20 April 2011

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

By email: taxboard@treasury.gov.au

Dear Sir/Madam

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

We are pleased to respond to the Board of Taxation's (**the Board's**) invitation for submissions for the purposes of the Board's review of the rights to future income and residual tax cost setting rules, in accordance with the Terms of Reference set out in the Assistant Treasurer's Media Release of 30 March 2011 and the Additional Guidance Material for Stakeholders issued by the Board on 6 April 2011.

In summary, we make the following primary points of submission for the Board's consideration:

(i) That the rights to future income and residual cost setting rules were introduced following extensive consultation with stakeholders and for specific reasons which under the current tax consolidation model continue to be valid.

(ii) It is not appropriate to review the effectiveness of the rights to future income and residual tax cost setting rules in the context of an "asset acquisition approach" given that our current income tax consolidation regime operates on an "inherited history model" (with limited modifications) and not an "asset acquisition model".

(iii) If the Board does give consideration to the taxation treatment of the direct acquisition of assets (particularly contractual assets) it will find that tax deductibility has been allowed by the Courts in a number of circumstances, but in other situations denied. A specific deduction for rights to future income was formulated to provide a deductible outcome that effectively prevented the risk of double taxation arising from ordinary jurisprudence.

(iv) Where the law as it currently stands is clear, it should not be amended with retrospective effect.

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(v) If there are unintended consequences such that retrospective amendment is deemed necessary, any amendment should only create a primary tax liability for taxpayers. No penalties or interest should be payable by taxpayers in respect of tax shortfall amounts which arise due to positions that have been correctly adopted based on the current law where the law is retrospectively amended.

(vi) There are previously identified existing uncertainties in the rights to future income and residual cost setting rules which should be addressed during this review.

(vii) Irrespective of any Board recommendation, Allocable Cost Amount (**ACA**) allocated to intangible assets recognised for tax cost setting purposes should always be provided with relief under the *Income Tax Assessment Act 1997* (***ITAA 1997***) through either a deduction, capital loss or cost base recognition and should not give rise to rise to "new" categories of blackhole expenditure.

1. Background and scope of the review

Broadly speaking, the Board has been briefed to examine the operation of the rights to future income and residual tax cost setting rules to clarify their scope and, if necessary, advise on changes to limit their scope and the date of effect of any such changes. It is our understanding that the review has been prompted by concerns in relation to the scope of the rights to future income and residual tax cost setting rules, and in particular, that the rules have a purportedly wider application and consequently a greater revenue impact than was first anticipated when the rules were introduced.

The rights to future income and residual tax cost setting rules were announced in December 2005 by the then Assistant Treasurer and introduced following extensive consultation with stakeholders (including the Australian Taxation Office (**ATO**) and industry and professional bodies) and other interested parties.

The specific rights to future income deduction provision was introduced to resolve defects that arose from the more general operation of the residual tax cost setting rules and their interaction with other provisions such as section 6-5, section 8-1 and section 25-95 of the *ITAA 1997* and current jurisprudence.

The Exposure Draft legislation released in April 2009 did not contain the specific right to future income deduction provision. Further, all the examples of rights to future income in the Exposure Draft Explanatory Memorandum were covered by the residual tax cost setting provision contained in the then proposed subsection 701-55(6) of the *ITAA 1997*. Of course, a specific provision was introduced and the final Explanatory Memorandum to *Tax Laws Amendment (2010 Measures No.1) Act 2010* provides the following explanation as to why the specific rights to future income deduction was introduced:

> *"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."*

To overcome uncertainties identified with the use of the residual tax cost setting provisions to deal appropriately with rights to future income (as detailed in Appendix A to this submission), the Government introduced a specific rights to future income deduction rule. It is submitted that the reasons for these provisions continue to be valid and that under the current tax consolidation model a specific rights to future income deduction rule continues to be warranted.

In relation to the residual tax cost setting rule contained in section 701-55(6) of the *ITAA 1997*, the consolidated group is not deemed to have acquired the relevant assets of the joining entity. Consistent with the inherited history model of our tax consolidation rules, the head entity is taken to have always held the relevant assets. The head company is deemed, by section 701-55(6) of the *ITAA 1997*, to have incurred the allocated tax cost setting amount to acquire the asset – for the purpose only of identifying the "cost" of that asset, or the reduction of subsequent taxable gain or loss in relation to that asset. This rule plays no part in the actual classification of the underlying asset as either of capital or revenue nature. It is the inherited history of the asset to which regard must be had in determining this tax characterisation and, ultimately therefore, in determining the application of section 8-1, section 40-880 or section 6-5 of the *ITAA 1997* to this amount.

