THE
Westpac
GROUP

2 May 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

Dear Ladies and Gentlemen

Review of Rights to Future Income and Residual Tax Cost Setting Rules (the *Review*)

This submission is made in response to the Board's invitation of submissions in relation to the Review. The Review is to examine the operation of the rights to future income and residual tax cost setting rules, with a view to clarifying their scope; to propose changes to limit that scope, if necessary; and to advise on the date of effect of those proposed changes.

Westpac has obtained substantial technical knowledge and practical experience of the operation of the residual tax cost setting rules in the course of applying them in relation to the entry of St.George Bank Limited into the Westpac tax consolidated group.

On the basis of that knowledge and experience, it is Westpac's view that in their present form the residual tax cost setting rules operate as intended and in a manner which is appropriate. Therefore those rules do not require any amendment. Westpac is further of the view that the rights to future income rules could be amended to clarify the scope of their intended application. Those amendments might include limiting the rights to future income rules to rights arising from present customer commitments (as opposed to expected future commitments, even if they are expected to arise under existing contracts). Alternatively, those amendments might more broadly exclude from consolidation cost setting altogether any assets which comprise elements of goodwill or which derive their value primarily from goodwill, such that the value attributable to those assets is reflected in goodwill itself.

In Westpac's view, if appropriate amendments were made to clarify the intended scope of application of the rights to future income rules, it would be unlikely that there would remain any scope for the residual tax cost setting rules to allow deductions in respect of assets which were excluded by those amendments from the rights to future income rules.

We set out below our reasons for the views expressed above and suggestions as to specific amendments which could usefully be made to the rights to future income rules. Finally, we comment below on the appropriate dates of effect of any changes which may be made to either set of rules. For the most part, we consider that amendments should be made to operate with prospective effect; retrospective amendments could only be justified in relation to certain aspects of the rights to future income rules.

1. Residual Tax Cost Setting Rules

The residual tax cost setting rule is contained in subsection 701-55(6) and section 701-56 of the *Income Tax Assessment Act 1997* (all subsequent section references are to sections of that Act). Those sections provide that, where other provisions of the tax law than those mentioned in earlier subsections of section 701-55 are to apply in relation to an asset which is brought into a consolidated group by a joining member, the resetting of the tax cost of those assets which occurs at the joining time means that the joined group is deemed to have incurred the tax cost setting amount in acquiring the assets.

Significantly, prior to its amendment last year by *Tax Laws Amendment (2010 Measures No 1) Act 2010*, subsection 701-55(6) stated simply that the other provision of the tax law *applies as if the asset's cost at* [the joining] *time were equal to its *tax cost setting amount.*

The amendment made to subsection 701-55(6) last year expressly deems the tax cost setting amount to have been incurred by the joined group in the acquisition of the asset. This removes any doubt that, where those other provisions of the tax law would allow a deduction for a cost incurred in acquiring the asset (such as where the asset is treated for tax purposes as being a *revenue asset*), a deduction is allowable in respect of the cost setting amount under that other provision.

It is significant to note, however, that the availability of such a deduction is not automatic; it depends upon the terms of the applicable deduction provision. For example, deductions would not be allowable under section 8-1 for the tax cost setting amounts deemed to have been expenditure incurred in acquiring assets which are capital assets, rather than revenue assets. Thus, the availability of deductions under the residual tax cost setting rules remains subject to an appropriate characterisation test.

The residual tax cost setting rules do not operate to allow deductions in respect of the reset tax cost of assets which comprise elements of goodwill, as the capital nature of those assets would preclude such a deduction under section 8-1. Assets such as financial instruments, on the other hand, are revenue assets in the hands of a bank. Although financial instruments are incorporeal assets, they are not intangibles in the same sense as that term is applied to internally generated intangibles, such as goodwill and its sources or constituent elements, including customer relationships. It is clear that the deemed acquisition of internally generated intangibles should not give rise to deductions. It is equally clear, however, that the deemed cost of the deemed acquisition of a revenue asset, such as a financial instrument in the case of a bank, should be recognised for tax purposes in the calculation of gain or loss on revenue account from that asset.

That proposition is recognised, and in Westpac's view is correctly applied, in a private ruling issued to a taxpayer (other than Westpac) under Authorisation Number 1011671577593 (an edited version is available on the ATO website). In that private ruling, it was recognised and accepted that interest rate swaps held by a joining entity and which had a positive net present value were assets for consolidation tax cost setting purposes. Further, as the nature of the business activities of the joining entity and the joined group were such that the swaps were characterised as revenue assets, the private ruling concluded that the tax cost setting amount of those swaps would be an allowable deduction upon realisation of them.

