20 April 2011

Review of Rights to Future Income & Residual Tax Cost Setting Rules
The Board of Taxation
C/o The Treasury
Langton Crescent
PARKES ACT 2600

taxboard@treasury.gov.au

Dear Sir/Madam

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

The Group of 100 (G100) is an organization of chief financial officers from Australia's largest business enterprises with the purpose of advancing Australia's financial competitiveness.

The G100 is pleased to provide a response to the Board of Taxation's BoT) request on 30 March 2011 for submissions for its Review of Rights to Future Income (RFI) and Residual Tax Cost Setting (RTCS) Rules. The G100 has taken into account the Board's additional guidance material for stakeholders released on 6 April 2011.

The G100 response comprises:

- **a high-level strategic response to the issues being considered by the Review (see below); and**
- **consideration of the specific issues raised in the BoT's additional guidance in Appendix A.**

HIGH LEVEL STRATEGIC ISSUES

1. RFI and RTCS rules provide an appropriate tax reflex for the tax cost of relevant assets for corporate groups

The G100 believes that the currently enacted RFI rules and RTCS rules meet the objective of providing an appropriate basis for the recognition of the tax cost of relevant assets under the *Income Tax Assessment Act* (the ITAA). The trend for business related income tax reforms over recent years has been for transactions to give rise to assessable or deductible amounts, rather than being treated on capital account or for black hole expenditures to arise. This is most evident in the various Taxation of Financial Arrangements (TOFA) reforms ranging from the foreign currency realisation rules in TOFA 2 to the broad ranging reforms in relation to financial arrangements in TOFA 3 & 4 as well as the reforms to black hole expenditure rules[1] in 2005. Those recent tax reform trends support the approach adopted for determining the tax reflex under the RFI rules and the RTCS rules under the ITAA.

Therefore, the G100 does not support claims that the RFI rules and RTCS rules as a whole are premised on the wrong policy basis. This submission reflects this fundamental approach.

[1] Section 40-880 was significantly rewritten with effect from 1 July 2005

The G100 sees a distinction between scenarios clearly contemplated in currently enacted RFI rules and RTCS rules as contained in the statute and explained in the explanatory memorandum commentary and its examples ("the measures whose outcomes was intended to date") and situations where taxpayers may be claiming tax outcomes of a nature which go beyond the previously intended reforms ('tax outcomes not intended'). These require different policy adjustments.

However, the G100 would be sympathetic to the issue of potential changes due to unanticipated costs to revenue, provided that those costs can be substantiated and the potential changes are reasonable.

2. Unspecified concerns frustrate determining appropriate solutions

The Assistant Treasurer's announcement on 30 March 2011stated that:

"There is some evidence that the rights to future income and residual tax cost setting rules may have a substantially greater revenue impact than anticipated."

However, there is no information as to:

- **the quantum of the revenue concerns raised;**
- **the extent to which the concerns relate to the RFI rules compared to the RTCS rules; and**
- **whether the revenue concerns are referable to specific categories of assets within either the RFI or RTCS rules. In this regard the Assistant Treasurer's announcement on 30 March 2011 does indicate that in relation to the RFI rules, "tax deductibility may be argued for types of assets that were not contemplated when the rules were introduced", however, the announcement (and the Board's additional guidance) does not provide any indication of such assets.**

When *Tax Laws Amendment (2010 Measures No. 1) Bill 2010* was introduced in February 2010 the expected cost to revenue from the relevant tax consolidation related measures (excluding amendments in Part 20 – not relevant for current purposes) was stated in the Explanatory Memorandum to be as follows:

> ***"Financial impact: These amendments, other than those in Part 20, are expected to have a small but unquantifiable cost to revenue."***

In May 2010, following a process of further consultation on the proposed RFI rules and RTCS rules, those rules were subject to some changes that were accompanied by a Supplementary Explanatory Memorandum, which provided the following guidance on the expected financial impact:

> ***"Financial impact: The explanatory memorandum to the Bill states that the amendments in Schedule 5 to the Bill, other than Part 20, have a small but unquantifiable cost to revenue. Since the Bill was introduced, more information has become available which impacts on the financial impact of the amendments in Schedule 5.***
>
> ***First, it has become apparent that the amendments in Part 1 (use of the tax cost setting amount) will have a significant but unquantifiable cost to revenue. Amendments 8 to 12 will reduce that revenue impact. However, the revenue impact will still be significant."***

There is much speculation as to the potential cost to revenue in relation to the relevant tax consolidation amendments. However, it is unknown how much those speculated amounts are greater than the "significant cost" that was contemplated by the Government.

