Australian Government

The Board of Taxation

REVIEW OF THE CONSOLIDATION RIGHTS TO FUTURE INCOME AND RESIDUAL TAX COST SETTING RULES

A report to the Assistant Treasurer

the board of taxation

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FOREWORD

The Board of Taxation is pleased to submit this report to the Assistant Treasurer following its review of the consolidation rights to future income and residual tax cost setting rules.

On 30 March 2011, the Assistant Treasurer and Minister for Financial Services and Superannuation announced that the Government had asked the Board to review the consolidation rights to future income and residual tax cost setting rules.

The Board has made a number of recommendations and proposed a range of options that the Government could consider to address the issues raised in this review. The limited time available for this review has meant that these recommendations and options are necessarily subject to the Government's formal costing of them. The Board also notes that the time allowed for this review has precluded the consideration of a number of related issues that have come to light in the course of the review. The Board considers that these latter issues should be examined further.

The Board established a Working Group, chaired by Keith James, to conduct its review. The Board held discussions with a range of stakeholders and received 24 submissions. The Board would like to thank all of those who so readily contributed information and time to assist in conducting the review.

The Board would also like to express its appreciation for the assistance provided to the Working Group by tax practitioners as members of the Expert Panel, by Andrew Mills, and by officials from the Treasury and the Australian Taxation Office.

The *ex officio* members of the Board — the Secretary to the Treasury, Martin Parkinson PSM, the Commissioner of Taxation, Michael D'Ascenzo AO, and the First Parliamentary Counsel, Peter Quiggin PSM — have reserved their final views on the recommendations in this report for advice to the Government.

Chris Jordan AO
Acting Chairman, Board of Taxation

Keith James
Chairman of the Board's Working Group
Member, Board of Taxation

EXECUTIVE SUMMARY

1. The tax consolidation regime operates so that a wholly-owned corporate group is taxed as a single entity. On 1 December 2005, the then government announced a range of amendments to the consolidation rules. These amendments were enacted on 3 June 2010 and took effect from the commencement of the consolidation regime on 1 July 2002. On 30 March 2011, the Government asked the Board to review the operation of two of these amendments: amendments to introduce rules regarding 'rights to future income', and amendments to modify the 'residual tax cost setting' rules.

2. The terms of reference set by the Government asked the Board to examine the operation of these rules, to propose changes if necessary and to advise on the date of effect of any proposed changes.

3. The Board's review discloses that the revenue impact of the rights to future income and residual tax cost setting rules have been significantly larger than expected. Claims under these rules from the 2002-03 to the 2009-10 income years, of which the ATO has become aware to date, total $30.1 billion. This represents claims from about 60 consolidated groups. The ATO does not accept that all the claims are allowable. However, if they were, the tax impact would be approximately $9 billion (at the 30 per cent company tax rate), excluding interest. The ATO also expects claims of significant amounts are still to be made by taxpayers for the 2002-03 to 2009-10 income years.

4. The ATO has also identified that 2,700 entities joined tax consolidated groups during the nine month period between 1 July 2010 and 31 March 2011. Given the significant number of entities joining consolidated groups in this period, the ATO also expects there will be significant claims for deductions in the 2010-11 income year[1].

5. The Board has concluded that the scope of the rights to future income and residual tax cost setting rules, as enacted, is broader than what was intended at the time of their original announcement in 2005. The Board considers that, as a general principle, consolidated groups should not be able to claim types of deductions that are not available to taxpayers outside of consolidation. However the rights to future income and residual tax cost setting rules allow consolidated groups to access potential deductions which are not available under the general tax law outside of the consolidation regime. The Board has concluded that the rules could be improved so that they do not advantage consolidated groups over taxpayers outside consolidation.

1 'Self-assessed' claims will also have a potentially significant impact.

6. The consolidation rules require consolidated groups to allocate tax costs to 'non-tax assets'. Consolidated groups are applying the modified residual tax cost setting rule to obtain a deduction for these tax costs. As the recognition of these non-tax assets is unique to the consolidation rules, this has provided consolidated groups with the potential to claim deductions for amounts which cannot be deducted by other taxpayers. It can also cause distortions to arise inside the consolidation regime and raises issues as to how certain non-tax assets are to be treated. The Board considers the consolidation rules would be improved prospectively if they were changed to deal only with 'tax assets'. As a result, non-tax assets would no longer need to be recognised (**Recommendation 1**).

7. The residual tax cost setting rules are also operating to enable a consolidated group to bring forward the time that the tax cost allocated to an asset is recognised for tax purposes in some circumstances, compared to the outcomes that would arise if those same assets were acquired as part of a business acquisition outside of the consolidation regime. The Board considers that the residual tax cost setting rules could be modified to treat these assets as having been acquired by a consolidated group as part of a business acquisition (**Recommendation 2**). This would more closely align the operation of the consolidation regime with the general tax law outside consolidation, and eliminate any advantage for consolidated groups over other taxpayers.

8. The rights to future income rules provide a specific deduction to consolidated groups which is not available under the general tax law for taxpayers outside consolidation. The Board considers the Government could amend the rights to future income rules, on a prospective basis, so that they align with deduction provisions in the general tax law (**Recommendation 3**). This would prevent consolidated groups obtaining access to specific deductions not available to other taxpayers.

9. The Board also considers that the integrity of the rights to future income and residual tax cost setting rules could be improved by changing the way in which they apply to 'majority-owned' assets (**Recommendation 4**). This is designed to prevent the double claiming of deductions by a single economic group in relation to the same revenue asset.

10. The Board has also outlined a number of options the Government could consider in deciding whether to address, retrospectively, the unanticipated cost to the revenue of the rights to future income and residual tax cost setting rules (**Options A to I**).

11. Finally, in the course of this review the Board has become aware that an issue may arise in respect of the treatment of certain types of liabilities included in the allocable cost amount for a joining entity. This includes the treatment of derivative contracts which are 'out-of-the-money' and are liabilities at the joining time. The Board considers that there may be some circumstances in which it would be appropriate for a future income tax deduction to be denied for the amount of a liability, or for that

liability to be wholly excluded from the allocable cost amount. However, at this stage the circumstances in which this issue arises require further clarification. Therefore, the Board has recommended that this issue be further investigated, and that any problems inherent in the treatment of liabilities under the consolidation rules be resolved as a matter of priority.

CHAPTER 1: INTRODUCTION

1.1 On 3 June 2009, the Government announced that the Board of Taxation would undertake a post-implementation review of certain aspects of the consolidation regime. The Board released a discussion paper in relation to those matters in December 2009 and a position paper in October 2010.

1.2 On 30 March 2011, the Assistant Treasurer and Minister for Financial Services and Superannuation announced that the Government had also asked the Board to review the consolidation rights to future income and residual tax cost setting rules.

TERMS OF REFERENCE

1.3 The Assistant Treasurer's press release on 30 March 2011 set out the terms of reference for the Board's review.

1.4 The Board was requested to:

- examine the operation of the rights to future income and residual tax cost setting rules (the rules) with a view to clarifying their scope; and
- propose changes to limit the scope of the rules, if necessary, and advise on the date of effect of those proposed changes (including whether they should apply retrospectively).

1.5 In undertaking the review, the Board was asked to consider:

- the taxation outcomes that arise when assets of the type that are covered by the rules are acquired directly by a company as part of a business acquisition outside of the consolidation regime;
- whether there are any circumstances in which these tax outcomes should be different if these assets are held by a company that joins a consolidated group;
- if a difference in tax outcomes is warranted, the appropriate basis for recognising the tax costs of any assets that should be treated differently on entry into a consolidated group; and
- the revenue impact of any changes to the rules it proposes.

1.6 In conducting the review, the Board was asked to seek public submissions and consult widely, and to produce a final report by 31 May 2011.

THE REVIEW TEAM

1.7 The Board appointed a Working Group of its members comprising Keith James (Chair of the Working Group), Dick Warburton AO (Chair of the Working Group until his retirement from the Board), Chris Jordan AO and Curt Rendall to oversee the review. The Working Group was assisted by members of the Board's Secretariat, the Treasury and the Australian Taxation Office (ATO).

1.8 The Board received assistance from a panel of experts comprising Aldrin De Zilva, Matthew Hayes, Alexis Kokkinos, Larry Magid, Wayne Plummer, Ken Spence and Tony Stolarek. The Board also received assistance from AndrewMills on a consultancy basis.