2. Asset acquisition approach is not valid on a retrospective basis

The Board has requested stakeholders to comment on the taxation outcomes that would arise when assets of the type that are covered by the rights to future income and residual tax cost setting rules are acquired directly by a company as part of a business acquisition outside of the consolidation regime, on the basis that this is broadly consistent with the "asset acquisition approach" currently being considered by the Board.

It was inherent in the original Government announcements in relation to the rights to future income and residual tax cost setting rules (included at Appendix A to this submission) that a provision that secures a tax deduction for rights to future income would in certain situations represent a different tax outcome for an entity joining a tax consolidated group than would apply if the consolidated group directly acquired all the business assets of the entity.

This outcome was considered appropriate in the context of a tax consolidation regime which applies an "inherited history model" rather than an "asset acquisition model".

The adoption of an "asset acquisition" model is a proposal which the Board has recommended be adopted on a prospective basis (Position Paper on the Post Implementation Review into Certain

Aspects of the Tax Consolidation Regime – October 2010). In further developing the detail of such a model it would be entirely appropriate to look for consistency of treatment as between an entity joining a tax consolidated group and a direct acquisition of the assets of that entity by the consolidated group. However, we do not currently have an "asset acquisition" model and, until such time, it is not appropriate to look for such a consistency of outcome. Provisions such as section 716-405 have been enacted on the premise that they will cause a uniform outcome for all taxpayers, even those taxpayers who would not obtain a deduction in an asset transaction.

3. Consideration of the case law for direct asset acquisitions

If, contrary to our submission above, the Board looks to the taxation treatment of direct asset acquisitions as providing some relevance for the review of the taxation outcomes for assets of a joining entity, it should find that the law is not definitive. We have attached as Appendix D a summary of the key cases.

A number of cases would support a position for deductibility of amounts paid (or allocated) to the acquisition of contractual assets. However, other cases have denied deductibility. It was within this context that the specific deduction for rights to future income was formulated. It was thought, given the equivocal state of the case law in this area that, without a specific deduction provision, the Government's announced deduction for rights to income for a joining entity could not be assured in all circumstances.

This position remains valid.

4. Date of effect of considerations and any amendment to law

The Board has invited stakeholders to comment on the appropriate date of effect of any proposed changes, including whether they should apply retrospectively. In particular, the Board has invited comments on how any retrospective changes should impact taxpayers who may have already relied on the existing rules in the course of structuring their tax affairs or in the course of conducting their business operations.

While the Board has been tasked with identifying the intended scope of the rights to future income and residual tax cost setting rules (and recommending appropriate further amending legislation, if necessary), it is critical that the Board approaches this task within the parameters of the "rule of law" and the need to ensure that taxpayers were appropriately able to rely on law, particularly to the extent that outcomes under that law were not subject to material uncertainty.

The approach of Parliament (and particularly the Senate) to Tax Bills which purport to apply on a retrospective basis is clearly set out in the Report on Aspects of Income Tax Self Assessment, 16 December 2004, Chapter 7 (extract included as Appendix B to this submission).

Many taxpayers have appropriately relied on the current law to both negotiate the price for transactions and report results to shareholders.

It is less likely price negotiations for transactions involving the joining of an entity into a tax consolidated group may have taken account of the potential outcomes under the rights to future income and residual tax cost setting rules from the date of the original Government announcement on 1 December 2005. However, from the date these rules became law then they may clearly have been reflected in price negotiations for these transactions.

In addition, from the time of the introduction of the rights to future income and residual tax cost setting rules, many corporate groups have gone to considerable cost and effort to investigate and confirm the application of these rules. Many groups have lodged amendment requests with the ATO; some have received tax refunds; some have lodged private ruling applications. In this context the current law (to the extent the outcomes of the application of the provisions are not materially uncertain) has been appropriately relied upon by taxpayers in respect of joining entities from the period commencing 1 July 2002 (i.e. the date of effect of the rights to future income and residual tax cost setting rules).

Furthermore, *Tax Laws Amendment (2010 Measures No.1) Act 2010* specified a window within which amendments to prior year assessments affected by the amendments (which would have been otherwise "out of time") could be made (i.e. by 3 June 2012). It would be inappropriate for the Government to place at a competitive disadvantage those groups who had not lodged or had processed amendment requests before a particular date (e.g. the date of announcement of the Board's review). It is therefore strongly submitted that any application of further amendment of the rights to future income and residual tax cost setting rules is based on the relevant joining time, rather than any reference to the timing of amendments requested or processed.

If the rights to future income and residual tax cost setting rules are amended retrospectively with no concession for deductions already claimed, we strongly submit that the amendments are such that taxpayers are not penalised by way of interest and penalties in respect of any tax shortfall for primary tax not paid. This would alleviate any revenue concerns sought to be addressed by any retrospective amendment while at the same time not penalise taxpayers who have taken positions based on the law as it is currently enacted.

