examples of assets specifically identified in the explanatory memorandum (**EM**) and supplementary explanatory memorandum (**SEM**) to the RTFI rules should continue to be deductible in accordance with the original intention of Parliament. The specific categories of assets are rights to future income under long-term construction contracts, rights to receive trailing commissions, rights to future income under land development agreements, rights to unbilled income for the supply of gas and rights to deferred management fees derived by a retirement village operator
- In addition, the Board should recommend that certain assets falling within the ambit and original policy intent of the provisions which are not specifically covered by examples in the EM and SEM should also continue to be deductible under the provisions. These rights, which result in the derivation of active income that is part of an entity's ordinary business operations, include funds management rights, franchise agreements under which services are provided, professional service contracts (such as for engineering, estimating, accounting, legal and nursing services), labour hire contracts and toll manufacturing contracts
- We do not believe that the effective adoption of an asset acquisition approach to the operation of those provisions dealing with the deductibility of RTFI assets is warranted on a retrospective basis as such an approach would not deal appropriately with instances of double taxation of economic gains and would also impose an unnecessary compliance burden on taxpayers. Instead, the Board should recommend that the government refine the scope of the RTFI, particularly in respect of chattel leases, contingent rights in contracts and the performance of work or services
- We understand that the exclusion for trading stock under the RTFI rules was intended to be quantitative and we recommend that the rules be amended to reflect this
- The Board should recommend that subsection 701-55(6) be retained as this provision gives effect to the original policy intention of the tax consolidation rules by clarifying the application of the tax cost setting amount for residual purposes generally
- If the Board is of the view that the law as currently enacted is too broad in scope such that further limitations beyond the original intention are required, we submit that an equitable way to achieve this (in the sense of not arbitrarily excluding a particular taxpayer, industry or asset type), while at the same time retaining taxpayer certainty of outcomes and minimising the compliance cost impact, is to focus on amending the methodology of calculation.

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Please contact me on 02 9322 7180 if you have any queries on the submission.

Yours sincerely

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1 Date of effect

From its press release of 30 March 2011, we understand that as part of its review the Board will be proposing changes to limit the scope of the RTFI rules, if necessary, and advising on the date of effect of those proposed changes (including whether they should apply retrospectively).

1.1 Rationale for prospective start date

Based on the original policy intention of the provisions, which is discussed at section 2, the Board should not recommend the retrospective application of any amendments to the RTFI or residual tax cost setting rules. We consider that any changes to the RTFI or residual tax cost setting rules should take effect prospectively. Our reasons are set out below.

Principles of fairness and equity require that any changes to the scope of the RTFI provisions should only be made on a prospective basis. Since the introduction of the RTFI rules and the amended residual tax cost setting rules, many taxpayers seeking to claim deductions under those rules for prior years of income have already incurred considerable time and expense in seeking professional advice, obtaining valuations, and preparing and submitting requests for private rulings, requests for amended assessments and objections. A key driver in this regard has been the deadline of 3 June 2012 by which prior year assessments must be amended (where these assessments would otherwise be out of time).

Furthermore, at the meeting of the NTLG Consolidation sub-group on 15 October 2010, the ATO confirmed that it would not be sufficient for taxpayers to simply lodge requests for amended assessments or objections by 3 June 2012, rather the amended assessments would need to actually issue. The ATO also advised that it had no discretion to extend the time period. Although we understand that the issue has been escalated to Treasury, this has provided many taxpayers with additional impetus to seek advice earlier rather than later to clarify their position under the rules and, where appropriate, prepare and lodge private ruling requests, requests for amended assessments or objections, thereby incurring time and expense in doing so.

We also note that there may have been acquisitions since the Bill received Royal Assent on 3 June 2010 (or, indeed, from when the Bill was introduced into Parliament on 10 February 2010) that may have factored the tax benefit of any deductions under the RTFI or residual tax cost setting rules into the purchase price. We are unable to estimate the number of such acquisitions, or the quantum of any such tax benefit (Treasury may be in a better position to provide such costings). Given the additional economic cost associated with these acquisitions, it would be inappropriate to penalise those groups by requiring them to disregard any deductions under the RTFI or residual tax cost setting rules that would otherwise have been available under the rules as currently drafted.

Finally, at the NTLG Consolidation sub-group meeting on 13 April 2011, the ATO indicated that the Board's review is completely independent of the ATO's obligation to administer the law as currently enacted. Accordingly, taxpayers may continue to seek advice, and lodge requests for private rulings, requests for amended assessments, or objections, based on the current rules (albeit with notice of the Board's review). Furthermore, when the Board issued its press release on 30 March 2011, taxpayers may have already lodged requests for private rulings, requests for amended assessments, or objections based on the current rules. Where there are interpretative issues with those requests or objections, the ATO has advised that it will place the finalisation of those requests or objections on hold, and will advise the relevant taxpayers of this, but that they will attempt to form a view based on the current rules and finalise them if taxpayers request them to do so.

For these reasons we consider that any changes to the RTFI and residual tax cost setting rules should take effect prospectively.

1.2 Start date

If the Board accepts that some or all of the changes that are ultimately recommended should only apply prospectively, we consider that the most appropriate date from which any such changes should take effect would be the date on which such changes are first introduced in Bill form. That is, changes should only apply in respect of acquisitions by consolidated groups that take place on or after the date the relevant Bill is first introduced into Parliament.

