FSC FINANCIAL SERVICES COUNCIL

20 April 2011

Review of Rights to Future Income and Residual Tax Cost Setting Rules
The Board of Taxation
c/- The Treasury
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REVIEW INTO THE CONSOLIDATION RIGHTS TO FUTURE INCOME AND RESIDUAL COST SETTING RULES

The Financial Services Council (FSC) welcomes the opportunity to provide a submission on the taxation treatment of rights to future income (RFI) assets.

The Financial Services Council represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers and financial advisory networks. The Council has over 130 members who are responsible for investing $1.8 trillion on behalf of more than 11 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalization of the Australian Stock Exchange and is the fourth largest pool of managed funds in the world. The Council promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

In summary, the FSC would like the Board to consider the following:

- The existing RFI asset provisions were agreed after a lengthy negotiation process between the Government and all interested parties. We believe that it is not appropriate to duplicate that process again given that the impact of the legislation was extensively considered during the consultation process.
- The granting of tax relief in the form of a deduction equal to an annual amortisation charge based on the cost of acquisition of RFI assets is fair and reasonable, as this measure aligns the economic return and taxable income produced by those assets.
- Any retrospective repeal of these provisions would be manifestly unfair to FSC members and investors. All parties have structured their affairs on the basis of the legislation in its existing form.
- The definition of an RFI asset should be clarified. The FSC submits that these provisions should apply to both investment and risk insurance contracts in force at the date of their acquisition by a life insurance company. There is no basis in logic or equity to exclude life insurance contracts from the RFI asset definition.
- The adverse revenue impact created as a result of the introduction of these measures should be treated a separate issue. If there are concerns regarding the revenue impact of these measures, the Government should consider other revenue measures or cost savings. Only after exhausting other revenue or cost savings, should the Government then consider separate measures such as capping of annual deductions, extending amortisation periods, or the least favourable scenario of limiting the scope of the measures with prospective effect.

Our submission below also contains our comments in respect of matters on which the Board requested submissions from stakeholders in the "Additional Guidance Material For Stakeholders" issued by the Board on 6 April 2011.The headings in this submission follow the numbering contained in the Guidance Material.
The FSC would welcome the opportunity to further discuss our submission if it would assist the Board further.

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If you have any questions regarding the FSC's submission, please do not hesitate to contact Senior Policy Manager, Pravin Madhanagopal or myself on (02) 9299 3022.

Yours sincerely

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Director of Policy

1. *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.*

Most FSC members are members of a tax consolidated group. Where the acquisition of rights to income assets is structured as the acquisition of shares in a corporate entity, the Tax Consolidation provisions including the existing RFI asset provisions would be applicable. In this scenario, the RFI asset would be identified as an asset in the allocable cost amount push down process. As a result of this process, the RFI asset would receive an allocated tax cost setting amount. This amount would qualify for amortisation under the RFI asset provisions.

In the case of direct acquisition of an RFI asset by an entity, the position is not clear. The FSC considers that a deduction would in most cases be available to the acquiring party for the reasons outlined below:

- The RFI asset is acquired pursuant to a profit making scheme on the part of the acquirer. Any profit would be assessable as it emerges. The profit emerging would be the gross income derived less applicable expenses, including the cost of acquiring the RFI asset. (a "wasting" revenue asset)

- Alternatively, the taxpayer would claim a tax deduction for the amortisation of the cost of acquisition using the High Court Case of *Coles Myer Finance Ltd v FC of T 93 ATC 4114* or *National Australia Bank Limited v FC of T 97 ATC 5153*. In the Coles Myer Case, the High Court allowed the spreading of a deduction in respect of finance charges on a negotiable instrument over the life of the instrument. In the National Australia Bank Case, the Bank received a tax deduction for a payment to the Commonwealth Government for the exclusive right to make subsidised loans to Defence force staff.

The FSC considers that subject to the allocable cost amount and tax cost setting amount rules in the Tax Consolidation provisions, there should be consistent treatment between RFI assets acquired inside a Tax Consolidation environment and RFI assets acquired outside Tax Consolidation.

It is important to note that prior to the introduction of the RFI asset provisions into the Tax Consolidation Rules there was inconsistency between the two situations. If one corporate entity acquired all the issued shares of another corporate entity, the acquiring party would not receive a tax deduction for the RFI assets in the company acquired which reflected the purchase price of those assets implicit in the cost of shares. In most situations in a Financial Services context, the acquisition or disposal of RFI assets would be via corporate entities. Therefore, there was no tax deduction for RFI assets in most situations in the financial services industry.