REVIEW PROCESSES

1.9 The Board has consulted widely in developing the recommendations and options in this report. The Board's consultation processes involved:

- preliminary consultations with tax consolidation experts;
- the release of additional guidance material to stakeholders on 6 April 2011, to clarify the matters stakeholders should take into account in submissions; and
- holding targeted consultation meetings with a number of key stakeholders.

SUBMISSIONS

1.10 The Board received 24 written submissions to this review.

BOARD'S REPORT

1.11 The Board has considered the views put by stakeholders in their submissions and at consultation meetings, and the views of its consultant and the expert panel. However, the Board's recommendations and options proposed by this report reflect its independent judgment.

CHAPTER 2: CONTEXT OF THE REVIEW

BACKGROUND TO THIS REVIEW

2.1 The Board's review of the rights to future income and residual tax cost setting rules comes less than a year after these amendments were enacted on 3 June 2010. The amendments were incorporated into the tax consolidation regime with retrospective effect from 1 July 2002.[2]

2.2 Since their enactment, the Government has been alerted to a significant revenue cost of the rules. To date, the ATO has become aware of claims and potential claims by taxpayers for deductions of $30.1 billion in respect of transactions undertaken in the 2002-03 to 2009-10 income years. While significant, the amount of $30.1 billion comprises claims from only 60 of the 10,000 consolidated groups in existence, excludes any interest payable on the claims and does not include claims for transactions which have taken place since 30 June 2010[3].

2.3 At the time the amendments were made, the expected revenue impact of the amendments was 'unquantifiable but significant'. However the Board understands the Government had not anticipated the rules would open claims for deductions well in excess of $30 billion.

TAXPAYER CLAIMS TO DATE

2.4 The ATO has advised that the amounts of which it has become aware up to the date of this report, that are claims by taxpayers as deductions in relation to the rights to future income and residual tax cost setting rules, can be broken down into the categories outlined in Table 2.1[4].

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2 Concepts referred to in this Chapter are outlined and discussed further in Chapter 3 of this report.
3 'Self-assessed' claims will also have a potentially significant impact.
4 Note that the ATO does not accept that all the claims in Table 2.1 are allowable.

Table 2.1: Summary of claims

Category	Type of assets	Amount
A	Work in progress	$1.2 billion
B	Rights to future income covered by the explanatory memorandum examples (except work in progress)	$0.6 billion
C	Rights to future income for scenarios in the nature of lease contracts and service contracts, such as funds management contracts, freighting and management contracts and management fees contracts	$9.7 billion
D	Rights to future income scenarios outside those included in the explanatory memorandum	$2.5 billion
E	Consumable stores deductible under the residual tax cost setting rule	$0.5 billion
F	Residual tax cost setting rule assets covered by the explanatory memorandum examples	$0.8 billion
G	Derivatives, insurance contracts and other revenue assets claimed under the residual tax cost setting rule	$11.6 billion
H	Customer relationship intangibles and know-how assets claimed under the residual tax cost setting rule	$3.2 billion
Total		$30.1 billion

2.5 The ATO has advised that this represents potential claims by about 60 consolidated groups in respect of acquisitions and formations that occurred between 1 July 2002 and 30 June 2010. In the same period, over 10,000 consolidated groups formed or acquired entities. The ATO therefore expects substantial additional claims will be made by consolidated groups who have not already lodged claims in relation to the 2002-03 to 2009-10 income years.

2.6 Taxpayers have made claims under the rights to future income rules for deductions for up to 10 years. In the case of the residual tax cost setting rule, taxpayers are broadly:

- claiming immediate deductions under the general deduction provision[5];
- taking the reset tax cost into account in working out an assessable or deductible amount[6]; or
- claiming deductions over five years under the business capital expenditure provision[7].

2.7 The majority of claims are backdated several years. As a result, tax refunds relating to several income years are being accumulated and paid out in the 2011-12 and 2012-13 income years.

5 Section 8-1 of the ITAA 1997.
6 The amount included as assessable income or allowed as a deduction is calculated on a net basis.
7 Section 40-880 of the ITAA 1997.

2.8 The ATO has also advised that over 400 merger and acquisitions and initial public offers to take up shares (with a combined value in excess of $80 billion) occurred between 1 July 2010 and 31 March 2011. During this nine month period, 2,700 entities joined tax consolidated groups. Given the significant number of entities joining consolidated groups in this period, the ATO expects there will also be significant claims for deductions by consolidated groups under the rights to future income and residual tax cost setting rules in the 2010-11 income year.

REASONS FOR THE UNEXPECTED REVENUE COST

2.9 It is apparent that at the time the rights to future income and residual tax cost setting rules were introduced in 2010 the Government did not fully appreciate the full revenue implications of the rules in the form in which they were enacted.

2.10 A number of factors, when combined, appear to have lead to the greater than expected revenue implications of these changes. In particular:

- the impact of the expansion in the scope of the rights to future income rules which occurred during the consultation process on the rules was not fully anticipated;
- there has been a significant level of merger and acquisition activity in the past five years, due partly to the global financial crisis;
- changes to the accounting standard for intangible assets (AASB 138), which effectively require goodwill to be split into a range of separately identifiable assets for accounting purposes, coincided with the introduction of the rules, with the result that tax costs were being pushed on to assets not ordinarily recognised for taxation purposes; and
- the scope of, and amount of claims under the general deduction and business capital expenditure provisions arising from the extension of the residual tax cost setting rule was not fully anticipated.

2.11 The significant revenue impacts of the rights to future income and modified residual tax cost setting rules are due, in part, to the fact the amendments apply retrospectively. Taxpayers are seeking refunds of tax for transactions that have taken place since the introduction of the consolidation rules in 2002.

2.12 During the course of conducting this review, the Board has been advised that the treatment of liabilities under the tax cost setting rules may be resulting in unintended outcomes with a significant revenue impact in certain circumstances. It has become apparent that this treatment, which has applied since the introduction of the consolidation regime in 2002, did not fully factor in the impact of merger and acquisition activity, especially activity at the levels which have occurred over the past five years.

2.13 Deductions under the rights to future income and residual tax cost setting rules, together with the tax cost setting treatment of liabilities, primarily impact at the time an entity joins a consolidated group. The recent rise in merger and acquisition activity has resulted in a significant number of entities leaving one consolidated group to join another group. As a consequence, it is becoming increasingly apparent that the benefits that arise under the consolidation regime will increase the volatility of company tax collections.

CHAPTER 3: OUTLINE OF THE CURRENT LAW

OUTLINE OF THE CONSOLIDATION TAX COST SETTING RULES

3.1 The consolidation regime was introduced in 2002 following a recommendation of the Review of Business Taxation. Under the consolidation regime, a group of Australian resident entities wholly owned by an Australian resident company can choose to form a consolidated group. Specific rules also allow certain resident wholly-owned subsidiaries of a foreign holding company to form a multiple entry consolidated group (MEC group).

3.2 Following a choice to consolidate, the consolidated group is treated as a single entity for income tax purposes. Subsidiary entities lose their individual income tax identity on entry into a consolidated group and are treated as parts of the head company.

3.3 When an entity becomes a subsidiary member of a consolidated group, the shares in the entity held by the group cease to be recognised for tax purposes and the entity's assets are treated as the assets of the head company. The tax costs of those assets are reset at an amount that reflects the group's cost of acquiring the joining entity. The reset tax cost of assets is determined, broadly, by a process of allocating the cost of acquiring a joining entity (the allocable cost amount) to the joining entity's assets based on their relative market values. However, the tax cost of some assets, such as cash, is retained.

3.4 The key impact of the tax cost setting process is that, except for retained cost base assets, the reset tax cost (rather than its original tax cost) for an asset held by a joining entity that becomes an asset of the consolidated group is intended to be used for the purposes of working out the taxation consequences that arise when a taxing event arises for the asset under ordinary income tax law.

3.5 These principles are reflected in section 701-55 of the *Income Tax Assessment Act 1997* (ITAA 1997), which outlines the way that the reset tax cost of an asset is used for subsequent income tax purposes. Prior to the amendments to the rules made in 2010[8], this provision specified that, broadly:

- if the asset qualifies for capital allowance deductions, the amount that the head company can deduct is generally based on the asset's reset tax cost;

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8 See *Tax Laws Amendment (2010 Measures No. 1) Act 2010*.

- if the asset is trading stock, the asset is taken to be trading stock at the start of the income year in which the joining time occurs and its value at that time is taken to be equal to its reset tax cost;
- if the asset is a qualifying security, the head company is taken to have acquired the asset at the joining time for a payment equal to its reset tax cost;
- if the asset is taxed under the capital gains tax (CGT) provisions, the cost base of the asset is adjusted so that it equals the asset's reset tax cost; and
- if the asset is a financial arrangement (under the taxation of financial arrangements regime), the head company effectively uses the asset's reset tax cost to determine the amount of its gain or loss on the asset.