5. Existing uncertainties in the rights to future income and residual tax cost setting rules

We understand that the Board is seeking to address the existing uncertainties and any unintended outcomes in respect of the application of the rights to future income and residual tax cost setting rules.

We recommend that to the extent possible, if there is any legislative amendment made to the provisions as currently enacted, that existing uncertainties are also addressed.

In addition we would strongly recommend that the Government provide clarification at an early stage as to whether the treatment of assets contained in the examples in the Explanatory Memorandum and Supplementary Explanatory Memorandum to the *Tax Laws Amendment (2010 Measures No.1) Act 2010*, will be retained.

We set out below some of the key contentious issues in relation to the application of the rules as submitted to the ATO by the external members of the NTLG tax consolidations sub-committee in October 2010 which in our view should be addressed by the Board.

Rights to future income

(i) What is the meaning of “right (including contingent right)” in section 701-90 of the ITAA 1997 and how does this meaning impact on aspects of the valuation of these rights – including treatment of renewal options; cancellation clauses; minimum spend v. likely spend; and umbrella agreements?

(ii) What is meant by the terms “the performance of work or services” in section 701-90 of the ITAA 1997? Should a “narrow view” be adopted which requires actual “personal performance” or a broader view which adopts more the “ordinary usage” of these terms? And how does this impact on the eligibility of contracts such as insurance; telephone contracts; franchise agreements and actively managed leasing (e.g. shopping centres)?

(iii) What is the scope of the terms “the provision of goods” in section 701-90 of the ITAA 1997? Will this cover contracts for the provision of the use of goods – e.g. chattel leasing? What is meant by the term “goods”?

(iv) What is meant by the trading stock exclusion in section 701-90 of the ITAA 1997? Does this exclude all contracts for the future provision of trading stock or is it only meant to exclude the value of trading stock “on hand” at the joining time?

Revenue deductions

(v) To what extent is the “entry history” of an asset overridden by section 701-55(6) of the ITAA 1997 and to what impact in relation to section 8-1 of the ITAA 1997? Is the reset tax cost setting amount to be characterised in relation to each asset separately or does the characterisation need to have regard to all of the assets joining a tax consolidated group under the same transaction?

Non-contractual customer relationships

(vi) Is a “blackhole” deduction under section 40-880 of the ITAA 1997 (or a revenue deduction under section 8-1 of the ITAA 1997) available for the tax cost setting amount allocated to a “non-contractual customer relationship”?

6. Other matters to consider during the review

Treatment of Assets not recognised in other parts of the Income Tax Assessment Act 1997

As you are aware, the tax consolidation regime operates under an inherited history model, whereby the reset tax costs of the assets of a joining entity are characterised on an “asset by asset” basis having regard to the history of each asset which the acquiring head company is deemed to inherit.

Fundamental to the current tax consolidation model is that an “asset’s” tax cost is set when an entity joins a tax consolidated group. It is important to understand what constitutes an “asset”. An asset is not defined for income tax purposes and therefore should take its ordinary meaning in the context of Part 3-90 of the *ITAA 1997*. Taxation Ruling **TR** 2004/13 states at paragraph 5, that an asset for the purpose of the tax cost setting rules is:

> *“…anything recognised in commerce and business as having an economic value, to the joining entity at the joining time for which a purchaser of its membership interests would be willing to pay.”*

Therefore it appears that intangible assets identified for financial reporting purposes (i.e. recognised in business and commerce) are assets for income tax consolidation purposes.

AASB 3 Business Combinations (Illustrative Examples) provides details of the sorts of intangible assets that can be recognised for accounting purposes in a business combination.

The context of TR 2004/13 and the consolidation regime’s recognition of accounting assets is illustrated in paragraph 7 of TR 2004/13 where the Commissioner of Taxation states that a Deferred Tax Asset (**DTA**) is an asset recognised for tax consolidation purposes and should be given a Tax Cost Setting Amount (**TCSA**).

Once a TCSA is set for an asset the difficulty arises as to what the correct income tax treatment is in respect of the TCSA. It is unclear as to how a DTA, know-how and other accounting assets are treated for other purposes of the Act. Section 701-55(6) of the *ITAA 1997* deems the group to have incurred or paid the TCSA to acquire the relevant asset. This outcome then links the reset cost into deduction provisions such as section 8-1 (general deduction) or section 40-880 (blackhole) of the *ITAA 1997*.

Should the Board form a view that amounts allocated to intangible assets (that are not otherwise recognised in the ITAA 1997) should not be deductible under section 40-880 or section 8-1 of the *ITAA 1997*, then to the extent there is no recognition of the expenditure, the tax law should ensure that the TCSA allocated to the asset is not otherwise blackhole. Under the current law, the TCSA may be reconstructed when the asset leaves the tax consolidated group by way of disposal of a subsidiary member however as these assets are not CGT assets, the TCSA may be "wasted" should the head company dispose of the asset by way of a sale of a business or the asset simply ceases to exist.