If the date of the relevant Bill's introduction is not accepted as the date for prospective application of amendments to the RTFI provisions, consideration could be given to the date of any announcement by government or the announcement of the Board's review (i.e. 30 March 2011) with our preference being for the former. This is due to the reasons given earlier, namely that the ATO is continuing to administer the law as it is currently enacted and taxpayers either have already lodged requests for private rulings, requests for amended assessments, or objections based on the current rules, or are continuing to do so.

In either case, it would only be acquisitions by consolidated groups or formations of consolidated groups that take place on or after the relevant date that would be subject to the amended rules.

Alternatively, the Board may wish to consider different dates of effect for different classes of affected taxpayers. For example, taxpayers who held any of the nine examples of RTFI or residual tax cost setting assets identified in the EM and SEM to the Bill arguably should not be subject to any retrospective limitation in the scope of the rules given that the policy intent in respect of these assets was clear. The same approach should be adopted for acquisitions since 10 February 2010 where a tax benefit in respect of any of the same examples of RTFI or residual tax cost setting assets may have been taken into account in determining the purchase price.

If the Board recommends that retrospective amendments be made to the RTFI rules, the Board needs to clearly identify the scope of any carve out. We understand that some taxpayers have sought to apply the RTFI rules in respect of assets which were outside the original policy intent of the provisions such as goodwill, passive income not derived as part of an entity's ordinary business operations or customer relationships. In relation to goodwill, however, clarification will be required as to whether it is 'tax' or 'accounting' goodwill that is carved out. We understand that there are a number of assets that are not treated as goodwill under the accounting standards which nonetheless may be considered by the ATO to be 'tax' goodwill.

It is in respect of those assets that we would support the making of retrospective amendments to the provisions. Any carve out from the current RTFI rules should only apply to those assets to which the rules were never originally intended to apply such as these. Any amendments to the RTFI or residual tax cost setting rules in respect of items falling within the scope of the original policy intent of the provisions should only be made on a prospective basis.

1.3 Penalties and interest

If the Board recommends that some or all of the changes to the RTFI or residual tax cost setting rules should apply retrospectively, we recommend that taxpayers that have already received refunds, or who have claimed deductions under the rules, should not be subject to penalties or interest as a result of any amendments to prior year returns.

2 Policy considerations

The Board's terms of reference state that, in undertaking its review of the scope of the RTFI rules, which includes proposing changes and advising on the date of effect, it should consider:

- The taxation outcomes that arise when assets of the type that are covered by the rules are acquired directly by a company as part of a business acquisition outside of the consolidation regime

- Whether there are any circumstances in which these tax outcomes should be different if these assets are held by a company that joins a consolidated group
- If a difference in tax outcomes is warranted, the appropriate basis for recognising the tax costs of any assets that should be treated differently on entry into a consolidated group
- The revenue impact of any changes to the rules it proposes.

The first three points suggest that symmetry between the outcomes under the consolidation rules and those under a direct acquisition of a business will be a significant consideration in the Board's review.

We do not consider that a focus on symmetry of outcomes is appropriate having regard to the policy of the RTFI rules and the consolidation regime more generally, particularly on a retrospective basis. Accordingly, we have prefaced our comments on the scope of the RTFI and residual tax cost setting rules with an outline of what we consider to be the relevant policy considerations.

2.1 Purpose of the RTFI rules

Following the introduction of the consolidation rules, submissions were made on the allocation of allocable cost amount (**ACA**) to assets of a joining entity that consisted of certain income streams. The concern was that ACA allocated to such assets would be wasted while the income received under the income streams would be included in the consolidated group's assessable income. The focus of those submissions was on formation cases where the income streams were "owned" assets. Accordingly, it was recommended that such assets be treated as retained cost base assets with tax cost setting amounts of nil. This would allow ACA that would otherwise have been allocated to such assets to be allocated to other assets of the joining entity. The basic premise of these submissions was that rules were required to overcome the double taxation that would otherwise arise in respect of these assets.

For example, A Co holds a contract to provide services in consideration for which it will receive amounts that will be included in assessable income. The contract has a tax cost of nil and a market value of $80. A Co is acquired by Head Co, the head company of a consolidated group. Assuming A Co has no other assets or liabilities, the purchase price of A Co is $80. Accordingly, the vendor of A Co, assuming it is also the head company of a consolidated group, will make a capital gain of $80 on the disposal of A Co. The $80 paid by Head Co for the shares in A Co will become the tax cost setting amount of the contract. A Co receives $80 after the joining time being consideration for the services it provides under the contract, which is included in Head Co's assessable income. Without any tax recognition of the tax cost setting amount of the contract of $80, the same economic gain would be subject to double taxation.

It is noted that the ATO's views in Taxation Determinations TD 2004/D74 and D75 (both withdrawn) meant that a deduction could not be claimed for the tax cost setting amount of $80 under section 8-1 where subsection 701-55(6) (as it was then worded) applied. A capital loss was also unavailable on the discharge of the contract because the cost base of the contract would have been set at $80 under subsection 701-55(5), which would equal the consideration received.

In response to those submissions, the then Minister for Revenue and Assistant Treasurer announced amendments on 1 December 2005:[2]

> *Finally, rights to future income (such as work-in-progress amounts and unbilled revenue) held by a joining entity will be treated as retained cost base assets provided that those rights accrued to the head company. The tax cost setting amount will be equal to the terminating value of those rights. In addition, the head company will be taken to have incurred expenditure to acquire the rights at the joining time. The deemed acquisition of assets at the joining time under these last two*

[2] Minister for Revenue and Assistant Treasurer's Press Release No. 098, 1 December 2005

changes will not override the entry history rule other than in respect of a cost being incurred for the acquisition of the assets at the joining time.