3.6 Where an asset is not covered by one of these specific categories, the residual tax cost setting rules[9] operate to specify how the reset tax cost is used.

3.7 A key objective of these provisions is to ensure that the ordinary income tax law applies to consolidated groups in the same way that it applies to other taxpayers. However, in 2005 concerns were raised that the residual tax cost setting rule did not apply to allow the reset tax costs of certain types of assets held by a joining entity to be used by the head company, with the result that the head company was disadvantaged when compared to the outcomes that arise outside the consolidation regime. These concerns were primarily raised in relation to the treatment of the reset tax costs allocated to consumable stores and rights to unbilled income (work in progress) held by a joining entity.

3.8 Taxpayers who purchase consumable stores and unbilled income outside of consolidation are able to claim deductions for the cost of acquiring these assets under the general deduction provision[10] or the ordinary work in progress deduction provision[11]. However, in 2004 the ATO concluded that, because the original residual tax cost setting rule only applied where another provision of the income tax law relied on the 'cost' of an asset, it did not operate to allow deductions to arise under the general deduction provision (which operates when losses or outgoings are 'incurred') or the work in progress deduction provision (which operates when a 'recoverable debt' has arisen or is reasonably expected to arise)[12].

3.9 As the intention of the tax cost setting rules is primarily to substitute a new cost for an asset, and not change the tax treatment of the asset, this outcome was inappropriate. The residual tax cost setting rule was intended to operate where a

9 Subsection 701-55(6) of the ITAA 1997.
10 Section 8-1 of the ITAA 1997.
11 Section 25-95 of the ITAA 1997.
12 Taxation Determination TD 2004/D85 (which was withdrawn in January 2006 following the former government's announcement).

provision of the law not specifically listed referred to an amount that is in the nature of cost, regardless of the precise expression used in the provision.

3.10 The then government announced in 2005[13] that the residual tax cost setting rule would be amended to ensure that it operated where:

- the general deduction provision applies;
- a specific deduction provision (such as the work in progress provision) applies; or
- the tax cost for an asset is taken into account in working out an assessable or deductible amount[14].

3.11 A key effect of this announcement was to clarify that deductions for consumable stores and rights to unbilled income which were available to taxpayers outside the consolidation regime would also be available to consolidated groups.

3.12 The 2005 announcement also proposed a specific adjustment to the tax cost setting rules where a joining entity holds certain 'rights to future income' (such as work in progress amounts and unbilled revenue). The announcement stated that where these rights to future income accrue to the head company, they will be treated as 'retained cost base assets'. As a result, the tax cost of these assets would not be reset. However, the head company would inherit the joining entity's tax cost for the assets.

3.13 The purpose of this specific adjustment was to ensure that an economic group would not receive a double benefit in relation to the same rights to future income asset. This principle is similar to other consolidation rules which treat certain majority-owned internally generated assets also as retained cost base assets[15].

3.14 The Board notes that while the 2005 announcement clarified that the residual tax cost setting rule would operate to grant consolidated groups deductions in certain cases, it did not contemplate that the amendments would give consolidated groups access to deductions for any types of assets that were not available to taxpayers outside the consolidation regime.

3.15 The 2010 amendments implemented the changes announced in 2005, introducing the rights to future income rules and modifying the residual tax cost setting rules. However, as set out in the balance of this Chapter and in Chapter 4, the provisions have extended application beyond the announced changes.

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13 This announcement can be viewed at the following link: http://assistant.treasurer.gov.au/DisplayDocs.aspx?pageID=&doc=pressreleases/2005/098.htm&min=mtb

14 The amount included as assessable income or allowed as a deduction is calculated on a net basis.

15 Section 701A-10 of the *Income Tax (Transitional Provision) Act 1997*.

RIGHTS TO FUTURE INCOME RULES

3.16 The 2005 announcement didn't contemplate that rules would be inserted into the consolidation regime to provide a specific deduction for rights to future income. It envisaged that these would be deductible via the operation of provisions in the general tax law through the residual tax cost setting rule. However, due to difficulties in applying the residual tax cost setting rules to amounts that were in the nature of rights to unbilled income (work in progress)[16], the rights to future income rules were developed and introduced as part of the 2010 amendments.

3.17 The difficulties emerged because the ordinary deduction provision that applies to work in progress amounts[17] contained a number of conditions that must be satisfied before it can apply. During the development of the rules, the conclusion was reached that in order to achieve a consistent outcome for both consolidated groups and taxpayers outside consolidation, it would be easier to introduce a specific deduction provision in the consolidation regime rather than modify the ordinary work in progress deduction provision. The aim of the new provision was to allow a revenue deduction to offset the assessable income as it was derived.

3.18 The objective was to have a consistent outcome under both the new rights to future income rules (which would apply inside consolidation) and the ordinary work in progress provision (which applies outside consolidation). However the scope of the new rights to future income rules was significantly broadened during the consultation process to apply in a much broader range of circumstances than the ordinary work in progress provision. This broadening occurred in response to requests for certainty in the tax treatment of other assets, similar to work in progress, which did not fall within the scope of the ordinary work in progress provision.

3.19 As a result, under the rights to future income rules certain valuable rights are treated as separate assets for consolidation purposes. This ensures that the asset is appropriately recognised for tax cost setting purposes.

3.20 Under the new rules a valuable right (including a contingent right) is treated as a separate asset if:

- the valuable right is a right to receive an amount for the performance of work or services, or the provision of goods (other than trading stock);
- the valuable right forms part of a contract or agreement; and

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16 Concerns in relation to consumable stores were addressed via modifications to the residual tax cost setting rule, considered from paragraph 3.28.

17 Section 25-95 of the ITAA 1997.

- the market value of the valuable right (taking into account all the obligations and conditions relating to the right) is greater than nil.[18]

3.21 The new rules also allow a specific deduction for the reset tax cost for the valuable right if the right to future income is held by an entity that is acquired by a consolidated group and it is reasonable to expect that an amount attributable to the right will be included in assessable income after the joining time, provided that the right is not a financial arrangement that is taxed under the taxation of financial arrangements regime. In these circumstances:

- if the contract or agreement giving rise to the valuable right is for a specified period that is less than 10 years — the reset tax cost can be deducted over that specified period; or

- if the contract or agreement giving rise to the valuable right has no specified period or is for a specified period of 10 years or more — the reset tax cost can be deducted over 10 years.

3.22 However, if it is reasonable to expect that no amount will be included in assessable income for any later income year, the balance of the reset tax cost can be deducted in that year.[19]

3.23 The reset tax cost for the right to future income broadly reflects a consolidated group's cost of acquiring that right (that is, broadly, the market value of the right). Hence, the rights to future income rules broadly allow a consolidated group to deduct the market value of a right to future income asset over a period of 10 years or less.

3.24 The new rights to future income rules also included provisions to give effect to the specific adjustment set out in the 2005 announcement for rights to future income that accrue to the head company. If the right to future income is acquired or created by an entity which, at that time, is part of an existing wholly owned corporate group, and that group subsequently elects to form a consolidated group (a formation case), the asset is treated as a 'retained cost base asset' for tax cost setting purposes[20]. Consequently, the joining entity's tax cost of the asset is retained by the head company under the tax cost setting rules. The joining entity's tax cost of a right to future income asset (that has not previously been acquired by the entity) is generally nil. In this case, the amount of the deduction which the consolidated group could claim for the rights to future income asset held by the joining entity is nil.

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18 Section 701-90 of the ITAA 1997. This extends beyond cases where the work has been done, in contrast to the former government's 2005 announcement.

19 Sections 716-405 and 716-410 of the ITAA 1997.

20 Paragraph 705-25(5)(d) of the ITAA 1997.

3.25 The explanatory memorandum for the bill introducing the rights to future income rules included four scenarios intended to be covered by the rules. These are:

- rights to future income under long term construction contracts (work in progress amounts);
- rights to receive trailing commissions;
- rights to receive an amount for the performance of work under a land development agreement; and
- rights to unbilled income for the supply of gas.[21]

3.26 The explanatory memorandum also indicated that rights of a retirement village operator to deferred management fees may be covered by the rules in some circumstances.[22]

3.27 In these examples, broadly:

- the work or service that gives rise to the right has already been wholly or partly completed before the entity joins the consolidated group; or
- the amount and likelihood of receiving income under the contractual right is substantially certain.