We believe the Board needs to be cognisant that these "other assets" are allocated ACA under the tax consolidation regime and some tax relief for this allocation needs to exist to avoid creating "new" blackhole expenditure.

* * * * * * *

We would welcome an opportunity to work cooperatively with the Board in relation to this review.

Should you have any questions or would like to discuss any of the above in further detail, please don't hesitate to contact me on (03) 8603 6733, Wayne Plummer on (02) 8266 7939 or Jason Karametos on (03) 8603 6233.

Yours sincerely

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APPENDIX A

Further background to the introduction of the rights to future income and residual tax cost setting rules

The original Government announcement in relation to RTFI is set out below:

> *"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 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." [Minister for Revenue and Assistant Treasurer, Press Release No. 098, 1 December 2005]*

The acceptance of this change by the current Government was announced on 13 May 2008 (Joint Press Release by the Treasurer and Assistant Treasurer, Minister for Competition Policy and Consumer Affairs).

During the course of consultation in relation to the rights to future income and residual tax cost setting rules, the following uncertainties were identified with the use of the residual tax cost setting provisions to deal appropriately with rights to future income (and therefore lead to the development of a specific deduction provision):

(i) It was unclear whether subsection 701-55(6) of the *ITAA 1997* would provide a context for determining whether amounts were incurred on revenue or capital account. The original announcement of the RTFI deduction (discussed above) did not suggest that a deduction would depend on the capital v. revenue characterisation of the relevant RTFI asset. It simply stated that a deduction would be allowed and that this would be achieved through the continued application of the entry history rule. It was therefore necessary to clarify, in a specific provision, the continued operation of the entry history rule and the allowance of a deduction for the reset tax cost allocated to a RTFI irrespective of questions as to the capital or revenue nature of that asset.

(ii) It was unclear whether a deduction would arise for a deemed cost incurred to acquire a relevant contract (under section 701-55(6) of the *ITAA 1997*) where the profit from that contract was returned on a net income basis under section 6-5 of the *ITAA 1997*.

(iii) It was unclear whether a cost deemed incurred under s701-55(6) of the *ITAA 1997* could give rise to a tax deduction prior to the expiry of the relevant underlying contract.

(iv) Finally, many expected the deemed cost incurred by subsection 701-55(6) of the *ITAA 1997* to provide a deduction for RTFI assets under the “work in progress” provision contained in section 25-95 of the *ITAA 1997*. However, it was highlighted during consultation that the provision required an entity to agree to pay an amount to another entity and it was considered doubtful that section 701-55(6) of the *ITAA 1997* to deem such an agreement to have occurred.

APPENDIX B

Extract from the Report on Aspects of Income Tax Self Assessment (16 December 2004)

7.3 Retrospective tax laws and other design issues

Submissions have also suggested that Parliament should not pass retrospective tax laws.

At various stages Parliament has reiterated its reluctance to pass retrospective tax laws except in limited circumstances. Evidence of this can be seen in comments made by the Scrutiny of Bills Committee, the Senate Standing Orders and Parliamentary debates.

The Scrutiny of Bills Committee examines all bills which come before the Parliament. It is governed by Senate Standing Order 24 and, in particular, the five principles set out in that Order. The relevant Order provides:

'24. (1)(a) … the Scrutiny of Bills shall be appointed to report, in respect of the clauses of bills introduced into the Senate, and in respect of Acts of the Parliament, whether such bills or Acts, by express words or otherwise: i) trespass unduly on personal rights and liberties …'

This principle has been interpreted as requiring the Committee to draw the Senate's attention to legislation that is to apply retrospectively (if passed). Usually if retrospective legislation is introduced the Committee will comment that the provisions breach the principle in the Order. However, provisions that have a beneficial effect are less likely to be commented on adversely. This principle has also been interpreted as requiring the Committee to draw attention to legislation that is expressed to operate from the day of an earlier press release foreshadowing the legislation.

Senate Standing Order 30 also addresses retrospective bills, solely in the tax context. The Order states that, where tax bills have been announced by press release more than six months before their introduction into Parliament (or publication), they will be amended to provide for a commencement date after the date of introduction (or publication). In this way, the Senate Standing Order is intended to reduce the period of retrospectivity, so that the law may commence no earlier than the time the bill was made public.