The announcement not only addressed issues raised in submissions on the treatment of "owned" rights to future income by proposing to treat such rights as retained cost base assets with a tax cost setting amount equal to their terminating value. However, the announcement also covered the treatment of "acquired" rights in respect of which the head company would be taken to have incurred expenditure at the joining time.

Exposure draft legislation intended to give effect to the announcement of 1 December 2005 was issued on 28 April 2009. Consistent with the announcement, the proposed amendments treated "owned" RTFI assets, namely those created when the joining entity was a subsidiary member (wholly owned) by the head company of the consolidated group, as retained cost base assets with a tax cost setting amount equal to their terminating value (which would typically be nil).

As foreshadowed by the announcement of 1 December 2005, the proposed amendments also treated "acquired" RTFI assets as reset cost base assets to which subsection 701-55(6) would apply to treat the tax cost setting amounts of such assets as a cost, outgoing, expenditure or amount of a similar kind incurred or paid to acquire the asset.

To overcome various issues identified during the consultation process, sections 716-405, 716-410 and 701-90 were introduced. The EM to the *Tax Laws Amendment (2010 Measures No. 1) Bill 2010* (**the Bill**) states:

5.31 Uncertainties arise regarding when and how the tax cost setting amount allocated to such an asset may be recognised for the head company's tax purposes.

5.32 To overcome these uncertainties, if section 716-410 covers an asset, section 716-405 may apply in relation to the tax cost setting amount allocated to the asset.

Further, paragraph 2.5 of the SEM to the Bill clarified that certain valuable rights would be treated as separate assets for consolidation purposes and would be allocated a tax cost setting amount under the consolidation cost setting rules.

Accordingly, it can be seen that symmetry with outcomes under a direct business acquisition was never a consideration in the drafting of the RTFI and residual tax cost setting rules. The fundamental purpose of the rules was to provide appropriate recognition of the tax cost of rights to receive income streams so as to avoid double taxation of the same economic gain.

We note that this is consistent with the objects of the consolidation rules as set out in section 700-10:

The objects of this Part are:

(a) to prevent double taxation of the same economic gain realised by a consolidated group; and

(b) to prevent a double tax benefit being obtained from an economic loss realised by a consolidated group; and

(c) to provide a systematic solution to the prevention of such double taxation and double tax benefits that will:

(i) reduce the cost of complying with this Act; and

(ii) improve business efficiency by removing complexities and promoting simplicity in the taxation of wholly-owned groups.

It is clear that a key object of the consolidation rules was to prevent double taxation of the same economic gain. As noted above, the RTFI and residual tax cost setting rules were introduced to address this very issue in respect of the assets to which they apply. Accordingly, we consider this aim of overcoming double taxation should be a key focus of the Board in its review.

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The Board should recommend that the tax cost setting amount allocated to assets specifically identified in the EM and SEM to the RTFI rules should continue to be deductible in accordance with the original intention of Parliament. The specific categories of assets are rights to future income under a long-term construction contract, rights to receive trailing commission, rights to future income under land development agreements, rights to unbilled income for the supply of gas and rights to deferred management fees derived by a retirement village operator.

In addition, the Board should recommend that certain assets falling within the ambit and original policy intent of the provisions which are not specifically covered by examples in the EM and SEM should also continue to be deductible under the provisions. These rights, which result in the derivation of active income that is part of an entity's ordinary business operations, include funds management rights, services provided under franchise agreements, professional service contracts (such as for engineering, estimating, accounting, legal and nursing services), labour hire contracts and toll manufacturing contracts.

Retaining the RTFI rules in respect of these assets as originally intended would enhance taxpayer certainty and reduce reliance on the capital/revenue distinction (discussed below at section 3.1).

2.2 Acquisition versus inherited history model

The consolidation rules are not currently based on an acquisition model. This was recognised by the Board in the discussion paper it issued under its post-implementation review into certain aspects of the consolidation regime, where it states:[3]

> *As the consolidation regime has matured, business and professional groups representing large businesses are now more focused on acquisition cases and have made representations suggesting that the inherited history model should be reviewed to* ***determine whether a deemed acquisition model****, supported by clean slate rules,* ***would be more effective going forward.*** **[emphasis added]**

Furthermore, in its subsequent position paper arising under the same review, the Board states:[4]

> *2.25 In this regard, the Board has considered the following options:*
>
> - *adopting an acquisition approach; or*
> - *adopting an asset acquisition approach.*
>
> *2.26 Broadly, both these alternate models adopt as the base case the acquisition of an entity, rather than the formation of a consolidated group.*
>
> *2.27 In this regard,* ***the acquisition approach replicates as closely as possible, outcomes that would arise under a direct acquisition of the underlying assets*** *and liabilities of the joining entity for their market value.* **[emphasis added]**

Accordingly, it is evident, in our view, that an acquisition model was not adopted from the introduction of the consolidation rules on 1 July 2002.