The FSC considers that the RFI provisions are applicable to the following assets in a financial services context:

- Customer contracts. This occurs where the purchased assets include a series of contracts with an adviser or client to manage the assets of that client in accordance with the relevant mandate. The contract in this situation would provide for the payment of a specific or determinable fee to the asset manager. The FSC submits that these contracts would constitute an RFI asset and the cost or allocated cost under the Tax Consolidation Regime qualifies for a deduction under the RFI provisions.

- Insurance contracts. In a life insurance business purchase, a portion of the purchase consideration is attributable to existing portfolio of insurance contracts. These contracts will produce a stream of assessable income in the form of premiums where the contracts are risk insurance contracts or fees where the contracts in question are investment contracts. It is submitted that these policies constitute RFI assets and the cost or allocated cost under the Tax Consolidation Regime qualifies for deduction under the RFI provisions.

There has been debate whether or not a risk insurance contract constitutes an RFI asset. Arguments for the exclusion of risk insurance contracts from these provisions include the following:

- The risk insurance contract operates on a year by year basis and its continued existence depends upon the policy owner exercising a right of renewal. The economic reality is that most contracts in a block of insurance contracts acquired will be continued (as distinct from "follow on" contracts being entered into) and purchasers of a life insurance business give value for a book of in force risk insurance contracts purchased. The premiums payable in subsequent years constitute assessable income and there is therefore no logical reason for the exclusion of risk insurance contracts from the RFI asset provisions. The FSC considers that as there is an automatic right of renewal (in the sense of continuation) under these contracts from the perspective of the life insurer, it remains bound to provide the insurance service specified in the contract for the payment of the specified premium. Policy owners only lose their rights to continued insurance cover without medical underwriting if they do not renew their policies.

  Increasingly risk insurance contracts are written with no expiry date or an expiry date linked to the policy holder's age or some other future event that may be many decades into the future. This means that the policies remain in force as long as premiums are received (the billing cycle may be monthly or annually). As such many of these risk insurance contracts do not exhibit the annual renewable features present in older risk insurance contracts and require the policy holder to take steps to cancel the contract. Increasing consumerism within the insurance sector now means that risk insurance contracts are becoming increasingly similar to customer contracts in other sectors.

- Risk insurance is an indemnity contract and the essence of the RFI asset is that it represents a service for which the provider receives some form of remuneration. It is submitted that the provision of risk insurance constitutes a service in the form of the provision of cover. The view that insurance is a pure indemnity contract without a service element does not accord with the treatment of insurance elsewhere under tax legislation such as the GST provisions. (In any event, this type of asset would then fall under the residual provision, with a less predictable but more likely favourable outcome.)

The FSC considers that the Board should recommend to Government that provisions be introduced to clarify the pre existing position that all forms of life insurance i.e. both investment life insurance and risk insurance should constitute an RFI asset and qualify for amortisation under the RFI asset provisions.

2. *Whether there are any circumstances in which these outcomes should be different if these assets are held by a company that joins a consolidated group.*

Under the present rules, the cost base of the assets of a company joining the tax group are allocated using the tax cost setting amount rules contained in Division 705 of the Income Tax Assessment Act 1997. The cost bases of the RFI assets are determined in accordance with these rules. The FSC submits that the RFI assets held by an entity joining a consolidated group should be treated no differently from any other asset acquired by the consolidated group. The existing rules are sufficient in this respect, and it is not appropriate to have special rules dealing with RFI assets in this situation.

3. *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.*

As discussed above, the FSC submits that the current difference in tax outcomes is predominantly one of predictability of amortisation profiles, rather than a fundamental difference in treatment, and therefore does not make any submission regarding any alternative basis of recognising assets.

The FSC accepts that there is uncertainty surrounding the acquisition of RFI assets outside the Tax Consolidation environment. This situation is best addressed by replicating the RFI deduction provisions elsewhere in Income Tax Assessment Act 1997. These provisions should allow a tax deduction for the cost of acquisition of an RFI asset over the life of the asset subject to a maximum amortisation period of ten years. This would create symmetry, as taxpayers who operate outside the Tax Consolidation environment and those consolidated groups who acquire RFI assets directly would be governed by those provisions. Consolidated groups who acquire the interest in an entity holding an RFI asset would be required to determine the tax cost setting amount for the RFI asset using the rules contained in Division 705 and amortise this amount in accordance with the existing RFI provisions.

In other words, increase the predictability of amortisation profile in direct asset acquisition, rather than decrease the predictability in a corporate acquisition.

4. *The revenue impact of any changes to the rules it proposes*

Current indications of revenue impact are being overstated for multiple reasons:

- The original legislation and interpretative indications from the ATO meant that taxpayers have taken conservative positions until the tax legislation was clarified;
- In many cases, deductions were available under the old legislation: the claims were simply deferred until the legislation was clarified and became less contentious vis-à-vis the ATO;
- In this regard, it was not anticipated that the legislation would only be updated in 2010;
- Accordingly, there is a backlog of nine years of claims reversing rapidly (many of which are being described as relating to the updated legislation, but fundamentally do not, as the deductions would have been available under the pre-existing law).
- A prime example of this would be allocations to “in the money swaps”.
- As such, the immediate deductions being claimed should be taken against above expectation corporate tax collections over the last few years.
- Any costing should take into account the reduction in franking credits arising from any repeal measure.