That private ruling addressed the consequences of a joining entity which held swaps at the joining time prior to the commencement of application of the Taxation of

Financial Arrangements regime in Division 230. It is worth noting that, once those provisions commence to apply, the effect of subsection 701-55(5A) is to preserve and continue exactly the same treatment of assets such as swaps in those circumstances. That is, in Westpac's view, express recognition of the appropriateness from a policy perspective of financial arrangements which are revenue assets attracting deductions for their tax cost setting amounts under section 8-1 through the application of the residual tax cost setting rules in subsection 701-55(6) and section 701-56.

It is worth noting that where those residual rules do facilitate a deduction, it is often allowable only once the revenue asset has been realised, such as by disposal or expiration, rather than at the joining time. The timing of any deductions would be governed by the applicable deduction provision, which would reflect the policy underlying that provision. It is Westpac's view that there is no need for the Review to revisit those policies or suggest any change to them.

The effect of subsection 701-55(6) in its present form is consistent with the asset-based model for the treatment of assets of entities joining a consolidated group. As stated in paragraph 5.6 of the Explanatory Memorandum to the *New Business Tax System (Consolidation) Bill (No. 1) 2002,* that model *treats a consolidated group's cost of acquiring a subsidiary entity as the cost to the group of acquiring the assets of that entity.*

Since the group's notional cost of the assets which the single entity rule treats as being assets of the group is to be treated as the cost of acquiring those assets, it is only to be expected that an allowable deduction would be available to the group where those assets are revenue assets. The amendment made last year merely makes explicit that which was implicit and which was in accordance with the original intention of the legislation, as expressed in that Explanatory Memorandum.

That the amendment merely conformed the language of the provision more closely to its original intention is made perfectly clear in Media Release No. 098, issued by the then Minister for Revenue and Assistant Treasurer on 1 December 2005. That Media Release announced that amendments would be made to the consolidation provisions, one of which was the amendment made last year to subsection 701-55(6). That amendment was described in the Media Release in the following terms:

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

The Media Release also specifically stated that the deemed acquisition at the joining time would not override the entry history rule, other than in respect of a cost being deemed to have been incurred for the acquisition of the assets at the joining time. This policy was enacted as section 701-56. In the application of the residual tax cost setting rules, the entry history rule therefore has application, subject to its limited modification for these purposes by section 701-56.

In cases where the joined group carries on the same or a similar business to that carried on by the joining entity, this application of the entry history rule would have limited or no effect. That is because the deemed acquisition of the joining entity's assets by the joined group would have the same tax character as the joining entity's

own acquisition of them, whether by reason of the joined group's own business activities or because of those attributed to it by the entry history rule.

In a case where the joined group did not previously carry on the same or a similar business to that carried on by the joining entity, it is possible that the joined group's own tax character of the deemed acquisition could be different to the tax character determined after the entry history rule attributes to the joined group the tax history of the joining entity. That attribution of tax history is consistent with the effect of the single entity rule, which lies at the core of the operation of the consolidation provisions.

It is Westpac's view that the application of the entry history rule in the operation of the residual tax cost setting rules produces a result which is consistent with the core provisions of the consolidation regime, in particular the single entity rule. The result of that application has clearly been the intended effect of the provisions, at least since the Media Release issued on 1 December 2005 declared it to be so, and I understand that the Board's post-implementation review of consolidation has recognised this. Accordingly, any change to it, which might be proposed to more closely align the tax consequences of consolidation in the acquisition case to the consequences of an actual asset acquisition, should only be made with prospective effect.

To make any such change operate retrospectively would unfairly prejudice those taxpayers who have been operating under a clear understanding of the intended effect of the provisions for a number of years. For the sake of completeness it should be noted that Westpac does not consider that it would be impacted by any such change, as it had already carried on the same business as St.George Bank Limited carried on, at the time that company joined the Westpac tax consolidated group.

In summary, the residual tax cost setting rules in their present form, taking into account the entry history rule, operate as they were originally intended to operate. That operation, which allows a consolidated group to claim a deduction in respect of the tax cost setting amount of revenue assets which a joining member brings into the group, is consistent with the asset-based model which has been adopted in the consolidation regime and produces an appropriate outcome.

2. Rights to Future Income Rules

The rights to future income rules, contained in subsection 701-55(5C) and sections 701-90, 716-405 and 716-410, allow deductions, over the shorter of ten years or the life of the asset, for the tax cost setting amounts of those assets which are within their scope. The rights to future income rules have limited application to banks, because paragraph 716-410(d) excludes from their scope assets which are financial arrangements to which Division 230 applies.