In summary, we do not consider that the Board's focus on symmetry is appropriate having regard to the policy of the RTFI rules and the consolidation regime more generally, at least retrospectively. On a prospective basis, however, given that the Board is now considering the adoption of an asset acquisition approach, that focus on symmetry may be appropriate. Our submissions on the Board's

[3] Board of Taxation, Post-Implementation Review into Certain Aspects of the Consolidation Regime Discussion Paper, December 2009, paragraph 5.5

[4] Board of Taxation, Post-Implementation Review into Certain Aspects of the Consolidation Regime Position Paper, October 2010, paragraphs 2.25 – 2.27

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discussion and position papers under its post-implementation review into certain aspects of the consolidation regime were supportive of an acquisition approach going forward.[5]

Notwithstanding our view that symmetry between the outcomes under the consolidation rules and those under a direct acquisition of a business should not be a relevant consideration when determining if any amendments to the RTFI or residual tax cost setting rules should apply retrospectively, we have sought to highlight below any differences between those outcomes that may arise, having regard, where appropriate, to the relevant common law authorities.

3 Scope of the RTFI and residual tax cost setting rules

3.1 Relevant common law authorities – RTFI rules

It is not possible to unequivocally state that the purchase price of any of the RTFI assets in the context of a direct business acquisition will be revenue or capital in nature. We have set out in the Appendix a number of authorities where the characterisation of expenditure to acquire assets has been considered. Many of these authorities turn on their facts and it is difficult to extract a general principle that would apply in all cases. In this regard, we note that, if the Board is seeking to obtain symmetry between the outcomes under the consolidation rules and those under a direct acquisition of a business, then any amendments to the RTFI rules should not provide for a consistent revenue or capital outcome (as compared with the current position under the RTFI rules which effectively treat the tax cost setting amount of RTFI assets as revenue in all instances).

A significant disadvantage of such an approach, however, is that would result in uncertainty, which in turn would lead to greater compliance costs. We note that one of the main reasons for introducing the specific RTFI rules was to overcome uncertainty that would otherwise arise from the application of subsection 701-55(6) as noted at paragraphs 5.31 and 5.32 of the SEM to the Bill. One of the issues giving rise to uncertainty was the characterisation of amounts under subsection 701-55(6) as revenue or capital in nature.

Furthermore, it was highlighted above that the RTFI rules, and amendments to the residual tax cost setting rules, were introduced in order to overcome double taxation. A move towards symmetry between the outcomes under the consolidation rules and those under a direct acquisition of business assets may not be consistent with the policy intent as outlined in section 2 of this submission. Instead, as discussed in section 4, we would suggest that the Board recommend to government that the existing RTFI rules be refined to limit the deductions never intended to fall within the scope of the existing rules. We have discussed possible refinements later in this submission.

In summary, it is difficult to derive a common thread from the various authorities discussed in the Appendix. The decisions in *John Smith and Son v Moore*[6] and *City of London Contract Corporation v Styles*[7] may support the characterisation of expenditure incurred to acquire RTFI assets as capital in the context of a direct business acquisition. However, in relation to *John Smith*, we have highlighted in the Appendix factors that may limit the relevance of the decision (particularly those identified by the Privy Council in *The Commissioner of Taxes (Appeal No. 32 of 1962) v Nchanga Consolidated Copper Mines Limited (Rhodesia & Nyasaland)*[8]).

In support of the deductibility of the cost of acquiring RTFI assets, decisions such as *Tyco Australia Pty Ltd v Federal Commissioner of Taxation*[9], *National Australia Bank v Commissioner of Taxation*[10],

[5] Deloitte Touche Tohmatsu, Submission on Board's Post Post-Implementation Review into Certain Aspects of the Consolidation Regime Position Paper, section 2, page 6
[6] (1921) 12 TC 266
[7] (1887) 2 TC 239
[8] [1964] UKPC 3
[9] 2007 ATC 4799
[10] 97 ATC 5153

and *BP Australia Limited v Commissioner of Taxation of the Commonwealth of Australia*[11] would be of relevance. Any analysis of characterisation would, of course, consider the decision in *Sun Newspapers Ltd v FCT*[12].

Based on the latter group of decisions identified above, we would expect that there would be reasonable arguments in support of the deductibility of the cost of the nine examples of RTFI assets identified in the EM and SEM to the Bill (including rights to deferred management fees under retirement village contracts as per the original EM). However, in the absence of authorities that are directly on point and, given earlier decisions such as *John Smith* and *City of London Contract Corporation*, the alternative capital characterisation cannot be readily dismissed.

Overall then, it appears that taxpayers would be somewhat disadvantaged by any attempt to introduce symmetry between the RTFI rules and a direct business acquisition. Even where the business acquisition context is ignored, it is by no means certain that taxpayers will be able to deduct the cost of RTFI assets notwithstanding decisions such as *Tyco* and *National Australia Bank*.

It should be noted that we have not sought to exhaustively cover all relevant authorities. There are other cases besides those set out in this submission that may be relevant to the characterisation of expenditure to acquire RTFI assets.

3.2 Residual tax cost setting rules

Subsection 701-55(6) gives effect to the original policy intention of the consolidation rules by clarifying the application of the tax cost setting amount for residual purposes generally. As indicated in the EM, subsection 701-55(6) is intended to be a residual or catch all provision. We note that the revenue/capital distinction continues to be relevant to the application of subsection 701-55(6) and, accordingly, we would envisage that any authorities that are relevant in a direct business acquisition context would also be relevant when determining character for the purposes of this provision.

The Board should recommend that subsection 701-55(6) be retained in its current form.