The validity of such speculated amounts, relevant asset types, relevant taxpayers and industries and relevant income years are all unknown.

The G100 is concerned that a review is being conducted by reference to an unknown starting base and unspecified existing revenue concerns. Without more information, it is difficult to ascertain the extent of any changes required and to consider the extent of policy adjustments which may be required.

We are concerned about the risk that an information vacuum might result in a blunt, ill-directed policy response to these rules.

3. Outstanding interpretative issues need to be considered

1. **Asset characterisation of the reset tax cost setting amount arising from subsection 701-55(6)**
2. **What is the scope of the terms "provision of goods (other than trading stock)" in subsection 701-90(1)?**
3. **What is meant by the terms "right (including a contingent right)" in section 701-90(1)?**
4. **What is the scope of the terms "provision of goods" in section 701-90?**
5. **Will a s40-880 deduction be available for the reset tax cost base allocated to a non-contractual customer intangible of a joining entity?**
6. **What is meant by the terms "the performance of work or services" in subsection 701-90(1)?**

The issues above cover some threshold, fundamental matters in relation to the application of the RFI rules and RTCS rules.

The G100 suggests that it would be appropriate for the BoT review to consider addressing those issues as part of any changes it may recommended to the RFI rules and RTCS rules, in order to minimise uncertainty and misunderstanding as to the application of the rules.

4. Announcement of potential retrospective amendments again raises sovereign risk concerns

The G100 distinguishes the need to distinguish between the measures whose outcomes was intended to date and tax outcomes not intended in the RFI and RTCS changes.

The G100 is concerned that the announcement of the review with an express aim of narrowing the scope of the measures whose outcomes was intended to date, potentially on a retrospective basis, has created undesirable uncertainty for merger and acquisition transactions that have relied upon the enacted law.

Whilst this issue is not of the same magnitude of the Resource Super Profits Tax announcement, there is a similar concern of adverse tax treatment for pre-existing commercial commitments.

Transitional safeguards are required to protect such legitimate arrangements and the measures whose outcomes was intended to date to ensure that commercial confidence in Australia's regulatory regimes is not again put into question. Ideally such safeguards should have been identified and included in the initial announcement of such a review.

As well, given the 'overhang' of uncertainty about tax consolidation caused by this review, it will be desirable for the government response to the review to be announced speedily.

We would be pleased to discuss these high level propositions in more detail if required. If you would like to discuss these issues in more detail please contact Michael Johnson (02 9282 8020).

Yours sincerely
Group of 100 Inc

Peter Lewis
President

APPENDIX A

RESPONSE TO THE BOT'S ADDITIONAL GUIDANCE SPECIFIC ISSUES

In the BoT's additional guidance document, it has raised several matters it was seeking stakeholders would address in their submissions. The G100 responses are as follows:

1. The taxation outcomes that arise when assets of the type that are covered by the rules are acquired directly by a company as part of a business acquisition outside of the consolidation regime

When the proposed amendments to the tax cost setting rules were announced by the Government on 1 December 2005, there was no express mention that the proposed amendments (in relation to relevant assets) would be confined to providing the same tax outcome as would arise under a business acquisition in contrast to an asset acquisition. Below is an extract of the Assistant Treasurer's Press Release:

> **"*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 tax consolidation tax cost setting rules adopt a variety of approaches in relation to determining the tax status or character of reset assets held by subsidiary members, ranging from an "entry history rule" approach to a notional acquisition of the particular asset approach. The approaches can vary depending on the type of asset, the circumstances of the entity and sometimes mixed approaches may apply to different aspects of the same asset, but, the entry history rule is the predominant approach. However, a whole of business acquisition approach is not currently a feature of the tax cost setting rules, and the RFI or RTCS amendments were never understood to be intended to revolutionise the structure of the tax cost setting rules.

