21 April 2011

The Board of Taxation
c/- Treasury
Langton Crescent
PARKES ACT 2600

By email: taxboard@treasury.gov.au

Dear Sir / Madam

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

The Institute of Chartered Accountants in Australia (the **Institute**) and The Tax Institute (the **Joint Bodies**) are pleased to respond to the Board of Taxation's (**Board's**) review of the consolidation rights to future income and residual tax cost setting rules.

Scope of the review

The review is to be conducted in accordance with the Terms of Reference set out in the Assistant Treasurer's Media Release of 30 March 2011 (**Media Release**) and the Additional Guidance Material for Stakeholders issued by the Board on 6 April 2011 (**Additional Submission Guidance Material**).

The Media Release indicates that, due to uncertainty regarding the scope of the rights to future income and residual tax cost setting rules, tax deductibility might be argued for types of assets that were not contemplated when the rules were introduced. As a consequence, the rules could have a substantially greater revenue impact than anticipated. The task of the Board is to clarify the scope of these rules and, if necessary, advise on changes to limit their scope and the date of effect of any such changes.

Both the Media Release and the Additional Submission Guidance Material raise, either as indicative of the intended scope of the rules, or as a possible option to limit their scope, an approach which seeks to generate outcomes equivalent to those that would arise where assets are acquired directly by a company as part of a business acquisition outside the consolidation regime.

Limitations of our response

The Joint Bodies welcome the opportunity to work with the Board in relation to this review. However, the capacity of the Joint Bodies to suggest alternative mechanisms and to respond to the specific questions in the Additional Submission Guidance Material, including the date of effect of any changes, is somewhat limited. The Joint Bodies have requested in previous discussions with the Board that further information be made available in relation to those elements of the existing policy that the government is concerned with.

Whilst the Joint Bodies appreciate the potential revenue cost of the current policy in this area, it would be useful to better understand the impact on costings of:

- the elapsed time between the introduction of the tax consolidation provisions (with effect from 1 July 2002) and the amendments made in June 2010
- the split between past, current and future deductions
- current amendment requests, objections and rulings lodged with the Australian Taxation Office (**ATO**)

It is important to acknowledge that given the complexity of the issues and the limited availability of detailed information, it has been difficult for the Joint Bodies to obtain a clear consensus on the most appropriate responses to the questions raised by the Board. Despite this, we have provided some comments below about the issues that we believe the Board should take into account as part of its review.

Development of the rights to future income and residual tax cost setting rules

The Board and the government will no doubt recall that the current consolidation rules were developed under an extensive joint design process involving Treasury, the ATO and a group of external stakeholders. This consultation process began almost three years before the commencement of the regime on 1 July 2002 and involved numerous meetings that considered a myriad of highly complex issues. During this process, the input from external stakeholders was overwhelmingly constructive and at times involved a frank discussion about integrity issues – for example, external stakeholders disclosed the revenue risks stemming from the revaluation of pre-CGT assets and identified the potential impact of the rights to future income and residual tax cost setting rules in respect of various assets.

Although the consolidation rules were substantially complete at the time of their introduction, and the formation process went more smoothly than many had anticipated, it was inevitable with such a complex change that some fine-tuning and rectification of anomalies would be required, and indeed a number of technical changes have been introduced since July 2002.

The rights to future income and residual tax cost setting rules were introduced after an extensive consultation process that has been under way since before they were announced by former Assistant Treasurer, Mr Mal Brough, in December 2005. In the course of the consultation process, external stakeholders sought to clarify with Treasury the underlying policy and the potential significance of the revenue cost attaching to that policy. Further, the ATO was involved in many of the key stakeholder consultation meetings during the course of the process, and to the best of our knowledge, they did not express any specific concerns with the effect of the policy on the operation of the consolidations law.

We believe that the Board should bear in mind that, in substance, last year's amendments attempted to do no more than provide tax relief for the cost of acquiring an income generating asset which, over its life and on its disposal, results in assessable income being recognised by the acquirer. When looked at on a holistic basis, including the fact that in each case there is usually a taxable vendor, the tax cost setting changes generally achieve the correct policy outcome.

Specific issues requiring clarification

ATO National Tax Liaison Group Issues

As part of the review process, the Joint Bodies believe that the Board should take into account a number of issues that are currently being considered by the Consolidation Sub-Committee of the ATO's National Tax Liaison Group. These issues have been raised for the purpose of seeking guidance in relation to certain aspects the rights to future income and residual tax cost setting rules. Any recommendations put forward by the Board should have regard to the impact of these interpretative issues in the context of the overall review. The issues include:

- Asset characterisation of the reset tax cost setting amount arising from subsection 701-55(6)
- What is the scope of the terms "provision of goods (other than trading stock)" in subsection 701-90(1)?
- What is meant by the terms "right (including a contingent right)" in section 701-90(1)?
- What is the scope of the terms "provision of goods" in section 701-90?
- 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?
- What is meant by the terms "the performance of work or services" in subsection 701-90(1)?