The Review concludes that the application date of measures should remain an issue to be examined and determined by Parliament on a measure-by-measure basis. While ideally, tax measures imposing new obligations should apply prospectively, retrospective start dates may be appropriate where a measure:

- *corrects an 'unintended consequence' of a provision and the Tax Office or taxpayers have applied the law as intended*

- *addresses a tax avoidance issue*
- *might otherwise lead to a significant behavioural change that would create undesirable consequences, for example bringing forward or delaying the acquisition or disposal of assets.*

APPENDIX C

Examples in AASB 3 of intangible assets recognised for accounting purposes

Some of the intangible assets included as examples in *AASB 3 Business Combinations (Illustrative Examples)* are as follows:

(i) marketing-related intangibles - trademarks, newspaper mastheads, internet domain names, non-competition agreements;

(ii) customer-related intangibles - customer lists, order or production backlog, customer contracts and the related customer relationships and non-contractual customer intangibles;

(iii) artistic-related intangibles - pictures, video and audiovisual material, literary works;

(iv) contract-based intangibles - construction permits, operating and broadcasting rights, servicing contracts (e.g. mortgage servicing contracts), construction/management/service/supply contracts; and

(v) technology - based intangibles - patented technology, software, unpatented technology, databases, trade secrets.

APPENDIX D

Review of case law – direct acquisition of contractual assets

Case law dealing with the tax deductibility of amounts paid (or allocated) to the acquisition of contractual assets can be considered in the context of:

(a) those cases dealing with direct acquisition of contracts in the absence of a broader business acquisition; and

(b) those cases dealing with amounts allocated to the acquisition of contracts as part of a broader business acquisition.

(a) Contract acquisitions (without a broader business acquisition)

Cases examined below, including *BP Australia Limited v FCT (1965) 112 CLR 386; National Australia Bank Limited v FCT 97 ATC 5153; and Tyco Australia Pty Ltd v FCT 2007 ATC 4799 -* have established that expenditure from "circulating capital" such as expenditure to acquire contractual rights which incrementally enhance an existing customer base of an existing business will generally be deductible under section 8-1.

Dixon J's approach in *Sun Newspapers* has been applied in numerous cases, including *B.P. Australia Ltd v FCT* (1965) 112 CLR 386. The Privy Council held that payments made by the taxpayer to service stations for exclusive trade ties were on revenue account and deductible.

Service stations had traditionally stocked multiple oil brands; however, the Shell Company had commenced signing up service stations to exclusive deals. In response, the taxpayer offered a "development allowance" incentive for exclusive trade ties of at least three and typically five years. The "development allowances" were calculated by reference to past and anticipated **future volumes of petrol sales**. The Privy Council cited with approval the following extract from the High Court minority decision by Dixon CJ:

> *"I do not think it was acquiring a capital asset or doing any more than so conducting its business on revenue account as to increase it and make as certain as it could that its business was continuing and also would continue, if possible, to expand."*

Similarly the Privy Council cited with approval the dissenting judgment of Kitto J in the High Court:

> *'But a promise by a service station operator not to deal with oil companies other than the appellant or its allies was only the negative side of the substantial positive advantage which it was the purpose and practical effect of the agreement to produce, namely the*

advantage of a practical certainly that the whole of the custom of the service station, for motor spirit, would be given to the appellant or its allies for the agreed period; and what the appellant really paid its money for was that positive advantage…

…the advantage was not the acquisition of a new market, not a new framework within which to carry on trade for the future, not an extension of the appellant's selling organization to include a regiment of resellers. It was not such an exclusion of competition as adds to goodwill a negative right and thus increases the value of goodwill. It consisted simply of the practical assurance of receiving bundles of orders for motor spirit, the circumstances being such that for the foreseeable future it would be only by getting similar bundles of orders that such a trade as the appellant's could be carried on.'

The Privy Council summarised the situation by stating that the taxpayer's "ultimate objective was to sell petrol and to maintain or increase its turnover" and that the taxpayer was "not achieving a monopoly nor buying off competition nor obtaining any substantial area for its own domain". As such where a taxpayer makes a payment for a contract with the commercial and business intent of securing future sales the payment should be seen as deductible.

In the case of *National Australia Bank v FCT* 97 ATC 5153 (*"National Australia Bank"*), the Full Federal Court held that the advantage sought by NAB in paying the Federal Government a bid price of $42 million as consideration for being appointed the exclusive lender for a period of 15 years, was to expand its customer base and to make further profits from its existing business. Specifically, it was held that:

"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."

Of note is that the Federal Court in *National Australia Bank* cited the following comments of Kitto J and Dixon CJ respectively in the High Court in *BP Australia* (with whom the Privy Council was in agreement on appeal):

"A payment made by a trader to a customer for the purpose of securing orders for a quantity of goods is prima facie part of the cost of selling the goods."