The G100 was of the understanding that the purpose of the amendments was to ensure that the tax cost setting amount of relevant assets would be given appropriate recognition under the Income Tax Assessment Act (ITAA).

This policy approach is consistent with the trend of Australian cases which have recognised the need for purchasers of business assets or entire businesses to be given appropriate recognition of their expenses. It is consistent with the judicial trend to deny businesses capital (that is, not taxable or concessionally taxable) treatment of their gains. It is consistent also with the acceptance by the Australian Taxation Office of such recognition under a 'profit emerging' basis where purchasers acquire grouped construction assets and financial assets, including in business acquisitions.
As noted above, the trend for business related income tax legislative reforms over recent years has been for transactions to give rise to assessable or deductible amounts, rather than being treated on capital account. This is most evident in the various TOFA reforms as well as the reforms to black hole expenditure rules in 2005. Those recent tax reform trends support the approach adopted for determining the tax reflex under the RFI rules and the RTCS rules under the ITAA.

If regard was to be given to tax outcomes as would arise for assets under a business acquisition in a non-consolidation context, there are different considerations for assets that fall within the scope of the RFI rules compared with the RTCS rules.

Treatment of assets within the scope of the RFI rules

The types of assets that fall within the scope of the RFI rules in section 701-90, section 716-405 and section 716-410 of the *Income Tax Assessment Act 1997* (the ITAA 1997) may be broadly described as contractual rights to income, under which future assessable income will be derived from the performance of work or services or the provision of goods (excluding trading stock).

The closest equivalent specific provision to the RFI rules in a non-consolidation context is section 25-95 of the ITAA 1997 for work in progress amounts which provide a deduction for an amount paid to the extent that the amount can be identified as being in respect of partly performed work that will be recoverable within 12 months. The effect of section 25-95 is that it provides an immediate deduction in contrast to the RFI rules where the deduction is spread over the lesser of the life of the contract or 10 years. Whilst the RFI rules may represent a broadening of scope of eligible items beyond short-term future recoverable work, the RFI rules significantly defer the timing of deductions in contrast to section 25-95. The mechanics of section 25-95 do not readily interact with the identification of an asset, with the consequence that a separate provision was always required to properly recognise the tax cost setting amount of a relevant asset. Section 25-95 does not distinguish between an asset acquisition scenario and a business acquisition scenario.

A more distant relation to the RFI rules, which is also relevant to consider, is subsection 27H(2) of the *Income Tax Assessment Act 1936* (the ITAA 1936) which operates to provide an effective deduction for the undeducted purchase price of an annuity. Under subsection 27H(2) the undeducted purchase price of an annuity (excluding any residual capital value) is effectively deducted over the life of the annuity, capped by the amount of the annuity income derived in a particular year of income. Again, this provision has some similar design features to the RFI rules, and is underpinned by a policy that seeks to provide a reasonable basis for deducting the purchase cost of an assessable income stream. Section 27H does not distinguish between an asset acquisition scenario and a business acquisition scenario.

The notable difference between section 25-95 and section 27H is they deal with situations where there is an actual payment of an amount in relation to work-in-progress amounts or in relation to an annuity, respectively, whereas the RFI rules notionally recognise the relevant assets as a result of a subsidiary member joining a tax consolidated group. It is a fundamental design feature of the tax consolidation rules that the tax cost setting amount of an asset should be appropriately recognised by provisions in the ITAA that seek to deal with that asset.

Treatment of assets within the scope of the RTCS rules

The RFI rules are examples of particular recognition in a specific provision, whereas the RTCS rules have application for all provisions in the ITAA.

The RTCS rules (subsection 701-55(6) and section 701-56 of the ITAA 1997) deal with assets that would be dealt with under a provision of the ITAA what is not covered by subsections 701-55(1) to (5C). The RTCS rules are broad ranging provisions which are necessary to ensure there is a catch-all mechanism that enables the appropriate recognition of the tax cost setting amount of an asset by provisions in the ITAA that seek to deal with that asset.