It is important to note the fundamental difference between these rules and the residual rules discussed above: the deductions under the rights to future income rules are automatic for assets which fall within them. They are not subject to any other or further characterisation testing, as is the case for the residual tax cost setting rules.

The only characterisation test for the deductions under the rights to future income rules is that implicit in the specification of which assets are within their scope. It is therefore critical that that specification be not only precise, but also express the correct policy outcome. In Westpac's view, that specification is perhaps not as

precisely expressed as it could be. It could usefully be amended to clarify its intended scope.

Under section 701-90, the rights to future income rules apply to assets which consist of a valuable right (including a contingent right) to receive an amount under a contract or agreement for the performance of work or services or the provision of goods. This would appropriately apply to give a deduction in respect of the imputed cost of acquiring rights to income to be received in respect of work partially completed by the joining entity at the joining time or in respect of goods provided by the joining entity but not yet billed for at the joining time. That is an appropriate operation of the rules and it is the operation which the then Assistant Treasurer's Media Release on 1 December 2005 indicated that these rules would have, where it referred to *rights to future income (such as work-in-progress amounts and unbilled revenue).*

Westpac understands that the express inclusion of the reference to contingent rights in the specification of those assets which are within these rules has caused uncertainty as to the scope of that specification. In particular, contracts under which income may be derived in the future from the provision of goods or services after the joining time may constitute contingent rights to future income and therefore come within these rules.

In this regard, a distinction should be drawn between future income from a contractual commitment which is in effect at the joining time and future income which may arise under a contractual customer relationship which is in effect at the joining time, but under which the customer has no commitment to accept goods or services beyond the current term of that arrangement. It may be argued that those rights to receive income in the future are rights which are contingent on, for example, the customer not terminating a contract which, absent cancellation, would continue from month to month or on some other periodic basis.

In Westpac's view, it is fairly clear that, although rights to future income from the provision of goods or services after the joining time were not referred in the 1 December 2005 Media Release, they were intended to be included, at least to some extent, within the rights to future income rules as enacted. That is clear from the examples included in the Explanatory Memorandum, several of which referred to those situations.

What is not clear is how far into the future the rules were intended to look, and how contingent a right could be and still be within the rules. One view might be that it should depend solely on whether the right is a present right at the joining time, or merely an expectation that a right will arise in the future.

It may not be clear whether a contract which continues from month to month, or on some other periodic basis, but which the customer is able to terminate at any time, gives rise to a present, but contingent, right to future income beyond the expiry of the period in which the joining time occurs, or merely an expectation that such a right would arise in future. That expectation may be reliably based on historical customer experience, but an expectation is quite different in character from an accrued right, even though it may be difficult in a particular case to decide which of those classifications is the correct one.

Westpac's view is that the rights to future rules should not extend beyond rights to income arising out of customer commitments to the extent that they exist at the joining time. They should not extend to future income which is merely expected to

arise if customers continue to accept existing arrangements, that is to say, that they do not exercise rights to terminate. We acknowledge that in some cases it may be difficult to draw the line between the two, but this limitation may go a long way towards ameliorating the perceived cost of the measures to revenue.

The application of the rights to future income rules to work-in-progress and unbilled revenue is in accordance with the then Assistant Treasurer's Media Release on 1 December 2005. Therefore, that application should not be disturbed in relation to joining times which occurred during, or which occurred pursuant to binding contracts entered into or transactions announced to a stock exchange during, the period up to any amendment being announced by the Minister.

Rights to future income from the provision of goods or services after the joining time were not stated in the then Assistant Treasurer's Media Release to be within the measures then announced. The Review may therefore wish to consider whether the rules should be amended so that they do not apply to rights of that kind in relation to joining times which occurred prior to the enactment of these rules on 3 June 2010.

If the Review recommends that the rights to future income rules be amended to exclude future income which is not the subject of a customer commitment at the joining time, or further, to exclude all rights to income from the provision of goods and services after the joining time, then those amendments should not be made to apply to joining times which occur between the date the rules were enacted in their present form (3 June 2010) and the date those amendments are announced by the Minister. (Again, however, further latitude may be given where a transaction was committed to or announced to a stock exchange during that period but completed after it.)

It should be noted that any assets which are excluded from the rights to future income rules by such amendments would be unlikely to attract deductions under the residual tax cost setting rules. That is because, as explained above, deductions under those rules are subject to the characterisation requirements of the general deduction provisions. Those characterisation rules would exclude deductions in respect of assets of this kind either because of their capital nature (section 8-1) or because they are CGT assets (section 40-880).