4 Potential changes to the scope of the RTFI rules

As stated above, we do not believe that the effective adoption of an asset acquisition approach to the operation of those provisions dealing with the deductibility of RTFI assets is warranted on a retrospective basis. It is our view that such an approach would not deal appropriately with instances of double taxation of economic gains but also create an unnecessary compliance burden on taxpayers.

Instead, we would suggest that the Board recommend that government refine the scope of the existing provisions by clarifying the position in respect of the trading stock exclusion, chattel leases, contingent rights in contracts (such as options to extend) and the performance of work or services. These items are explained further below.

4.1 Trading stock exclusion

An issue has been submitted to the ATO on whether the exclusion for trading stock, which manifests itself in the terms "provision of goods (other than trading stock)" in subsection 701-90(1), was intended to be qualitative or quantitative in nature. The difference between the two interpretations was explained to the ATO as follows:

> *Target subsidiary (TS) entered into a timber supply agreement on 1 July 2009 to supply 1000 tonnes of timber at $45 per tonne in 12 months. TS joined a consolidated group on 1 January 2010 and at that time the price of timber had fallen to $35 per tonne. Assume the tax cost setting amount of the timber supply agreement was $9,000.*

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[11] (1965) 112 CLR 386

[12] (1938) 61 CLR 337 at 359-63

The timber supply agreement would not fall within section 701-90 at all if a qualitative approach is adopted. However, under a quantitative approach, the timber supply agreement would be covered by section 701-90 with the value of the right being reduced by the market value of the trading stock on hand at the joining time.

The SEM to the Bill does not provide any express guidance on the meaning or scope of the reference to trading stock in subsection 701-90(1).

We understand that the exclusion for trading stock was intended to be quantitative and recommend that the rules be amended to reflect this. We acknowledge that this may broaden the scope of the RTFI rules. However, this would, in our view, be in line with the original policy intent of those rules.

4.2 Passive assets

Although the intention as expressed at paragraph 2.11 of the SEM to the Bill was that rights which result in the derivation of passive income that is not part of an entity's ordinary business operations should not fall within the RTFI rules, this does not appear to be reflected in the wording of the provisions.

Subsection 701-90(1) covers "a valuable right (including a contingent right) to receive an amount for the performance of work or services or the provision of goods (other than trading stock)". The reference to the provision of goods could be read, for example, as extending to leases under which the use of goods is provided.

Furthermore, it is not clear what the drafters meant by the reference to the derivation of passive income that is not part of an entity's ordinary business operations. That is, the statement could be read as encompassing all rights to receive income such as rent, interest, annuities or royalties, or it may mean that it was never intended to exclude such rights where they arose in the course of carrying on a business. To continue with the example of a lease given above, it is not clear whether leases of goods were intended to be excluded from the RTFI rules regardless of whether or not the consolidated group carries on a business of leasing.

Accordingly, we recommend that the policy intent be confirmed and more plainly reflected in the wording of the relevant provisions. An amendment to reflect either of the views expressed above would result in a limitation of the scope of the current RTFI rules.

4.3 Contingent rights

Currently, there is uncertainty as to whether contingent rights in contracts such as options to extend, can be taken into account in valuing those contracts. We understand that the policy intent may have been that the term 'contingent' in section 701-90 was intended to refer to a contingency against the performance of work and services or the provision of goods. Accordingly, this aspect of the RTFI rules should be clarified by the Board. If the term 'contingent' is limited to contingencies against the performance of work and services, then there would be less scope to adopt inflated valuations that may take into account options to extend.

4.4 Meaning of performance of work or services

The meaning of "the performance of work or services" in subsection 701-90(1) is fundamental to the scope and operation of section 701-90 and, in turn, of the deduction allowed under section 716-405. Clarification is required as to whether the reference to services requires an element of work or personal performance or whether a broader interpretation is warranted. Whilst it is clear from the SEM that rights which result in the derivation of passive income that is not part of an entity's ordinary business operations should not fall within the RTFI rules, this is not clear from the wording of the provisions. The Board should specify exactly what falls within and what does not fall within the meaning of performance of work or services.

5 Alternative options

If the Board is of the view that the law as currently enacted is too broad in scope such that further limitations beyond the original intention are required, we submit that an equitable way to achieve this (in the sense of not arbitrarily excluding a particular taxpayer, industry or asset type), while at the same time retaining taxpayer certainty of outcomes and minimising the compliance cost impact, is to focus on amending the methodology of calculation.

There are a number of ways in which this may be achieved but the objective of any such amendment should be to result in a uniform effect (at least proportionately) for all taxpayers. For example, a cap (in absolute or relative terms) could be placed on the actual tax cost or the valuation of the RTFI asset. Perhaps a simpler approach may be to consider the method of spreading the allowable deduction over time.

One possible way of at least spreading the impact to the revenue would be to require deductions under the RTFI rules to be claimed over 10 years (or some other fixed term) regardless of the term of the contract.