Modifications to the residual tax cost setting rules

3.28 The 2010 amendments also modified the residual tax cost setting rules to ensure that, for the purposes of applying other provisions of the income tax law (such as the general deduction provision[23]), the reset tax cost of an asset can be used by the head company when a taxing event arises for the asset. For example, when a joining entity had purchased consumable stores prior to the joining time, the 2010 amendments clarified that the head company can deduct the reset tax cost allocated to the stores either just after the joining time or as they are used (consistent with the treatment of consumable stores for other taxpayers). Similarly, if the joining entity had purchased a revenue asset for the purpose of making a profit by sale prior to the joining time, the amendments clarified that the head company can use the reset tax cost (rather than the original cost) to work out the amount of the assessable gain or deductible loss at the time of the disposal of the asset. However, all history of the asset, apart from cost, is retained.

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21 Examples 2.1, 2.2, 2.3 and 2.4 of the Supplementary Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010 (the 2010 Measures No. 1 Bill).

22 Paragraphs 2.20 to 2.22 of the Supplementary Explanatory Memorandum to the 2010 Measures No. 1 Bill.

23 Section 8-1 of the ITAA 1997.

3.29 The residual tax cost setting rules apply to specify how the reset tax cost is used where an asset is not covered by a specific tax provision listed in the rule relating to the use of the reset tax cost of an asset[24] (this rule and the specific tax provisions it lists are described in paragraph 3.5). The residual tax cost setting rules operate where a taxing event happens to the asset and a provision of the income tax law outside those specifically listed applies to include an amount in assessable income, or allow an amount as a deduction, in a way that brings into account (directly or indirectly) any of the following amounts:

- the cost of the asset;
- outgoings incurred, or amounts paid, in respect of the asset;
- expenditure in respect of the asset; or
- an amount of a similar kind in respect of the asset.

3.30 In these circumstances, the head company is taken to have incurred or paid an amount to acquire the asset for its reset tax cost at the joining time. However, all of the joining entity's history for an asset, other than cost, is retained.[25]

3.31 If a provision of the income tax law that is not specifically listed applies to an asset, the residual tax cost setting rule operates so that the reset tax cost of the asset (rather than its original tax cost) is used for the purposes of applying that provision. The determination of which provision in the income tax law is to apply to an asset is a question of fact that depends on the particular circumstances of each case based on the characterisation of the asset.

24 Section 701-55 of the ITAA 1997.
25 Subsections 701-55(6) and 701-56(1) of the ITAA 1997.

3.32 The explanatory memorandum included five scenarios that are intended to be covered by the rules. These are:

- consumable stores;
- revenue assets (where the taxable gain or loss is worked out on a net basis);
- traditional securities;
- trade receivables; and
- land carrying trees[26].[27]

26 Section 70-120 of the ITAA 1997 allows a deduction for an amount paid to acquire land carrying trees if, broadly, some of the trees are felled during the income year for the purposes of producing assessable income.

27 Examples 5.1, 5.2, 5.3, 5.5, 5.6 and 5.12 of the Supplementary Explanatory Memorandum to the 2010 Measures No. 1 Bill.

Chapter 4: What are the issues arising under the current law

4.1 The consolidation tax cost setting rules operate to reset the tax costs of a joining entity's assets by pushing the cost of acquiring the entity into its underlying assets. The reset tax costs of the assets are then used by the head company for subsequent tax purposes.

4.2 Outside the consolidation regime, the tax cost of acquiring the shares in the joining entity will generally be recognised only when a CGT event happens to those shares (or later if a CGT roll-over applies to defer the CGT taxing event). However, if an asset is acquired directly, the tax cost is taken into account when a taxing event happens to the asset.

4.3 As a result of the tax cost setting rules, the tax cost of acquiring the shares in the joining entity will be recognised when a taxing event applies to the underlying assets, similar to the outcome that arises where an asset is acquired directly. Therefore, compared to a share acquisition, the effect of the tax cost setting rules is to bring forward the time of recognition of the tax cost of acquiring a joining entity in many cases.

4.4 The recent amendments to the residual tax cost setting rules gave full effect to this outcome for revenue assets held by a joining entity. They also have the potential for the reset tax cost allocated to some assets to qualify for deduction over five years as business capital expenditure[28]. As a consequence, in an endeavour to obtain access to immediate tax deductions, some taxpayers are seeking to characterise assets as being held on revenue account or to have the reset tax costs characterised as business capital expenditure.

4.5 In addition, in an endeavour to provide certainty, the rights to future income rules introduced a specific deduction for consolidated groups that is not available to other taxpayers. However, the rules were primarily intended to replicate the outcomes that would otherwise arise under the ordinary income tax law.

4.6 Concerns have arisen that the rights to future income and modified residual tax cost setting rules are having a broader impact than that contemplated when the amendments were announced.

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28 Under section 40-880 of the ITAA 1997.

RIGHTS TO FUTURE INCOME RULES

4.7 The rights to future income rules are the only part of the consolidation provisions that allow a specific deduction. Although this specific provision was introduced to overcome difficulties applying the provision that ordinarily applies to allow a deduction for work in progress amounts[29], the rights to future income provision covers a broader range of circumstances than the work in progress provision. They therefore appear to give consolidated groups an advantage over other taxpayers who are unable to consolidate or choose not to consolidate.

4.8 Some taxpayers within consolidation are taking a more detailed approach to identifying assets as rights to future income, in an attempt to gain access to the specific deduction provision. This has led, in part, to concerns that the rules are having a greater revenue impact than expected.

4.9 The ATO has advised that claims for rights to future income deductions that fall within the scope of the explanatory memorandum examples are in the order of $1.9 billion (Categories A and B in Table 2.1).

4.10 The ATO has also advised that taxpayers have made claims under the rights to future income rules in a range of scenarios outside those detailed in the explanatory memorandum. These claims for deductions are in the order of $12.2 billion (Categories C and D in Table 2.1).

4.11 The claims cover things such as:

- rights to receive income for work or services yet to be provided where the contract (or the right) may be terminated at any time by the customer for no penalty — examples include certain investor administration service contracts, funds management contracts, trustee service contracts and insurance contracts;

- rights to receive income for work or services yet to be provided where the contract (or the right) is for a set term but contains renewal clauses, or is automatically renewed if the customer does not terminate the contract at the end of its fixed term (that is, there is an expectation of renewal), or there is no set termination date but the contract can be terminated by one of the parties — examples include records management contracts, strata management contracts, security service contracts, telecommunications industry support contracts and beverage processing contracts;

- rights to receive income for work or services yet to be provided in respect of a large group of contracts (rather than a single contract) where the rights

29 Section 25-95 of the ITAA 1997.

comprise an expectation of renewal and are in the nature of a customer relationship asset;

- rights to receive income for work or services yet to be provided where the market value of the rights is determined on a gross basis because it is argued that there are no obligations or conditions relating to the rights;
- rights to receive income for goods yet to be provided where the contract is an operating lease and the goods are plant or equipment (which fall within the scope of the capital allowance provisions); and
- rights to receive income for goods yet to be provided where these goods will be trading stock.

4.12 Some of the claims seek to extend the rights to future income rules to cover assets that are more akin to goodwill. Under the general tax law, goodwill is a CGT asset and is not deductible when it is acquired. The Board is advised that types of assets in the nature of goodwill being claimed include:

- customer relationships and other intangible assets; and
- rights to future income which are contingent on the renewal or non-cancellation of a contract.

4.13 The identification of these types of assets has arisen partly because of changes to the accounting standard for intangible assets (AASB 138) which coincided with the amendments to the consolidation residual tax cost setting rules. The changes to the accounting standards effectively require goodwill to be split into a range of separate assets for accounting purposes. Some taxpayers are using the same approach to identify and deduct the reset tax costs for intangible assets akin to goodwill under the rights to future income rules.

4.14 In addition, some of the rights to future income comprise (wholly or partly) rights of renewal in a contract, or contracts which can be cancelled but have no set date for cancellation. As the likelihood of receiving income under these contractual terms is contingent on expected future activities that are not locked in, the Board is advised that the value attributable to these contractual terms appears to be in the nature of goodwill.

Residual tax cost setting rules

4.15 Concerns have also been raised that the broader scope of the residual tax cost setting rules could also allow consolidated groups to obtain an advantage over taxpayers who are unable to consolidate. This advantage would largely arise where, because of the operation of the entry history rule, the reset tax cost is characterised as being on revenue account or will qualify as a business capital expenditure (which can be deducted over five years[30]), whereas outside consolidation the same type of expenditure would be characterised as relating to a CGT asset.