Despite that, it is also worth observing that the expectation of future trade or custom with existing customers is a hallmark of goodwill, which is a capital asset. It would not be appropriate in any event for the rights to future income rules to operate in a way which allowed a deduction for tax cost setting amounts which are attributable to the deemed expenditure on the deemed acquisition of what is essentially goodwill.

An amendment to section 701-90 to make it clear that the provision is limited to presently existing rights as at the joining time should result in excluding from its scope any asset which is properly to be considered as part of goodwill. However, it may also be the case that recent developments in the recognition of assets for financial reporting purposes make it desirable to make a more general amendment to the consolidation provisions to clarify that assets which are part of, or the value of which is primarily attributable to, goodwill (as understood from a legal perspective) are not to be separately identified as assets for the purposes of any of the consolidation cost setting rules.

The consolidation provisions require that at the joining time the allocable cost amount be allocated among all of the assets of the joining entity. The asset recognised at law as goodwill attracts an allocation of allocable cost amount which cannot give rise to an allowable deduction, due to the capital nature of goodwill.

The identification of rights or benefits as being assets separate from the asset recognised at law as goodwill raises the prospect that some of those assets may arguably qualify for a deduction under the rights to future income rules, if they relate to customer contracts or relationships, or even under the residual tax cost setting rule, if they have a sufficiently non-capital character to qualify for deduction under section 8-1, or if they are not a CGT asset and therefore could attract a deduction under section 40-880.

In Taxation Ruling 2004/13, the Commissioner noted that the term *asset* is not defined for these purposes but attributed a wide, commercial or economic, rather than a legal, meaning to the term:

> *3. The meaning of an asset in Part 3-90 is not defined in the ITAA 1997. In contrast, the meaning of a liability is defined in subsection 705-70(1). A liability is recognised and measured in accordance with the Australian Accounting Standards Board (AASB) accounting standards and statements of accounting concepts. The inclusion of a definition of a liability and the omission of a definition of an asset is consistent with the word 'asset' being given its ordinary commercial or business meaning.*
> *4. The meaning of the word 'asset' is found within the commercial or business context that applies where a single entity joins an existing consolidated group (Subdivision 705-A of the ITAA 1997). Assets are recognised for the purposes of the consolidation tax cost setting rules on the basis that a head company of a consolidated group is acquiring a joining entity. All the assets of the joining entity therefore need to be identified. The total costs (both direct and indirect) of acquiring the joining entity are allocated to the underlying assets of the joining entity.*
> *5. Accordingly, an asset for the purpose of the tax cost setting rules is anything recognised in commerce and business as having economic value to the joining entity at the joining time for which a purchaser of its membership interests would be willing to pay. The business or commercial assets of a joining entity would include the things that would be expected to be identified by a prudent vendor and purchaser as having value in the making of a sale agreement in respect of all the membership interests in an entity and its business. These assets would also come within the scope of a due diligence examination undertaken on behalf of a prudent purchaser of such an entity and business.*
> *6. The commercial or business meaning of an asset in Part 3-90 is not limited to assets that would be recognised under accounting standards or statements of accounting concepts. Internally generated assets would not normally be disclosed in the financial statements of a joining entity prepared in accordance with generally accepted accounting principles when they do not possess a cost or other value that can be measured reliably. However, these assets would be identified under the wider criteria that apply for the consolidation tax cost setting rules.*

Bearing in mind these views that *asset* has a commercial meaning and is not even limited by accounting standards or concepts, it is not surprising that taxpayers are identifying as assets separate from goodwill the benefits which may be obtained under customer contracts or relationships, since the accounting standards and concepts themselves have recently been evolving to promote or even require that separate recognition.

Until the adoption of International Accounting Standards, the accounting treatment for identifying and measuring intangible assets and goodwill varied from country to country. Before Australia transitioned to IFRS in 2005, goodwill was amortised over 20 years under Australian GAAP and there was little emphasis on identifying intangible assets separately from goodwill as both were amortised to profit and loss (typically merely a classification difference).

With the introduction of IFRS in Australia in 2005, more guidance was provided under IFRS which required entities to identify types of intangible assets that were not previously identified separately from goodwill. Under IFRS, goodwill would no longer be amortised (although it is tested for impairment) and therefore entities placed further scrutiny on identifying intangible assets separate from goodwill to ensure appropriate amortisation of this value to the income statement. Consequently, under IFRS, more intangible assets have been recognised separately from goodwill on an entity's balance sheet as a result of a business acquisition than in the past.

Understanding the background to how intangible assets have been accounted for in Australia provides a useful context to the changes to the tax consolidation rules as it is in relation to these separate items that deductions may be sought under the rights to future income rules and the residual tax cost setting rules. Where these assets are closely aligned with what is recognised at law as goodwill, it may be thought inappropriate from a policy perspective to allow those deductions.