Alternatively, the deduction period could be based on the life of the relevant contract as follows:

Life of contract	Period of deduction
<1 year	When incurred
≥1 year, <3 years	Spread on a pro-rated days basis over 3 years
≥3 years, <10 years	Spread on a pro-rated days basis over 10 years
≥10 years	RTFI deduction not allowed (deemed capital account treatment)

An added benefit of such an approach is that limited scope modifications may be required to the existing rules such that the scope of assets considered RTFI is not necessarily reduced. This is important as assets that would be excluded from the RTFI rules through scope modifications would necessarily fall for consideration under the residual provision contained in s701-55(6). This provision has been acknowledged by the Board as carrying its own uncertainties, not the least of which is the onus placed on the taxpayer to evaluate the revenue/capital distinction. A reduction in scope of the RTFI rules may not, therefore, achieve a reduced cost to revenue and may increase taxpayer uncertainty and compliance costs. It is for this reason that we submit that where a reduction in scope of the RTFI rules is considered necessary by the Board consideration be given to alternatively focussing on approaches to modifying the methodology of calculating the allowable deduction.

Appendix – common law authorities

At the outset, we note that there are not many authorities on the treatment of consideration given for the acquisition of RTFI or residual tax cost setting assets as part of a business acquisition. A number of decisions – the first three discussed in the Appendix – were referred to by the ATO at a recent seminar[13] as examples of authorities setting out the relevant principles in the context of a direct asset acquisition.

John Smith and Son v Moore

The decision of the House of Lords in *John Smith and Son v Moore* was about the deductibility of the purchase price of unexecuted coal contracts for the supply of coal from colliery owners at fixed prices, in the context of the acquisition of a coal merchant's business, for the purposes of working out Excess Profits Duty. The charging section for Excess Profits Duty in section 38 of the *Finance (No. 2) Act 1915* calculated profits for the purposes of the duty on the same principles as profits are determined for income tax.

The House of Lords held that the sum of £30,000 paid for the contracts was not an admissible deduction in computing the profits of the business for the purposes of Excess Profits Duty.

Viscount Haldane, in drawing the distinction between fixed and circulating capital, stated that the appellant had made a profit with circulating capital by buying coal under the contracts at a fixed price and selling it for more. He was able to do this because he had acquired the contracts but it was by retaining the contracts, not by selling them, that he was able to employ his circulating capital in buying under them. Accordingly, His Lordship was of the view that the contracts were part of the appellant's fixed capital.

Lord Sumner, in also holding that the purchase price of the contracts was capital, relied upon the decision in *City of London Contract Corporation v Styles*, which is discussed below.

Viscount Cave did not consider whether the purchase price of the contracts was capital in nature but found it could not be deducted for other reasons.

Viscount Finlay dissented from the majority and expressed the view that there was no difference between having coal and having a contract that enabled you to get it. The contracts could not be regarded as a fixed asset and were merely the machinery for getting coal. Furthermore, Excess Profits Duty was charged upon profits, which was the surplus by which receipts from the trade or business exceeded the expenditure necessary for the purpose of earning those receipts, so it was not possible to ignore what had been paid for the coal by the sale of which the profits were made. His Lordship also distinguished the decision in *City of London Contract Corporation v Styles* on the basis that the business acquired in that case was the business of carrying on contracts for the construction of public works, railways, etc., to be carried out by contractors. In the present case, however, the business acquired was that of a coal dealer and the contracts were for the supply of coal for re-sale in the course of business. That is, the business was not to carry on these contracts rather they were entered into merely as the most convenient way of getting coal to be supplied to customers.

Although the decision in *John Smith* might be viewed as authority for the proposition that the purchase price of unexecuted contracts should be capital in nature, we note that the decision concerned contracts to acquire goods, not sell them. We further note that only three of the four judges considered the question of whether the purchase price was capital and that the decision of those three judges was not unanimous. The reasoning of the two judges that held the purchase price to be capital also differed with Viscount Haldane focussing on the distinction between fixed and circulating capital and Lord Sumner relying upon the decision in *City of London Contract Corporation v Styles*.

[13] Peter Walmsley, Rights to future income, The Tax Institute, NSW Division, 10 March 2011

The reasoning of Viscount Haldane and Lord Sumner fell for consideration by the Privy Council in *The Commissioner of Taxes (Appeal No. 32 of 1962) v Nchanga Consolidated Copper Mines Limited (Rhodesia & Nyasaland).* The case was about the deductibility of compensation paid by the respondent, Nchanga, to a related company for it to cease production of copper for a year. The arrangement was entered into in the context of falling global copper prices due to supply in excess of demand. The Commissioner of Taxes sought to advance his case that the payment was capital in nature based on the decision in *John Smith*. Viscount Radcliffe, in delivering the judgement of the Council in favour of the respondent, provided the following comments on the reasoning of Viscount Haldane and Lord Sumner in *John Smith*:[14]

> *It appears clearly from a close study of the speeches of Lord Haldane and Lord Sumner that two elements in the case, or rather the combination of those two elements, determined their decision. First, no sum of £30,000 had ever been paid. What was acquired was a business consisting of a variety of assets, among which was the benefit of the contracts, and involving a number of liabilities; the only money that the son had paid was the sum representing the net value of that business. "He bought a business and its assets" said Lord Sumner (p.295), "at its valuation ... He bought no coals; the business had none, nor any stock in trade; nor did he acquire any stock in trade in any business sense of the term ... He did not pay this sum as the consideration for the assignment of the benefit of the contracts to himself: he took no assignment." **It is evident that both the learned Lords felt it impossible to say that a sum paid to acquire a business as representing the net value of that business, but not specifically allocated to individual assets of the business, was anything but a capital expenditure upon a fixed asset.*** **[emphasis added]**

His Lordship continued as follows:[15]