4.16 The ATO has advised that claims falling within the scope of the examples in the explanatory memorandum[31] are in the order of $1.3 billion (Categories E and F in Table 2.1).

4.17 The ATO has also advised that claims have been made under the residual tax cost setting rules to apply in a range of scenarios that may be beyond those identified in the explanatory memorandum, such as:

- derivatives which are not taxed under the taxation of financial arrangements regime;
- insurance contracts;
- other revenue assets;
- customer relationship intangibles; and
- know-how.

4.18 Claims for the first three items: derivatives, insurance contracts and other revenue assets, are in the order of $11.6 billion (Category G in Table 2.1). These items come within the scope of things that could be covered by the residual tax cost setting rules because they would generally be deductible as revenue assets for taxpayers outside consolidation. However, issues arise in relation to the treatment of certain derivatives because of the way that liabilities are treated in the tax cost setting process. This issue is further considered by the Board in paragraph 6.28.

4.19 The Board is advised that the final two items: customer relationship intangibles and know-how, appear to be akin to goodwill. The Board understands these were not contemplated as covered by the residual tax cost setting rules. The ATO has advised that claims for these amounts total $3.2 billion (Category H in Table 2.1) and are being made under the business capital expenditure provision.

30 Section 40-880 of the ITAA 1997.
31 See paragraph 3.32.

CHAPTER 5: IMPACT OF ANY CHANGES TO THE RULES ON TAXPAYERS

5.1 The Board's Charter states that the Board's function is, among other things, to advise the Treasurer on improvements to the general integrity and functioning of the taxation system. The Board has been mindful of its obligations under its Charter in considering any changes which may be required to improve the integrity and functioning of the rights to future income and residual tax cost setting rules.

5.2 In the course of conducting this review, the Board has considered the operation of the rights to future income and residual tax cost setting rules in each of three separate periods:

- First period: transactions to be undertaken prospectively under any future regime;
- Second period: transactions undertaken between the introduction of the rights to future income and modified residual tax cost setting rules and the commencement of any future regime; and
- Third period: transactions undertaken between 1 July 2002 and the introduction of the rights to future income and modified residual tax cost setting rules.

5.3 The recommendations and options identified by the Board in this report are summarised in **Appendix A**.

FIRST PERIOD: THE FUTURE REGIME

5.4 The first period covers transactions undertaken by a consolidated group after the date of the Government's announcement of any changes to the rules in response to the Board's review. The Board makes four recommendations on the future operation of the rights to future income and residual tax cost setting rules (**Recommendations 1 to 4**).

5.5 These recommendations to modify the future operation of the rights to future income and residual tax cost setting rules are discussed in Chapter 6.

SECOND PERIOD: THE POST-ENACTMENT PERIOD

5.6 The second period covers transactions undertaken in the period between the introduction of the rights to future income and modified residual tax cost setting rules and the commencement of any future regime.

- The Board considers that taxpayers who undertook transactions in this post-enactment period have more compelling grounds for relying on the rights to future income and modified residual tax cost setting rules as enacted in legislation. These taxpayers' facts and circumstances are somewhat different to those in the third period set out below. They may have factored the availability of deductions under those rules in the pricing of those takeovers and acquisitions and should not be adversely affected by any retrospective changes to the rights to future income and modified residual tax cost setting rules.

5.7 Nevertheless, the Board acknowledges the operation of the rights to future income and modified residual tax cost setting rules during this period are having a greater than expected revenue impact. It has thus identified options for changes the Government may wish to consider in the event it determines the revenue implications are such that some retrospective change during this period may be necessary. The options are discussed in Chapter 7. However, if the Government elects to adopt any of the options, it could consider special treatment for transactions undertaken in this period.

THIRD PERIOD: THE RETROSPECTIVE REGIME

5.8 The third period covers transactions undertaken in the period between 1 July 2002 (the introduction of the consolidation regime) and the introduction of the rights to future income and modified residual tax cost setting rules.

- The Board considers that consolidated groups with joining times during this period would not have relied on the modified residual tax cost setting and rights to future income rules when undertaking transactions (as evidenced by the claims lodged with the ATO since the provisions were enacted in 2010). This gives greater scope to modify the rules to clarify their retrospective operation.

- Nevertheless, based on the 2005 announcement, the Board considers that taxpayers could have rightly assumed that consumable stores and work in progress amounts would be deductible and it proposes no change to the operation of the rules in their application to them.

- The Board also considers it appropriate to give special consideration to taxpayers who have, for example, received ATO rulings or amended assessments in relation to joining times falling within this period.

5.9 Options for changes that the Government may wish to consider in respect of transactions undertaken within this period are discussed in Chapters 7 and 8. However, if the Government elects to adopt any of the options, it could consider special treatment for taxpayers in these circumstances.

CHAPTER 6: RECOMMENDATIONS FOR THE FUTURE OPERATION OF THE RULES

6.1 The Board has identified changes which, subject to formal Government costings, could be made to improve the operation of the consolidation regime to ensure that the tax outcomes for consolidated groups are more consistent with the outcomes that arise outside the consolidation regime.

6.2 The Board considers that, as a systemic improvement to the consolidation regime, the consolidation tax cost setting rules should apply only to assets already recognised for taxation purposes (**Recommendation 1**).

6.3 The Board also proposes the following specific changes to the rights to future income and residual tax cost setting rules:

- The residual tax cost setting rule should be modified so that, for the purpose of applying the rule to an asset, the consolidated group is taken to acquire the asset as part of a business acquisition (**Recommendation 2**).
- The rights to future income rules should be limited to rights to unbilled income (or work in progress amounts) (**Recommendation 3**).
- Majority-owned revenue assets should be treated as retained cost base assets (**Recommendation 4**).

6.4 The Board suggests that Recommendations 1 to 4 be implemented together as a package of recommendations.

Recommendation 1: Apply the tax cost setting rules only to assets already recognised for taxation purposes

6.5 Some of the difficulties under the rights to future income and residual tax cost setting rules arise from the fact that the tax cost setting rules allocate tax costs to assets that are not ordinarily recognised for income tax purposes. This causes distortions because taxpayers understandably seek to have those tax costs recognised. Examples of assets not ordinarily recognised for income tax purposes include non-contractual customer relationships and other accounting intangible assets.

6.6 The Board proposes that the tax cost setting rules be improved by limiting their operation so that they operate only to reset the tax costs of assets that are recognised for taxation purposes. Limiting the application of the tax cost setting rules to CGT assets may be an appropriate method of achieving this outcome.

6.7 The definition of a CGT asset[32] encompasses both assets taxed under the CGT rules and assets that are not generally taxed under the CGT rules (such as tax depreciable assets, revenue assets and trading stock), and would broadly align with the concept of assets that are recognised for tax purposes. Although the tax cost setting rules would apply to CGT assets held by a joining entity, the character of each asset whose tax cost is set under the rules would be separately determined based on the nature of that asset (for example, a tax depreciable asset is a CGT asset and would have its tax cost reset, but the capital allowance provisions in the income tax law apply to the tax cost setting amount for the asset).

6.8 This recommendation will ensure that the assets recognised by consolidated groups are broadly the same as those that would be recognised by an entity that acquires a business outside of the consolidation regime. Thus, consolidated groups would not seek to allocate tax cost to assets such as non-contractual customer relationships and other accounting intangible assets. In addition, as the tax cost setting rules would not allocate tax costs to assets that are not generally recognised for income tax purposes, the complexities associated with finding an appropriate tax treatment for these tax costs will not arise.

6.9 The Board also considers that it may be appropriate to ensure that taxpayers should not be able to split an asset into its component parts on the basis that each component part represents a separate CGT asset, where in commercial reality the asset is generally taken to be a whole and indivisible asset. For example, it may be inappropriate for a right to receive lease income on a piece of equipment to be split into a CGT asset separate from the plant itself.

6.10 The Board notes, however, that there may be specific circumstances where it is appropriate for certain component parts of an asset to be split out and considered separately. An example is a right of renewal in a contract. In this case, the right of renewal would be treated separately as an asset akin to goodwill, distinct from the treatment applying to the remaining rights in the contract. Further consideration should be given to this issue in the implementation of this recommendation.

Recommendation 2: Modify the residual tax cost setting rule to apply a business acquisition approach

6.11 The Board proposes that the residual tax cost setting rules be modified so that, for the purpose of applying the rules to the reset tax cost for an asset, the consolidated group is taken to acquire the asset at the joining time as part of a business acquisition.