Under AASB 3, the acquirer in a business combination is required to identify the assets and liabilities acquired and measure these assets and liabilities under the relevant accounting standards. Examples of assets that may be acquired as part of a business combination include:

- depreciable assets, such as property, plant and equipment, which would be subsequently measured at either cost or fair value under AASB 116 Property, Plant and Equipment;
- inventory, which would be subsequently measured at the lower of cost and net realisable value under AASB 102 Inventories; and
- financial instruments such as loans and derivatives (including interest rate swaps as an example), which are measured at either fair value or amortised cost under AASB 139 Financial Instruments: Recognition and Measurement.

Given that the excess of the purchase consideration over the fair value of assets and liabilities acquired is generally considered to be goodwill, the acquirer is required by AASB 3 paragraph 10 to consider whether any additional assets or liabilities exist as a result of the acquisition.

Paragraph 10 of AASB 3 states that:

> *As of the acquisition date, the acquirer shall recognise, separately from goodwill, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree. Recognition of identifiable assets acquired and liabilities assumed is subject to the conditions specified in paragraphs 11 and 12.*

Paragraph 12 of AASB 3 states that:

> *In addition, to qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must be part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination transaction rather than the result of separate transactions. The acquirer shall apply the guidance in paragraphs 51-53 to*

determine which assets acquired or liabilities assumed are part of the exchange for the acquiree and which, if any, are the result of separate transactions to be accounted for in accordance with their nature and the applicable Australian Accounting Standards.

Furthermore, Paragraph 13 of AASB 3 states that:

The acquirer's application of the recognition principle and conditions may result in recognising some assets and liabilities that the acquiree had not previously recognised as assets and liabilities in its financial statements. For example, the acquirer recognises the acquired identifiable intangible assets, such as a brand name, a patent or a customer relationship, that the acquiree did not recognise as assets in its financial statements because it developed them internally and charged the related costs to expense.

AASB 3 Appendix B31 also provides guidance for separating intangible assets from goodwill:

The acquirer shall recognise, separately from goodwill, the identifiable intangible assets acquired in a business combination. An intangible asset is identifiable if it meets either the separability criterion or the contractual legal criterion.

Intangible assets acquired as part of a business combination are recognised separately from goodwill when they meet the definition of an intangible asset, as set out in AASB 138 Intangible Assets.

Key requirements under AASB 138, paragraphs 11 and 13 for recognising an intangible asset are:

- the intangible asset must be separately identifiable, that is, able to be identified separately from goodwill;
- the entity must control the intangible asset; and
- the intangible asset must generate future economic benefits which will flow to the entity.

For an intangible asset to be separately identifiable from goodwill under AASB 138, paragraph 8.12, the asset must be either:

- separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, regardless of whether the entity intends to do so; or
- arise from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Intangible assets acquired in a business combination (such as the right to benefit from customer relationships) would generally meet the definition as they arise from contractual or legal rights, usually under the contracts with customers. In light of these accounting considerations, it seems likely that the trend of taxpayers identifying intangible assets which are similar to goodwill, in that they involve or depend for their value upon the expectation of future or continuing trade or custom with existing customers of the business, will continue in future. It seems equally likely that the availability of deductions in respect of such assets would be tested by some of those taxpayers (noting for the sake of completeness that Westpac is not in that category).

In Westpac's view, it would be appropriate to amend the consolidation provisions to clarify that assets which are part of, or the value of which is primarily attributable to, goodwill are not to be separately identified as assets to that extent for the purposes of any of the consolidation cost setting rules. From a policy perspective, that would

conform with the common understanding that goodwill is a capital asset in respect of which deductions are not allowable. It would also align with the treatment of those assets which they would be expected to have in a direct business or asset acquisition outside the context of consolidation. Such a limitation would apply to both the rights to future income and residual tax cost setting (indeed, all of the tax cost setting) rules.

It is important to recognise, however, that such a change would be contrary to the Commissioner's clearly articulated explanation of the meaning of asset for these purposes in TR 2004/13 (as quoted above). Therefore, any such amendment should only be made with prospective effect from the date of its announcement, in order not to unfairly prejudice taxpayers who have justifiably relied on TR 2004/13 to date.

Westpac would like to have the opportunity to discuss these issues with the Board and its review team, once you and they have had an opportunity to review this and other submissions, but before the Review is completed. For that purpose, as well as if you have any questions regarding this submission, please contact Michael Barbour, General Manager-Group Taxation, either by email on mbarbour@westpac.com.au or by phone on 02 8253 3348.

Yours sincerely

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