Further information in respect of these issues can be provided to the Board if required.

Rights to future income – revenue versus capital characterisation

The enacted rights to future income statutory rules perform multiple functions including:

a) overcoming the requirement to consider the revenue or capital nature of the acquisition; and
b) permitting a deduction over time.

The rights to future income rules in section 701-90 and, in particular, sections 716-405 and 716-410 mandate a deduction for the ACA allocation made to certain intangible assets. The Joint Bodies recognise that by eliminating the requirement to determine the revenue or capital nature of the acquisition, certain taxpayers may have obtained a more advantageous outcome. That is, for certain taxpayers depending upon their particular circumstances, a revenue deduction may not otherwise have been available had the intangible asset been acquired as part of an asset acquisition transaction.

To this extent, these provisions have an operation which is different to the operation of many other assets covered by section 701-55. For assets such as; trading stock, assets subject to Division 230 or CGT assets, the tax treatment of the assets will be the same for all taxpayers irrespective of whether an entity acquisition or an asset acquisition occurs.

In our view, it cannot be disputed that the rights to future income legislation has mandated a tax outcome which otherwise would not have been obtained by all taxpayers in an asset acquisition transaction. In this respect, the rights to future income provisions stand distinct.

If the Board identifies any concerns with the underlying policy in this area, consideration could be given to the possible prospective adoption of an asset acquisition approach (discussed below).

Goodwill and non-contractual customer relationships

The Additional Guidance Material suggests that there may be cases where the rights to future income rules or residual tax cost setting rules are being applied in relation to claims for goodwill or for non-contractual customer relationships. In our view, these would appear to go beyond the scope of the original policy parameters of the consolidation amendments. The Joint Bodies therefore recognise that the Board may wish to consider changes in this area either on a prospective or retrospective basis, depending on the materiality of this issue. This issue should be the subject of further discussion with the Board as part of this review process.

Asset acquisition approach – viable on a prospective, but not a retrospective, basis

In the December 2010 submission to the Board in respect of its Position Paper, the Joint Bodies supported the asset acquisition approach, subject to a number of specific comments made at that time. The joint submission also observed that particular care would have to be taken in formulating the new provisions to ensure that they did not create new and more difficult challenges for taxpayers.

Consistent with the Board's views about the asset acquisition model as set out in the Position Paper, the Joint Bodies could only support the adoption of such an approach on a prospective, and not retrospective, basis. The reasons for this are set out below:

(a) Fundamental policy change

The current tax consolidation regime primarily adopts an "entry history rule" approach, and this has been a clear policy design principle that has been in place since the commencement of the regime in 2002. Except in relation to certain assets where a quasi-asset acquisition approach is adopted (e.g. certain capital allowance assets), the entry history rule predominantly applies in respect of a number of other asset categories, and also in regard to the tax status of assets.

Therefore, it would be inappropriate to retrospectively seek to apply a totally different policy formulation. Even seeking to apply an asset acquisition approach retrospectively to a particular class of assets or to a particular tax outcome could have complex and potentially far-reaching implications.

In our view, policy changes of this nature should only be undertaken on a prospective basis so that all the flow-on and interrelationship issues can be appropriately considered and dealt with.

(b) *Speed of implementation*

As noted above, if an asset acquisition approach were to be adopted it would require a significant time commitment and careful consideration of the issues involved. Such an approach, in our view, should only be considered on a prospective basis. Any measure to deal with existing concerns which may have a retrospective impact must be capable of quick implementation.

Date of effect considerations and resolving present uncertainty

The Joint Bodies believe that the enacted law in respect of the assets covered by the Explanatory Memorandum (**EM**) and Supplementary EM to the *Tax Laws Amendment (2010 Measures No 1) Act 2010* should be retained, without amendment retrospectively. The reasons for this include:

a) the reliance placed on last year's changes in relation to transactions involving consolidated groups;
b) the significant expenditures on compliance with the measures;
c) the disclosures to financial markets of the tax outcomes; and
d) the broader issues about the stability of Australia's tax system.

To the extent that the Board believes it is necessary to consider retrospective changes, the Joint Bodies would value the opportunity to discuss the precise areas of concern, and the mechanisms available to meet the government's objectives whilst taking into account the effect of any such changes on corporate taxpayers.

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We have kept our comments in this submission relatively brief, on the basis of the limited information that is available to us at this point. The Joint Bodies would welcome an opportunity to continue to work collaboratively with the Board to identify outcomes that are consistent with the government's objectives.

If you require any further information or clarification of any issue raised, please contact at first instance either Susan Cantamessa on 02 9290 5625 or Peter Murray on 03 9288 6677.

Yours sincerely

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