6.12 In the current business environment, the consolidation tax cost setting rules are primarily relevant on the acquisition of an entity by a consolidated group, as opposed to on formation of a consolidated group. Therefore, where the residual tax cost setting

32 Section 108-5 of the ITAA 1997.

rule applies, the revenue or capital character of an asset for the consolidated group should be determined on the same basis that would apply if the group were to acquire the asset as part of a business acquisition.

6.13 This will also ensure that the residual tax cost setting rules operate consistently with most of the other tax cost setting rules.

6.14 The Board considers that this recommendation would make the taxation consequences that arise when a consolidated group acquires an asset by acquiring an entity more consistent with those that arise when an asset is acquired directly in the context of a business acquisition. A key issue in this context is the revenue or capital character of the expenditure incurred to acquire the asset. Although this is ultimately a question of fact, it is likely that the deemed business acquisition approach would result in more assets acquired by a consolidated group being characterised on capital account than is the case under the current rules.

6.15 The Board considers, however, that consumable stores should remain as deductible assets for consolidated groups under the residual tax cost setting rule. This would ensure that the policy intention clearly expressed by the then government in its 2005 announcement would be retained.

6.16 As part of its broader post-implementation review of the consolidation regime, the Board suggested that an asset acquisition model be adopted to replace the existing inherited history model and that this should apply to all assets in the consolidation regime. The Board notes that although the changes proposed to the residual tax cost setting rule in Recommendation 2 are broadly consistent with an asset acquisition model, the Board is still considering the question of whether an asset acquisition model should be adopted more broadly in the consolidation regime as part of that broader review.

Recommendation 3: Restrict the rights to future income deduction to unbilled income

6.17 The Board proposes that the rights to future income rules be modified so that they apply only where it is reasonable to expect that a recoverable debt will arise in respect of the completion or partial completion of that work within 12 months of the joining time.

6.18 The rights to future income rules were developed because of the difficulty of applying the ordinary deduction for work in progress amounts[33] to the reset tax costs for these kinds of assets. The scope of the rules was broadened as a result of the consultation process that was undertaken during the development of the rules in an endeavour to provide certainty for the tax treatment of the reset tax cost of these kinds

33 Section 25-95 of the ITAA 1997.

of assets. However, this has resulted in the rules giving consolidated groups an advantage over other taxpayers, which is difficult to justify.

6.19 The Board considers that this recommendation will ensure that the income tax law applies consistently to consolidated groups and other taxpayers. Moreover, if the Government concludes that the income tax law should specify the taxation outcomes that apply to the tax cost of acquiring a particular type of asset in order to provide certainty, any changes to the law should apply consistently to both consolidated groups and other taxpayers.

Recommendation 4: Treat majority-owned revenue assets as retained cost base assets

6.20 Some assets such as cash are treated as 'retained cost base assets' under the tax cost setting rules[34]. As a result, rather than having their tax cost reset, these assets retain their original tax cost.

6.21 If a right to future income asset is acquired or created by an entity which, at that time, is part of an existing wholly owned corporate group, and that group subsequently elects to form a consolidated group (a formation case), the asset is treated as a 'retained cost base asset' for tax cost setting purposes[35]. The effect is to ensure that a tax deduction does not arise in respect of the reset tax cost for this asset.

6.22 The Board proposes that this principle be extended so that it also applies to all revenue assets, any other assets covered by the residual tax cost setting rule and assets covered by the modified rights to future income rules, where members of the consolidated group own more than 50 per cent of the membership interests in the joining entity at the time the asset was acquired.

6.23 This change will prevent a double deduction from arising in respect of 'majority-owned assets'. A double deduction would arise for the same economic group since both the head company and its majority-owned subsidiary would be able to claim a deduction in relation to the same assets — the subsidiary at the time it incurs expenses in creating or acquiring an asset and the head company at the time it acquires 100 per cent of the subsidiary and is entitled to claim a deduction for the reset tax cost of the asset.

6.24 The effect of treating majority-owned assets as retained cost base assets is to prevent the tax cost of these assets being reset under the tax cost setting rules. This will mean that the consolidated group will continue with the joining entity's tax costs for the assets, thereby preventing a double deduction from arising in respect of these assets.

34 Section 705-25 of the ITAA 1997.
35 Paragraph 705-25(5)(d) of the ITAA 1997.

6.25 Consideration could also be given to expanding this recommendation to cover cases where the joining entity and the consolidated group are under common ownership at the time the asset was acquired. For example, it may be inappropriate for a consolidated group owned by a foreign parent to acquire a sister company (an Australian company which is also owned by the foreign parent) and be able to reset the tax cost of a revenue asset developed by that sister company. In this case, the single economic group could be claiming a double deduction in relation to the same revenue asset.

Application date of Recommendations 1 to 4

6.26 The Board notes that Recommendations 1 to 4 above represent a significant change to the consolidation regime, and therefore further recommends that they be applied with prospective effect.

Other issues for further investigation

6.27 During the course of the review, the Board identified an additional two issues the Government could investigate further:

- the treatment of liabilities in the tax consolidation regime; and
- capping the tax cost setting amount allocated to assets in the tax consolidation regime.

Treatment of liabilities

6.28 The Board notes that a significant portion of potential claims under the residual tax cost setting rule relate to derivatives, insurance contracts and other revenue assets ($11.6 billion, or Category G in Table 2.1). These items come within the scope of things which could be covered by the residual tax cost setting rules because they would generally be deductible as revenue assets for taxpayers outside consolidation.

6.29 The Board has become aware that an issue may arise in respect of the treatment of certain types of liabilities included in the allocable cost amount for a joining entity. This includes the treatment of derivative contracts which are 'out-of-the-money' and are liabilities at the joining time. The Board considers that there may be some circumstances in which it would be appropriate for a future income tax deduction to be denied for the amount of a liability, or for that liability to be wholly excluded from the allocable cost amount. However, at this stage the circumstances in which this issue arises require further clarification. The Board also understands that the issue may cease to arise in relation to out-of-the-money derivatives under the new taxation of financial arrangements regime, which became operative from 1 July 2010, but could apply electively from 1 July 2009.

6.30 The Board notes that this issue arises because of a problem in the way the consolidation allocable cost amount calculation treats these liabilities. It has emerged in the context of the mergers and acquisitions which have taken place in the financial services sector as a consequence of the global financial crisis. The issue relates to the treatment of liabilities under the tax cost setting rules in place since 1 July 2002 (and not the operation of the rights to future income and modified residual tax cost setting rules introduced in 2010).

6.31 As such, the issue is not one which strictly falls within the scope of the Board's current review. Nevertheless, the Board considers the treatment of liabilities to be fundamental to the structure of the consolidation regime. Accordingly, the Board recommends this issue be further investigated, and that any problems inherent in the treatment of liabilities under the consolidation rules be resolved as a matter of priority.

Capping the tax cost setting amount allocated to assets

6.32 During the course of conducting this review, the Board considered an option to cap the tax cost setting amount for all assets in the consolidation regime at the greater of their market value or terminating value (which is generally the CGT cost base for the asset). This would extend the current treatment for revenue assets in the tax cost setting process to all tax assets.

6.33 Any excess allocable cost amount remaining after the tax costs of assets are capped would be allocated to goodwill. If a company does not have goodwill, any excess allocable cost amount would give rise to a capital loss[36].

6.34 Whilst this option should result in greater neutrality, in most circumstances, between consolidated groups that acquire a business (by acquiring the entity that carries on the business) and entities that acquire a business directly, it may not be the case in all circumstances — for example, where a purchaser, for commercial reasons, is willing or required to pay more than what would otherwise be the market value.

6.35 The Board considers that the Government should further investigate this option, noting that it would represent a significant change to the treatment of assets in the tax cost setting process. This underlines the need for careful consideration in investigating and considering the option.

36 CGT event L4 (section 104-515 of the ITAA 1997).

Chapter 7: Options for changes to the retrospective rules

7.1 Under the terms of reference, the Board was asked to consider whether any changes should be made to the retrospective operation of the rights to future income and residual tax cost setting rules.

7.2 The Board considers that any decision to change the retrospective operation of the rights to future income and residual tax cost setting rules is solely a matter for the Government's judgment. However, having regard to the terms of reference, the Board has identified a number of options that the Government may wish to consider.

7.3 Those options are listed in order, from those which would impose the least change to the existing law, through to those which would impose the greatest change.