> *"I do not think it* [BP Australia] *was acquiring a capital asset or doing any more than so conducting its business on revenue account as to increase it and make it as certain as it could that the business was continuing and also would continue, if possible, to expand."*

The Federal Court commented:

> *"The Privy Council* [in BP Australia] *also said that "the only ultimate reason for any lump sum payment was to maintain or increase gallonage" (at 393). In our view the only reason for the lump sum payment here (and the contemplated annual payments) was to increase sales of the Bank's* [NAB] *product."*

The Federal Court in *National Australia Bank* cited the following comments of the Court in *Federal Commissioner of Taxation v Raymor (NSW) Pty Ltd* (1990) 24 FCR 90:

> *"It can be said of every payment pursuant to a contract that it secures to the payee the contractual rights under the contract. In that sense every payment made under a contract confers upon the payee a chose in action which can be described as an asset and which contractual right is discharged by the performance of the contract. But such an analysis is of no assistance in the resolution of whether a particular outgoing is on capital or revenue account."*

The Federal Court in *National Australia Bank* provides clear guidance for the proposition that the payment for the acquisition of a contract should rightly be considered as a deductible outgoing where the intention of the taxpayer is not to increase the framework by which it undertakes its business but to increase the regular custom / patronage from whom it derives its income.

Further, in *Ounsworth v Vickers Ltd* (1915) 3KB 267 the Court held that expenditures which are a constant demand on a business are on revenue account.

In *Tyco Australia Pty Ltd v Federal Commissioner of Taxation* [2007] ATC 2799, Tyco Australia Pty Limited ("Tyco"), carried on a business of electronic security monitoring. Tyco entered into written agreements with independent contractors whereby these contractors would assign service agreements they held with customers to Tyco in exchange for a fee. Allsop J considered the nature of payments made by Tyco to the independent contractors as consideration for the assignment of the service agreements. Each service agreement assigned to Tyco had an agreed term of approximately 36 months.

Allsop J held that the regular payments made by Tyco to the independent contractors were to secure customers, each assignment being an incremental accretion to its customer base, and to obtain future revenue from those customers. On this basis, Allsop J came to the view that the payments were revenue in nature and, hence, deductible to Tyco. Importantly, these payments were recognised as reflecting the future value of the connection with the customers and the future revenue stream to be derived. Essentially, the advantage sought by purchasing the right to the service agreements was the engagement of customers such that they could be retained and exploited for future revenue in return for services to be provided.

Allsop J specifically notes in *Tyco* at 41:

> *As these passages reveal, the regular payment of sums to secure customers, to add incrementally to a customer base and thus to expand a business and to obtain revenue from such customers is able to be seen to be on revenue account.*

Further at 81 Allsop J notes regarding the acquisition of the customer contracts:

> *This was not the purchasing or creation of a business structure. It was, to paraphrase and elaborate upon the words of Dixon J in Sun Newspapers 61 CLR at 360, the building of the extent of the profit yielding subject (being the customer base of TAPL) as the product of the course of operations, by the incremental winning of customers by the chosen method of organising and remunerating an independent, but controlled, sales force.*

Tyco Australia is therefore authority for the position that a company should be entitled to a tax deduction for a cost to acquire a contract where such contract represents a new customer for the business.

(b) Contract acquisitions (as part of a broader business acquisition)

Whilst there are certainly cases which may support the proposition that the acquisition of contracts in the case of a broader business acquisition may be an affair of capital, the position is not absolute and is yet to be thoroughly tested in the courts.

Indeed those cases that do deal with the acquisition of assets as part of a broader business acquisition generally deal with the situation where the acquiring entity, through the acquisition, is establishing itself in a particular industry, rather than acquiring a business which results in the incremental expansion of an existing business. It is not unreasonable to suggest that, where a company acquires a business that incrementally adds to its existing business, and that acquired business includes a portfolio of additional customer contracts, a future court may allow a deduction under section 8-1 “to the extent” the price paid for the acquisition of the business assets relates to those customer contracts. The court may accept that the price paid to acquire that portfolio of customer contracts represents the price paid to acquire the finite business represented by those contracts. It does not represent an enduring capital asset such as the business structure itself which is necessary to service those contracts (or the enduring tangible assets such as plant, land etc). A future court might distinguish such circumstances from the acquisition of a completely new business (eg. in a different industry).