Any restriction in the scope of the existing RFI Rules would reduce the deductions claimable under these provisions, and therefore have a positive effect on the Government’s revenue.

However, any restriction in the scope of these rules would result in a manifestly unfair situation to affected taxpayers. These taxpayers have incurred expenditure in the acquisition of RFI assets and will be paying tax on the income produced by those assets without any effective tax relief in respect of the cost of acquiring the relevant RFI assets. This would result in a return to the situation prevailing prior to the introduction of these rules where the tax liability was based on an amount in excess of the economic return on the RFI asset.

The FSC submits that there needs to be symmetry in tax treatment between the outflow and subsequent inflow and that this is consistent with the fundamental principles within the tax legislation that expenditure that is economically revenue in nature should be treated as such. The FSC notes that this is also the treatment adopted under International Financial Reporting Standards. This further supports the view that such expenditure is revenue in nature.

If it is determined that the RFI provisions as enacted produce an undue drain on revenue, the Government should consider measures other than the repeal of provisions which correct a manifest inequity in the tax system. Measures which the Government should consider in these circumstances include:

- Extending the period over which an RFI asset is amortised.
- Deferring the deduction claimable by capping the quantum of any claim in one year and allowing any excess over the cap to be carried forward for deduction in subsequent years.

- Prospective repeal of the provisions subject to adequate protection for taxpayers in the process of acquiring RFI assets. This is clearly a retrograde step as it would re-create the inequity which existed prior to the introduction of the RFI asset rules.

5. *Date of effect considerations*

Any changes to tax legislation should apply with prospective effect, and not apply retrospectively. Taxpayers have relied on these rules in structuring acquisitions of financial services and life insurance businesses. The financial services industry is presently undergoing structural change and acquisitions of financial services entities since the effective date of this legislation have been made on the basis that any RFI assets purchased would qualify for amortisation for tax purposes. Any retrospective change would alter the effective cost and projected return in respect of these investments.

It is also important to note that the impact of any legislative change on acquisitions of RFI assets which are in progress. The acquisition of a financial services entity involves a number of formalities including shareholder and regulatory approvals. These formalities may only be completed after a few months. It is therefore submitted that not only should any legislative change not be retrospective, but that it should also not be applicable to any transaction which has commenced, but not been completed on effective date of the repeal of legislation. We therefore suggest that any change to the legislation only becomes effective after a period of six months from the date of announcement of the repeal. Taxpayers should be entitled to claim a deduction of the amortisation expense with respect to any transactions entered into prior to the date six months after the announcement.

At present the RFI asset provisions apply with effect from 1 July 2002, the date of commencement of the Tax Consolidation Legislation. It is submitted that any change in this effective date would create disruption in the taxpayer community for the following reasons:

- Some taxpayers have prepared their annual financial statements on the basis of the law as it now stands. These entities would suffer the shareholder impact of having to issue a market announcement indicating that the financial statements as originally published are no longer correct.
- Companies will have paid dividends based on previously disclosed profits including the benefit of RFI deductions. If the legislation is altered or repealed, this may result in companies having over paid dividends which will result in lower dividends in future periods. Again, this will have significant shareholder impact for these companies.
- Other taxpayers have disclosed the existence of and quantum of claims by way of note to their annual financial statements. Users of these financial statements have a clear expectation that the company concerned has a valid claim under the RFI asset provisions.
- Users of the financial statements above have also entered transactions at the investor level based on the information contained in these financial statements and in many instances have dealt with their shares on the basis of information contained in those financial statements.

Suggested alternative dates in the Additional Guidance Material

The FSC provides comment on the following dates nominated in the Additional Guidance Material as effective dates for changes to the RFI rules.

- 1 December 2005 & 10 February 2010- The scope of the RFI Rules has changed considerably by negotiation since this date and the importance of this date has been superseded by the legislation as enacted by Parliament.
- 3 June 2010. This is date of royal assent of the RFI Asset rules and in the absence of any provisions to the contrary would have been the effective date of the RFI asset rules. However, the legislation as enacted contains specific rules on the effective date which makes 3 June 2010 largely irrelevant for the purposes of the RFI Asset rules.