7.4 The options are:

- Option A: Retain the existing rules;
- Option B: Deny deductions under the business capital expenditure provisions;
- Option C: Clarify the operation of the existing rules;
- Option D: Repeal the 2010 amendments, except for the explanatory memorandum examples;
- Option E: Repeal the 2010 amendments, except for consumable stores and work in progress;
- Option F: Convert all prior year deductions to capital losses; and
- Option G: Repeal the 2010 amendments.

7.5 Each of the options is discussed below, together with the transitional issues that the Government may wish to consider if it were to implement any of these options.

7.6 The Board has also summarised the likely impact of each option on the taxpayer claims that the ATO is aware of at the time of this report. These claims are described in Table 2.1.

Option A: Retain the existing rules

7.7 At one end of the spectrum, the Government could retain the existing rights to future income and residual tax cost setting rules without any retrospective change.

7.8 If this option was adopted, none of the taxpayer claims of $30.1 billion would be affected by legislative change. The ATO may challenge some of these claims, but this option would have the greatest revenue cost.

Option B: Deny deductions under the business capital expenditure provision

7.9 The Government could modify the operation of the residual tax cost setting rule to clarify that the business capital expenditure provision does not apply to allow a deduction for the reset tax cost of an asset.

7.10 As a result, instead of the reset tax cost being deductible over five years, a capital loss would arise when a CGT event happens to the asset or when an entity leaves the group taking the asset with it.

7.11 If this option is adopted, the ATO considers that the likely impact on taxpayer claims would be to disallow claims in Category H — that is, claims of $3.2 billion for customer relationship intangibles and know-how. The tax cost allocated to an asset would be recognised on disposal of the business or when an entity leaves the group with the asset. Therefore, $26.9 billion in claims would be unaffected by this proposal.

Option C: Clarify the operation of the existing rules with effect from 1 July 2002

7.12 The Government could clarify the operation of the existing rights to future income and residual tax cost setting rules from 1 July 2002. The clarifications would cover three areas:

- The tax treatment of assets akin to goodwill could be clarified under the rights to future income and residual tax cost setting rules (**Option C1**).
- The value attributed to rights to future income assets could be clarified in certain circumstances (**Option C2**).
- The tax treatment of mine site improvements could be clarified under the residual tax cost setting rules (**Option C3**).

7.13 These clarifications would address areas of material uncertainty in the operation of the existing rules, and ensure that the rules operate in a way that is consistent with the apparent policy intent. They would also ensure that the income tax law applies consistently to consolidated groups and other taxpayers.

7.14 If these options were adopted as a package, the ATO considers that the likely impact on taxpayer claims would be to disallow:

- an unquantifiable part of claims of $5.7 billion for rights to future income in Category C (that is, rights to future income for scenarios in the nature of service contracts, such as funds management contracts, freighting and management contracts and management fees contracts). This is on the basis that some of these claims relate to contractual assets where rights to future income are contingent on the renewal or non-cancellation of the contract;

- an unquantifiable part of the remaining $4 billion for rights to future income in Category C (which include fixed term contracts). This is on the basis that some of these claims relate to contractual assets that have no value additional to the unencumbered market value of the underlying CGT asset to which they relate;

- an unquantifiable part of claims of $3.7 billion for rights to future income relating to insurance contracts in Category G. This is on the basis that some of these claims relate to contractual assets where rights to future income are contingent on the renewal or non-cancellation of the contract;

- claims of $2.5 billion for rights to future income outside the scope of the explanatory memorandum examples in Category D. This is on the basis that these amounts are not within the rights to future income or the residual tax cost setting rules; and

- claims of $3.2 billion for customer relationship intangibles and know-how assets in Category H. This is on the basis that these claims relate to non-contractual assets akin to goodwill.

7.15 It would be necessary for the Commissioner to obtain valuations in respect of rights to future income that are contingent on the renewal or cancellation of the contract in order to determine the full impact of these options. However, the cumulative effect of these options would be to significantly reduce the cost of current claims under the rights to future income rules.

Option C1: Clarify the treatment of assets akin to goodwill

7.16 The Government could clarify the rights to future income and residual tax cost setting rules to specify that the following types of assets are treated as goodwill, or as separate CGT assets which are excluded from the scope of the general deduction provision or the business capital expenditure provision:

- a non-contractual asset akin to goodwill (such as a customer relationship asset or other accounting intangible asset);

- a contractual term, to the extent that its value is contingent on the renewal of the contract (such as renewal clauses which may give rise to the extension of an existing contract, or to a future contract, where income would be receivable); and
- a contract that can be cancelled except to the extent that any rights to receive income are certain[37].

Option C2: Clarify the value attributed to rights to future income assets in certain circumstances

7.17 The Government could clarify that no value is to be attributed to a right to future income for tax cost setting purposes where:

- there is a contractual right to future income from an asset; and
- the combined value of the asset and the right does not exceed the market value of the asset (assuming that the asset is unencumbered).

Option C3: Clarify that the residual tax cost setting rule does not apply to mine site improvements

7.18 The Board notes that it received submissions which raise concerns about the treatment of mine site improvements, such as overburden, under the tax cost setting process. These submissions suggest that these assets should be recognised under the capital allowances regime. However, given uncertainty about this treatment, some taxpayers may be seeking to apply the residual tax cost setting rule to obtain deductions under the general deduction provision for the tax cost setting amount. The submissions suggest that this outcome would be inappropriate.

7.19 The Board understands that affected taxpayers are having ongoing discussions with the ATO about the treatment of these assets under the capital allowance regime.

7.20 However, to clarify that deductions do not arise under the general deduction provision or the business capital expenditure provision for the tax cost setting amount allocated to these assets, the Government could clarify that the residual tax cost setting rules do not apply to mine site improvements.

Option D: Repeal the 2010 amendments, except for the explanatory memorandum examples

7.21 The Government could repeal the rights to future income rules and the residual tax cost setting amendments, and replace them with amendments to ensure that a deduction is available only for the reset tax cost of assets that are covered by the

37 Some implementation issues may arise in relation to determining the value of the income that is certain.

examples in the explanatory memorandum (other than the example relating to revenue assets).

7.22 This would ensure that a deduction is available for the reset tax costs for assets that are:

- consumable stores
- land carrying trees[38];
- traditional securities;
- trade receivables; or
- a right to receive income for the performance or work or services, or the provision of goods, where:
  - the work or services have been performed, or the goods provided, before the joining time; and
  - the asset is held by an entity that is acquired by a consolidated group[39].

7.23 The reset tax cost of all other assets would be taken to be on capital account, so that a capital loss will arise when a CGT event happens to the asset or when an entity leaves the group taking the asset with it.

7.24 If this option is adopted, the ATO considers that the likely impact on taxpayer claims would be to disallow claims of $27 billion in Categories C, D, G and H. Claims of $3.1 billion in Categories A, B, E and F would continue to be allowed. The tax cost allocated to other assets would be recognised on disposal of the asset or when an entity leaves the group with the asset. This is likely to result in a significant deferral in the time that the cost is recognised as most groups tend to lack sufficient capital gains to immediately absorb capital losses.

Option E: Repeal the 2010 amendments, except for consumable stores and work in progress

7.25 The Government could repeal the rights to future income rules and the residual tax cost setting amendments, and replace them with amendments to ensure that a deduction is available for the reset tax cost of assets that are:

- consumable stores; or

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38 Section 70-120 allows a deduction for an amount paid to acquire land carrying trees if, broadly, some of the trees are felled during the income year for the purposes of producing assessable income.

39 The tax cost setting amount for these types of assets would continue to be deductible over 10 years or the life of the contract, whichever is lesser.

- a right to receive income for the performance or work where it is reasonable to expect that a recoverable debt will arise in respect of the completion or partial completion of that work within 12 months of the joining time.

7.26 The reset tax cost of all other assets would be taken to be on capital account, so that a capital loss will arise when a CGT event happens to the asset or when an entity leaves the group taking the asset with it.

7.27 This proposal would be consistent with the former government's 2005 announcement.

7.28 If this option is adopted, the ATO considers that the likely impact on taxpayer claims would be to disallow claims of $28.4 billion in Categories B, C, D, F, G and H. Claims of $1.7 billion in Categories A and E would continue to be allowed. The tax cost allocated to other assets would be recognised on disposal of the asset or when an entity leaves the group with the asset. This is likely to result in a significant deferral in the time that the cost is recognised as most groups tend to lack sufficient capital gains to immediately absorb capital losses.

Option F: Convert all prior year deductions to capital losses

7.29 The Government could convert all prior year deductions arising under the rights to future income and residual tax cost setting rules to capital losses.