In John Smith and Son v Moore [1921] 2 AC 13 Lord Sumner noted:

> *That decision [City of London Contract Corporation v Styles] seems indistinguishable from the present case. There the taxpaying company was incorporated to buy as a going concern the business from a firm of contractors, who had been entirely engaged in executing some construction contracts still uncompleted. The company bought this business, including the benefit of these contracts, and proceeded with the execution of them. In the purchase price was included a sum, ascertainable if not ascertained, for their value. The company claimed that, before their profits from carrying out these contracts could be ascertained, there must be deducted whatever sum represented their value in the price paid for the contractors' business generally…The Court held that this sum was paid with the rest of the aggregate price to acquire the business and thereafter profits were made in the business; the sum was not paid as an outlay in a business already acquired…*

In relation to the acquisition of the "book" of a business, Allsop J in *Tyco Australia* states at 77:

> *"I do not infer from the evidence, as the respondent submitted I should, a plan to acquire such an initial mass of customers, irrespective of quality, to place the institution of the AD Program as the equivalent of buying a book of business in one transaction (such as was done from Honeywell). None of the evidence reveals such a plan. By the winning of customer by customer (in significant numbers) TAPL built up its customer base and it's hoped for future revenue. It is important to recognise that each Assignment Fee was payable in respect of each Customer Service Agreement assigned and novated. Each assignment and novation and each passing of a customer to TAPL was an incremental accretion to the customer base of TAPL. This distinguishes the payments (as a collection of individual payments) from the purchase of a book of business as was involved in the Honeywell transaction."*

In *QCT Resources Limited v Federal Commissioner of Taxation* 97 ATC 4079 *(QCT Resources)* the Federal Court considered the deductibility of an amount paid by the taxpayer in respect of certain work-in-progress under the contract to acquire an operating mine. The vendor had incurred deductible expenses in undertaking "overburden work-in-progress", which refers to the work of overburden removal comprising drilling, blasting and moving of overburden from a strip to be mined to the adjacent previously mined strip. Referring to *City of London Contract Corporation Ltd v Styles* (1887) 2 TC 239, *John Smith and Son v Moore* [1921] 2 AC 13, and *Commissioner of Taxes v Nchanga Consolidated Copper Mines* [1964] AC 948, Drummond J stated at 4086:

> *"Styles and Lord Sumner's views in John Smith, accepted as correct in Nchanga, are, in my opinion, authority for the proposition that, where a purchaser acquires as a new venture for it, an entire business as a going concern and the purchase includes the acquisition of the benefit of work done by the vendor which will, with further work by the purchaser, yield*

income to the purchaser from the business, anything paid as part of the purchase price which can be allocated to the acquisition of that benefit is an outgoing on capital account."

Earlier when referring to *Commissioner of Taxes v Nchanga Consolidated Copper Mines* [1964] AC 948, Drummond J stated

"…the Privy Council, at 963-964, accepted that, as a general rule, if a man acquires and pays for stock-in-trade for his own business on the taking over of another he is entitled to set off against the gross proceeds of realising the stock the identifiable cost of acquiring it. But it is clear, from the Privy Council's reference to Lord Sumner's dictum in John Smith and Son v Moore[1921]2 AC 13 at 39*, that it regarded the principle as applicable only where an existing business acquires a profit-yielding asset for realisation in that business eg goods which would comprise trading stock of the purchaser's business or something analogous to trading stock, such as contracts which would generate income for that business".*

QCT Resources is authority for the proposition that the deductibility of an amount allocated to an asset under a purchase price allocation must be established by reference to the existing business of the purchaser. That is, given that the QCT acquisition represented a new business venture for the taxpayer, in an area which it previously did not conduct business, it could not be said that the outlay was in the ordinary business of the taxpayer. Instead, the amount was held to be in the nature of capital.

Drummond J goes on to state at 4086:

"… It is its similarity to outgoings that have already been incurred by the existing business and which undoubtedly have the character of revenue outgoings of that business that requires such an outlay to be characterised in the same way; the character of the advantage sought from such an outlay is the same income-generating advantage sought from similar outlays made and to be made in the ordinary course of carrying on the existing business. This justification is absent where part of the cost of acquiring a new business of a kind not previously conducted by the purchaser is an outgoing which will be similar in kind to revenue outgoings which the purchaser can expect to make in the future, once it commences to trade: in this situation, the character of the advantage sought by making the particular outlay is the same as that sought from making the other outlays which together comprise the price paid for acquiring the capital asset, viz, the new business as a going concern. From a practical and business point of view, there is no justification for characterising one component of the stated price paid to acquire such an asset differently from any of its other components: the entire price has to be paid to acquire the new business."

In *QCT Resources* Drummond J reasons that an amount paid for the acquisition of an asset as part of a business acquisition, which otherwise would be revenue in nature and therefore deductible, may be considered capital in nature as a component paid for the structural benefit of acquiring the business as a whole as a going concern.