The RTCS rules were not drafted against the backdrop of a consolidation regime with a business acquisition model as a core concept. The existing RTCS should not be interpreted by reference to such a principle.

Consequently, the relevant comparable is the treatment of assets that would fall within the scope of the RTCS rules, based on an application of the relevant provision of the ITAA, that would typically have an equivalent in an asset acquisition scenario.

2. 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

The G100 believes that both the RFI rules and the RTCS rules provide appropriate outcomes in the context of a business tax reform initiative and the recent trends in such reforms. That is, the RFI rules and the RTCS rules are the current best tax reform practice that should also apply in a non-tax consolidation context.

The G100 notes that a broader review of the tax treatment of rights is currently off the agenda. That reform process is the appropriate forum for dealing with the issue of aligning tax consolidation outcomes with the necessary reforms required for an appropriate recognition of business acquisition costs in a non-tax consolidation context.

3. If a difference in tax outcomes is warranted, the appropriate basis for recognising the tax costs of any assets that should be treated differently on entry into a consolidated group

The G100 believes that the RFI rules provide an appropriate basis for recognising the tax costs of relevant assets that fall within the scope of those rules.

In relation to the RTCS rules however, there is some merit in considering whether income tax recognition of the deemed expenditure should be on a basis that provides an appropriate matching to the expected income flows relating to the relevant asset.

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

As stated in the high level strategic issues section of this response, the G100 is in no position to provide any accurate indication of the impact of existing provisions, nor is it aware of the target expected by the Government.

The G100 notes that the BoT has requested comment on the treatment of:

- **Non-contractual customer relationships**
- **Goodwill.**

The G100 is not aware of the nature of the claims in question and is not of the view that the intention of the relevant consolidation changes was to enable 'pure' business goodwill to be eligible for the deductions, in circumstances where it would not otherwise be recognised for taxation purposes. As a result, some clarification or rectification of the specific measures may be appropriate.

If the concern was that the general revenue costs of the RFI or RTCS measures was problematical, ignoring optimum tax reform policy principles, then G100 notes the scope for potential use of various mechanisms already used in the relevant amendments:

- **Amend the period of deduction under the RFI rules. There are existing rules governing the period of the deduction which might be adjusted if necessary**
- **Clarify the scope of the RTCS rules (specifically, section 701-56) so that no deduction arises under the black hole expenditure rule in section 40-880 in relation to the tax cost setting amount of business assets that are not otherwise dealt with under the income tax law (e.g. deferred tax asset, know-how, non-contractual customer relationship that is not goodwill etc)**
- **Restrict the application of some of the RTCS rules, in situations other than designated cases, so that these rules do not apply to formation situations, assets that were created whilst the subsidiary member was a member of a consolidatable group (i.e. an equivalent limitation to that operating in the RFI rules).**

However such policy modifications involve consideration of the correct policy settings, transitional and date of effect issues, certainly in relation to the measures whose outcomes was intended to date such as the treatment of consumable supplies.

5. Date of effect considerations

The G100 is strongly of the view that any changes should only apply on a prospective basis, where they relate to the measures whose outcomes was intended to date. This should preferably be from the date of any Government announcement.

If it is determined that any proposed changes to the measures whose outcomes was intended to date will apply from 30 March 2011 or earlier, then safeguards will be required for pre-existing transactions that have relied upon the enacted law. Compensation will be required for consolidated groups that have incurred significant compliance costs in relation to the enacted law, including tax compliance costs and valuation costs.

The G100 would also support transitional provisions that would protect positions adopted by consolidated groups prior to the announcement on 30 March 2011.

6. Addressing present uncertainty pending finalisation of the BoT's review

The BoT should provide further additional guidance on the potential scope of the review, including clarification of assets that may be considered outside the scope of the review, such as all the RFI and RTCS examples in the Explanatory Memorandum and Supplementary Explanatory Memorandum which should be indisputable.

The BoT should ensure that the review and any government announcement are conducted as speedily as possible to minimise uncertainty.

Irrespective of the start date of any changes safeguards are required for pre-existing transactions that have relied upon the enacted law, and these should be announced as soon as practicable (and should not be deferred until any final Government announcement).