7.30 This would have the effect of deferring the recognition of the reset tax costs of relevant assets until the consolidated group has capital gains to offset the capital losses.

7.31 If this option is adopted, the ATO considers that all the claims would still be allowed but only against capital gains. This is likely to result in a significant deferral in the time that the cost is recognised as most groups tend to lack sufficient capital gains to immediately absorb capital losses.

Option G: Repeal the 2010 amendments

7.32 At the other end of the spectrum, the Government could repeal the 2010 amendments, with retrospective effect.

7.33 This would have the impact of removing deductions for the reset tax costs for, among other things, revenue assets and rights to future income.

7.34 As a result, the recognition of the reset tax costs of these assets would be deferred until a CGT event happens to the asset or until the time when an entity leaves the group taking the asset with it.

7.35 If this option is adopted, the ATO considers that all taxpayer claims of $30.1 billion would be treated on capital account and only allowed as CGT assets (including goodwill). The tax cost allocated to an asset would be recognised on disposal of the asset or when an entity leaves the group with the asset. This is likely to result in a significant deferral in the time that the cost is recognised as most groups tend to lack sufficient capital gains to immediately absorb capital losses.

APPLICATION DATE FOR OPTIONS

7.36 If the Government were to adopt any options to change the retrospective impact of the rights to future income and residual tax cost setting rules, it could consider applying these changes to:

- joining times from 1 July 2002 (consistent with the 2010 amendments) to the date of the Government's announcement of its response to the Board's review; or

- deductions claimed on or after 10 February 2010 (the date of introduction of the amending Bill into Parliament), including to requests for amendments to assessments of prior year income tax returns made on or after that date.

7.37 The Board considers that the Government may also need to consider the impact of any options that it may adopt on:

- transactions undertaken by taxpayers within both the second and third periods (that is, the period from 1 July 2002 to the date of the Government's announcement of its response to this review)[40]; and

- taxpayers who have obtained rulings from the ATO or who have already received amended assessments.

7.38 The Board also notes that when the rights to future income and amended residual tax cost setting rules were enacted on 3 June 2010, the rules had retrospective application to 1 July 2002. Taxpayers have until 3 June 2012 to lodge any amendments to prior year income tax assessments to take advantage of the rules. The Board considers it appropriate the 3 June 2012 deadline for amendments be maintained as long as retrospective changes to the rules are enacted in a timely manner.

40 These periods are referred to in Chapter 5.

CHAPTER 8: OTHER OPTIONS FOR CONSIDERATION

8.1 The Board notes the Government's concern about the amount of revenue involved in claims under the rights to future income and residual tax cost setting rules. This is evidenced by the amount of claims already raised with the ATO under the rules (totalling $30.1 billion, detailed in Table 2.1). These claims, together with further claims not yet made and interest payable, will result in a very substantial refund of income tax.

8.2 The size of these claims is largely due to the fact that the 2010 amendments which introduced the rights to future income and modified the residual tax cost setting rules applied retrospectively.

8.3 In light of this, the Board raises two further options the Government may wish to consider:

- withdrawing interest payable on income tax refunds in some circumstances (**Option H**); and/or
- changing the period over which tax deductions under the rights to future income rule are spread (**Option I**).

Option H: Withdraw interest payable on income tax refunds

8.4 A significant element of the revenue cost of the rights to future income and the residual tax cost setting rules arises because the 2010 amendments applied retrospectively from 1 July 2002, and interest is payable on amendments to prior year assessments.

8.5 By way of illustration, the ATO has become aware of $30.1 billion of deduction claims under the rules for joining times between 1 July 2002 and 30 June 2010. Assuming $1 billion of these claims are for deductions in the 30 June 2003 income year, with tax refundable of $300 million, interest on this claim to 30 June 2011 would total $123 million. If $1 billion of these deductions relate to the 30 June 2007 income year, interest to 30 June 2011 would total $53 million.

8.6 In light of this, the Board suggests that the Government consider withdrawing interest on tax refunds payable to taxpayers where the prior year amendment relates to an asset other than consumable stores or work in progress (both of which were clearly covered by the original announcement in 2005 to reform these rules). This would prevent consolidated groups obtaining the payment of interest on amendments to prior year assessments which claim deductions for asset types not specifically contemplated by the 2005 announcement.

Option I: Change the period over which tax deductions under the rights to future income rules are spread

8.7 Another option the Government may wish to consider is to change the period over which tax deductions are spread under the rights to future income rules.

8.8 Currently, if the rights to future income rules apply, the reset tax cost can be deducted over 10 years or the remaining life of the contract, whichever is lesser. If the right comes to an end before the expected period expires, the balance is deductible at the time the right ends.

8.9 Due to the retrospective nature of the 2010 amendments, a significant budgetary impact is arising to the Government in the short term. This budgetary impact could be spread by changing the period over which tax deductions under the rights to future income rules are spread. For example:

- the deductions in respect of prior years could be allowed only from the 2010-11 income year, and be spread over the remaining part of the 10 year period or contract life;
  - therefore, if the contractual right to future income commenced on 1 July 2006 and is for eight years, the deduction would commence in the 2010-11 income year and be spread over the remaining four years of the contract period;
- the deductions in respect of prior years could be allowed only from the 2010-11 income year, and be spread over a deemed 10 year period;
  - therefore, if the contractual right to future income commenced on 1 July 2006 and is for eight years, the deduction would commence in the 2010-11 income year and be spread over a 10 year period (even if the contract comes to an end within that 10 year period);
- the period over which the tax deductions are spread could be extended;
  - therefore, if the contractual right to future income commenced on 1 July 2006 and is for eight years, the deduction would commence in the 2006-07 income year but could be spread over a period longer than eight years (but be capped at a 20 year period).

8.10 If deductions under the rights to future income rules were to be allowed only from the 2010-11 income year, the issue of interest being payable on refunds of tax would not arise for claims under these rules.

8.11 If the Government adopts this option to spread the tax deductions available under the rights to future income rules, the Board notes that there may be an additional benefit depending on how this option is implemented.

8.12 Under Australian accounting standards for the recognition and measurement of deferred tax assets and deferred tax liabilities, the Board understands that taxpayers entitled to revenue deductions would, in many cases, have recognised a tax base valued at the gross amount of the future deductions available (that is, not subject to present value adjustments).

8.13 If deductions available to taxpayers are spread over a longer time period, this may result in no change to the gross amount of future deductions available to that taxpayer under the rights to future income rules. In this case, the net profit or loss in a taxpayer's financial statements may not change because any increase in the current tax expense (for current tax deductions that are now deferred) may well be offset by a decrease in the deferred tax expense (for an increase/decrease in a deferred tax asset/deferred tax liability).

APPLICATION DATE FOR OTHER OPTIONS

8.14 If the Government adopts either of these two options, the Board considers that consideration may need to be given to the impact on:

- transactions undertaken by taxpayers within both the second and third periods (that is, the period from 1 July 2002 to the date of the Government's announcement of its response to this review)[41]; and
- taxpayers who have obtained rulings from the ATO or who have already received amended assessments.

41 These periods are referred to in Chapter 5.

Appendix A: Summary of the Board's recommendations and options

Recommendations[42]

Recommendation 1: Apply the tax cost setting rules only to assets already recognised for taxation purposes

Recommendation 2: Modify the residual tax cost setting rule to apply a business acquisition approach

Recommendation 3: Restrict the rights to future income deduction to unbilled income

Recommendation 4: Treat majority-owned revenue assets as retained cost base assets

Other issues for further investigation

Issue 1: The treatment of liabilities in the tax consolidation regime

Issue 2: Capping the tax cost setting amount allocated to assets in the tax consolidation regime

42 Refer to the body of the report for application dates for all recommendations and options.

OPTIONS

Option A: Retain the existing rules

Option B: Deny deductions under the business capital expenditure provisions

Option C: Clarify the operation of the existing rules with effect from 1 July 2002

> Option C1: Clarify the treatment of assets akin to goodwill
>
> Option C2: Clarify the value attributed to rights to future income assets in certain circumstances
>
> Option C3: Clarify that the residual tax cost setting rule does not apply to mine site improvements

Option D: Repeal the 2010 amendments, except for the explanatory memorandum examples

Option E: Repeal the 2010 amendments, except for consumable stores and work in progress

Option F: Convert all prior year deductions to capital losses

Option G: Repeal the 2010 amendments

OTHER OPTIONS FOR CONSIDERATION

Option H: Withdraw interest payable on income tax refunds

Option I: Change the period over which tax deductions under the rights to future income rules are spread