In *CIR v New Zealand Forest Research Institute (NZFRI)[2000](72TC628)* NZFRI took over forestry related research previously performed by a division of the Ministry of Forestry, acquiring specific assets and liabilities from previous Crown entities. The legislation provided that where any employee of a government department transferred to NZFRI and did substantially the same work as before, the employment by NZFRI was to be on the same terms as by the government department. The consideration paid by NZFRI was calculated by deducting from the value of assets transferred, inter alia, an estimated sum in respect of the assumption by NZFRI of the Crown's liabilities to its staff at the transfer date. NZFRI subsequently paid those sums to the transferred employees and sought to claim a deduction for them. The Privy Council found that the payment was capital Lord Hoffman noted at pages 631C

> *…the position was that the Institute, pursuant to the transfer agreement and as part of the consideration for the purchase of the assets, accepted a liability under its employment agreements with former Crown employees not merely to remunerate them for services to the Institute but also to discharge obligations, either vested or contingent upon some future event, which were attributable to their previous service with the Crown. It seems to their Lordships plain that, viewed in this light, the payments were capital expenditure, being part of what was paid for the acquisition of assets. There can be no doubt that the discharge of the vendor's liability to a third party, whether vested or contingent, can be part of the purchase price. It does not matter that the payment is not made at once but pursuant to an arrangement whereby the purchaser agrees to be substituted as debtor to the third party.*

There is little specific guidance from the Courts on the treatment of costs to acquire customer contracts where an established business regularly seeks to increase its customer base through the acquisition of other businesses, including their existing portfolios of customer contracts. That is, where the acquisition of existing contracts of other businesses was done as a means to increase custom but the acquisition should not be viewed as the purchase or creation of a business structure.

In *Hallstroms Pty Limited v Federal Commissioner of Taxation (1946) 72CLR634 at 647* Dixon J observed:

> *The contrast between the two forms of expenditure corresponds to the distinction between the acquisition of the means of production and the use of them; between establishing or extending a business organisation and carrying on the business between the implements employed in work and the regular performance of the work in which they are employed between an enterprise itself and the sustained effort of those engaged in it.*

In *Cliffs International Inc V FCT* 79 ATC 4059, the taxpayer purchased all the shares in a company which held the iron ore mining rights under a contract. An amount of $200,000 was paid for the purchase of the shares "plus deferred payments equal to 15 cents (US) per tonne of iron ore". The taxpayer did not mine the iron ore itself, but organised a consortium to do that, which paid 30 cents per tonne of ore mined. These receipts from the consortium were included in the taxpayer's assessable income. The Commissioner, however, initially disallowed the taxpayer's claim to a deduction in respect of the payments by it to the vendor of the 15 cents per tonne on the grounds that they were outgoings relating to the purchase of a capital asset and therefore were capital in nature.

However, the High Court held for the taxpayer and endorsed the proposition that the mere fact that a payment is associated with a capital transaction does not mean it is on capital account. Rather one must look at the quality of the outgoing in relation to the gaining of the income against which it is sought to be deducted in order to determine whether it is on revenue or capital account.

ATO position

The following ATO statements represent a more "narrow" view of the ability of a purchaser to claim a deduction for part of the cost of acquiring a business, to the extent of the customer contracts, where that businesses acquisition represents the incremental expansion of the acquiror's existing business.

Taxation Ruling TR 2000/1

Taxation ruling TR 2000/1 deals with the tax consequences of the acquisition and disposal of insurance registers which are a record of the rights of an insurance agent to future income from renewals and also provide a record of policyholders that an agent has an exclusive right to deal with on behalf of an insurance company. At paragraph 13 TR 2000/1 states

> *Expenditure incurred by an agent acquiring an insurance register would be of a capital nature…irrespective of the legal form of the transaction and consequently not allowable as a deduction under section 8-1 of the Act.*

ATOID 2004/656

In ATO Interpretative Decision ATO ID 2004/656 the Commissioner expressed the view that the cost to an Internet Service Provider (ISP) of acquiring a subscriber base, as part of the acquisition of another ISP business was an outgoing of capital and therefore not deductible. The taxpayer carried on the business of an ISP, in order to expand its business and acquire new customers the taxpayer embarked on a series of acquisitions of other ISPs. Under the terms of the acquisition agreements, vendors were to cease their activities and were prohibited from operating in the same business as the taxpayer for specified periods.

ATOID 2007/226

In ATO Interpretative Decision ATO ID 2007/226 the Commissioner expressed the view that a premium paid as a component of the purchase price of part of another entity's business was an outgoing of capital, or of a capital nature. In that Interpretative Decision the taxpayer carried on the business of marketing financial products, including the indirect making of loans through brokers and advisors who acted as intermediaries between the taxpayer and its customers. The taxpayer acquired the direct lending loan book of another entity as a means to develop a direct clientele relationship model. However, contrary to the NAB case, payment of the premium enabled the taxpayer the subject of the Interpretative Decision to gain an enduring advantage through the enlargement of its business framework, as the expenditure enabled the taxpayer to establish a new market through the acquisition of an existing customer base.