> *The second feature that was treated as of importance was the fact, alluded to by Lord Sumner, that in paying something in respect of the benefit of the contracts the son had not acquired stock in trade or anything like such stock. **It is not difficult to suppose that in a different context a sum paid by a running concern to a trader for the right to take over his supply contracts at fixed prices, if limited to the year of profit ascertainment, might fairly be regarded as part of the cost of acquiring the commodity to be supplied and, as such, chargeable against the gross proceeds of its sale.** Lord Sumner indeed seems to have visualised this, when he said (p.296) in explanation of the Styles decision "the sum was paid with the rest of the aggregate price to acquire the business and thereafter the profits were made in the business; the sum was not paid as an outlay in a business already acquired, in order to carry it on and to earn a profit out of this expense as an expense of carrying it on."* **[emphasis added]**

Accordingly, the Privy Council appears to have read down the decision in *John Smith*. One key element of the decision, in the Council's view, was the fact that the purchase price of the business was not specifically allocated to individual assets of the business. The other key element was that the contracts to purchase coal were not stock in trade or akin to stock in trade.

At the very least, the comments by Viscount Radcliff in *Nchanga* suggest that where such a purchase price allocation is performed, this may affect the characterisation of that part of the purchase price given to acquire unexecuted contracts.

City of London Contract Corporation v Styles

In *City of London Contract Corporation v Styles*, which was the second decision referred to by the ATO, the taxpayer was a company incorporated to buy as a going concern the business of a firm of contractors. The business included construction contracts that were uncompleted. The purchase price included a sum paid for the contracts. The taxpayer sought to argue that the price of the contracts was

[14] Ibid at 6
[15] Ibid at 6

deductible in working out the profits from carrying out the contracts. The court unanimously held that the sum was paid with the rest of the aggregate price to acquire the business.

Esher, M.R. stated:[16]

> *[I]t is as plain as plain can be that you cannot deduct from those net profits so arrived at any part of the capital which you so invested, whether you paid it or not for the purchase of the business which you were obliged to purchase before you could begin the difference between expenditure and income year by year. If you do not darken it with words, it is as plain as plain can be.*

The sum was not paid as an outlay in a business already acquired in order to carry it on and to earn a profit. Lord Justice Fry stated that the price paid was a sum employed or intended to be employed as capital in the trade of the company.[17]

The court emphatically concluded that the purchase price of uncompleted construction contracts in the context of a business acquisition was capital. The cost of the contracts was not deductible upfront nor was it a deduction from the profits arising from the performance of the contracts.

Notwithstanding the principle that may be derived from this decision, that the purchase price of uncompleted contracts is capital in nature, we note that the decision has been cited with approval mainly in cases on the deductibility of amounts paid for work in progress[18], not broader acquisitions of businesses.

Commissioner of Inland Revenue v New Zealand Forest Research Institute Ltd[19]

The third case put forward by the ATO in the seminar, *Commissioner of Inland Revenue v New Zealand Forest Research Institute Ltd*, was one in which the taxpayer was denied a deduction for the extinguishment of a liability it had assumed as part of the acquisition of a business on the grounds that it was a capital expense. The Court of Appeal stated:[20]

> ***It is by no means remarkable that acceptance of liability to discharge another person's obligations to make payments in return for a capital payment or a capital asset should be a capital expense**, even though the same payments if made by the original debtor would have been a revenue expense. In this case, Their Lordships think there is no doubt that if the Crown had been a taxable entity and had itself paid the accrued staff liabilities, they would have been deductible revenue expenses. But that does not affect the conclusion that the Institute's acceptance of liability to pay them was a capital expense. In the circumstances, the ascertainment of the income year in which the Crown would notionally have been entitled to deduct the payments is irrelevant.*
> **[emphasis added]**

The decision is of doubtful precedential value in determining the characterisation of expenditure incurred in acquiring RTFI or residual tax cost setting assets since it was about the character of payments made to discharge a liability assumed as part of a business acquisition. Furthermore, the above extract from the decision indicates that the court reached its conclusion on the basis that the assets acquired were capital assets. However, it is precisely this characterisation that the Board is attempting to determine, that is, whether RTFI or residual tax cost setting assets would be capital or revenue in nature in the context of a direct business acquisition.

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[16] (1887) 2 TC 239 at 244
[17] Ibid at 245
[18] *QT94/233 and Deputy Commissioner of Taxation* [1996] AATA 202; *Re Commissioner of Taxation of the Commonwealth of Australia v Keith Henry Grant; Edward Eugene Falk; Geoffrey Owen Thomas and Mervyn John Mallet* [1991] FCA 336; *Re Alan Ronald Coughlan; John Gianchino and Ian David Riley v the Commissioner of Taxation of the Commonwealth of Australia* [1991] FCA 237; *VT87/146, VT87/3515 and VT89/487 and Commissioner of Taxation* [1990] AATA 190
[19] [2003] 3 NZLR 1
[20] Ibid at 5

Moving away from the decisions identified by the ATO, there are a number of other authorities that may be relevant to determining the characterisation of amounts paid to acquire RTFI assets in the context of a direct business acquisition.

Tyco Australia Pty Ltd v Federal Commissioner of Taxation[21]

In a more recent decision, *Tyco Australia Pty Ltd v Federal Commissioner of Taxation*, the taxpayer carried on a business of electronic security monitoring for home owners and small businesses in Australia, known as ADT Security. The taxpayer derived income in the form of fees paid for those security monitoring services. The taxpayer engaged contractors (Authorised Dealers) to secure customers and to enter into alarm monitoring contracts directly with those customers, and paid these Authorised Dealers a lump sum (Assignment Fees) for the novation of each contract, which was calculated by reference to a multiple of the monthly fee payable by the customer. The lump sum represented the total fees payable under the life of the contract.