- 30 March 2011. It is submitted that the use of this date as an effective date of any change would not be appropriate, as the scope and extent of any change to the legislation is not clear at this date. The effective date should occur only after the Government has announced the relevant changes.
- The date of any Government announcement. This would be an appropriate date provided that the announcement allows any transaction in train at announcement date to be taxed under the rules prevailing prior to the change.
- 1 July 2011. (or the date of lodgement of the 30 June 2010 tax return if that date occurs after 1 July 2011).Taxpayers should not be prejudiced if the due date of lodgement of their return falls after the date of any Government announcement. All taxpayers should be given the same access to existing law regardless of when they lodge their returns.

  An effective date along the lines outlined above, would assist administrative and compliance costs as it would allow taxpayers to apply any changes from the commencement of the year of income. However, any commencement date should also contain measures enabling transactions in train at that date to be taxed under the existing RFI Rules, notwithstanding the fact that completion may only occur after 1 July 2011.

Particular Circumstances Of Taxpayers

Comment has been sought on the application of any legislative change to the following circumstances:

- Joining A Consolidated Group

  Under the existing rules, the RFI provisions in relation to an entity joining a consolidated group would apply from the date the entity joins the consolidated group. Any legislative amendments should not disturb this rule except in circumstances where a transaction is in train. In these circumstances, the transaction should be taxed under the existing RFI rules notwithstanding the fact that the acquiring entity may only join the consolidated group after the effective date of legislative change.

- Amendment Requests Lodged With the ATO

  If the amendments have retrospective effect, it is submitted that the existing RFI Rules should continue to apply to taxpayers who have lodged amendment requests with the ATO. These taxpayers have acted in good faith in accordance with legislation as enacted by Parliament. It is manifestly inequitable to deny these taxpayers the benefit of these provisions. These taxpayers have also incurred considerable expense in investigating the validity of their claims, gathering evidence and formulating their amendment requests.

  It is also important to note that a number of taxpayers have also lodged objections to prior year assessments on the basis that these assessments are incorrect following the enactment of the RFI provisions. These taxpayers should be accorded the same treatment as taxpayers who have chosen to pursue their claims via an amendment request.

- Private Ruling Requests Lodged and Approved By the ATO

  It is submitted that these ruling requests should be determined in accordance with the RFI provisions as originally enacted. These taxpayers should be accorded the same treatment as taxpayers who have pursued their claim under these provisions by way of amendment request.

6. *Addressing present uncertainty pending finalisation of the Board's Review*

The Government's announcement has created uncertainty on the future application of the rules in relation to RFI assets. This uncertainty will prevail until the final resolution of the matter by way of Government announcement.

The Government should assure taxpayers of the continued application of the RFI Rules until ultimate legislative resolution of all associated issues. Once modifications have been determined, these should be announced and made effective from the announcement date with appropriate transitional measures for those taxpayers who have transactions in progress at the date of the relevant announcement.

At the very minimum, companies which have lodged tax returns based on the current legislation should not incur penalty or interest charges if the legislation is changed retrospectively.

7. *Other Matters*

(i) Impact On Government/Taxpayer Relationship

The FSC considers that any repeal of the existing provisions with retrospective effect would destroy the Government's credibility in the eyes of the taxpayer community. The existing RFI provisions are the product of a lengthy negotiation process. Any retrospective appeal amounts to the Government resiling from a previously negotiated position.

It is important to note that during the negotiation process the question of RFI assets embedded in service contracts was specifically discussed and examples were included in the Supplementary Explanatory Memorandum covering these situations. Therefore, all parties accepted the inclusion of contracts of service without any qualification as to type of service.

(ii) Inherent Equity Underpinning The RFI Measures

The granting of a tax deduction for the cost of RFI assets over the life of the asset in question is a correct reflex of the economic position of the taxpayer.

The economic return of the taxpayer is the net profit emerging from the use of this asset. The net profit is the income generated by the RFI asset less the cost of that asset and associated expenses. The amortisation provisions are a step closer to aligning the tax position with the economic gain associated with the RFI asset. Therefore these provisions are inherently fair and equitable.

(iii) Integrity Issues

The FSC is not aware of any inappropriate use of these provisions. The provisions as enacted contain sufficient integrity and checks and balances. Taxpayer's have the onus of proving the validity of their claims via valuations etc. In addition, the ATO has its powers under the existing anti avoidance provisions of Part IVA of Income Tax Assessment Act 1936 to block any inappropriate use of these provisions.

Therefore, it is the FSC's view that these provisions should be retained. If these provisions create an unacceptable hole in the Federal Budget estimates, this fact should be acknowledged and the corrective action should focus on mitigating this effect. This would then limit the remedial action to Budget related measures, such as deferring the deductions allowed.

(iv) Costs To the Taxpayer

Taxpayers have incurred considerable costs in formulating claims which are compliant with the relevant provisions and submitting amendment requests and rulings to the ATO. Any retrospective legislation would mean that these funds and resources have been wasted through no fault of the taxpayers concerned.