The question for the court was whether the payment of Assignment Fees to Authorised Dealers in respect of the assignment and novation of the contracts to Tyco was on revenue or capital account.

In contrast, *Tyco* submitted that:

- Looking at the Assignment Fee payments in their wide and proper business context, whatever might be the precise juridical form of the payment and assignment of rights and novation of responsibilities, from a practical and business perspective the character of the advantage sought was the incremental delivery of customers and the anticipated or hoped-for revenue flow therefrom
- The payments and each assignment did not affect the business structure or organisation set up; rather they and it added to the customer base and thus anticipated revenues.
- Parallel to *BP Australia*, the advantage sought was not the tying of the retailer sellers or the changing of the capital structure of the business, but was the promotion of sales and the winning of customers. Likewise here, it was submitted, the real object was not the purchase of the rights as such, but the revenue and orders flowing therefrom.

The Federal Court held that the payments were on revenue account, based largely on the agreement of the court with Tyco's submissions: [22]

> *75. It is uncontroversial that the payment of the Assignment Fees led to an acquisition of rights by TAPL by assignment and novation. Those rights can be seen to be assets purchased by TAPL. The price of the assignment of the assets was, under the first two versions of the Authorised Dealer Agreement, equivalent to almost all of the revenue stream inherent within the term of the rights assigned, and, under the third version, about two thirds of all the revenue stream within the term of the rights assigned. Thus, TAPL could be said to have been buying bundles of rights so that it might profit from the acquisition of the person with whom the assigned contract is made, as a customer, beyond the three year term. Mr Brown said as much.*
>
> *76. This does not make this an affair of capital. The asset or the so-called accretion to structure was, in practical and business terms (and in legal terms), the winning of a customer. That a very attractive (to the Authorised Dealer) Assignment Fee was set reflected the anticipation not of the value of the contract rights themselves that were assigned, but rather the future value of the connection with the customer and the future revenue stream once the customer was won. The advantage sought by each payment was the winning of a customer, so that he, she or it might be*

[21] 2007 ATC 4799

[22] Ibid at paras 75 and 76

retained and exploited (using that word in a neutral sense) for future revenue for services to be provided.

Although the Assignment Fees were held to be on revenue account, the facts in *Tyco* were very different to the acquisition of a business that has unexecuted contracts. Tyco was not acquiring a business rather it was already carrying on the relevant business and the assignment of the contracts occurred as part of that business. Accordingly, the relevance of *Tyco* to determining the characterisation of amounts paid for RTFI assets in the context of a direct business acquisition may be limited.

National Australia Bank v Commissioner of Taxation

In *National Australia Bank v Commissioner of Taxation*, the appellant (the bank) paid $42 million to the Commonwealth for the exclusive right, for a period of 15 years, to participate as the lender under the scheme of housing loan assistance established by the *Defence Force (Home Loans Assistance) Act 1990*.

The Full Federal Court ruled in the bank's favour, holding that the $42 million was deductible fully in the year in which it was incurred. The Commissioner had initially disallowed the deduction on the grounds that the payment was of a capital nature notwithstanding that it was incurred in gaining or producing the bank's assessable income and necessarily incurred in carrying on a business for the purpose of producing such income.

In reaching its decision confirming the deductibility of the payment, the court made the following observation:[23]

The payment to the Commonwealth did not enlarge the framework within which the Bank carried on its ordinary activities of borrowing and lending money. It was incurred as part of the process by which the Bank operates to obtain regular returns by means of regular outlay, the difference between the outlay and the returns representing profit or loss. Not only was the payment made as part of the Bank's ordinary trading or income earning activities, it was made in the expectation that the amount would be recouped out of profits made from the loans and other bank products sold to ADF personnel who, it was hoped, would become the Bank's customers.

Hence, the essential character of the advantage sought by the making of the payment was considered by the court to be the expansion of its home loan customer base and the subsequent earning of income from the loans[24].

Like *Tyco*, this was not a case involving the acquisition of RTFI assets under a direct business acquisition. The appellant was already carrying on a business of lending money and simply sought to acquire a right to lend to a new customer base.

BP Australia Limited v Commissioner of Taxation of the Commonwealth of Australia[25]

In the Privy Council's decision in BP Australia Limited, the company successfully secured deductions for amounts paid as trade ties to service station proprietors so that the latter would deal exclusively in its products for a fixed period where payments were made to service station owners to tie them to selling BP's petrol.

As such, the advantage sought was not the tying of the retailer and sellers or changing the capital structure of the business, but was the promotion of sales and the winning of customers. It was concluded that these outgoings were on revenue account as the real object was not the purchase of the rights as such (although they were invariably acquired), but the revenue and orders flowing from

[23] 97 ATC 5153 at 5163
[24] Ibid at 5165
[25] (1965) 112 CLR 386

them. The payments made were considered as part of BP’s normal business operations, as a working expense. The advantage sought consisted of the practical assurance of receiving orders for their product, thus enabling the firm to continue to operate its normal business activities.

This was also a case where the taxpayer was not acquiring a new business. As noted by the court, the payments were made as part of the taxpayer’s normal business operations.