Initial submission

MINERALS COUNCIL OF AUSTRALIA

Board of Taxation's review of rights to future income and residual tax cost setting rules

18 April 2011

1 Executive summary

The Minerals Council of Australia (**MCA**) was extremely surprised and disappointed by the Assistant Treasurer's announcement on 30 March 2011 regarding the Government's reconsideration of the relatively recently enacted consolidation amendments, and the suggestion that any such changes may have retrospective application. However, as evidenced by this submission, the MCA will work constructively with Government and the Board of Taxation (**BoT**) to seek to find a reasonable and workable resolution to the issues and concerns outlined in the Assistant Treasurer's press release.

The recommendations of the MCA, as outlined in this submission, are summarised as follows.

(a) As a matter of urgency, a briefing session for representatives of a limited number of industry groups and professional bodies should be conducted by Treasury and the Australian Taxation Office (**ATO**) to assist in identifying key concerns and possible solutions. Briefing sessions such as this have very successfully been used in the past to deal with similar "unintended outcome" issues (refer 2 below).

(b) On a prospective basis, the Government should announce that it will adopt the "asset acquisition approach" (**AAA**) as outlined by the BoT in October 2010 and as submitted on jointly by the MCA and the Corporate Tax Association (**CTA**) in November 2010 (refer 3 below).

(c) As a short-term measure, possibly with retrospective application, particular issues that are of concern to the Government should be addressed by specifically focused legislative amendments. Simultaneously, some other specific drafting problems in this same legislation should be corrected which may otherwise adversely impact on taxpayers (refer 4 below).

(d) In its concurrent review of the implementation of the Tax Design Review Panel recommendations, the BoT should propose to the Government that Treasury is provided with additional funds to engage specialist expert consultants in formulating significant legislation of this nature, to reduce the likelihood of similar problems arising in the future (refer 5 below).

The MCA would like to be represented at a briefing by Treasury and ATO executives, as proposed above, and following this briefing the MCA may wish to lodge a supplementary submission with the BoT regarding these issues.

2 Immediately facilitating more productive consultation

The MCA has felt hamstrung in preparing this response to the BoT's request for submissions because of the lack of critical information.

From the following statements in the Assistant Treasurer's press release of 30 March 2011, it is apparent that two aspects are driving this unprecedented review of recently enacted legislation:

(a) **Scope uncertainty:** *"due to uncertainty in the scope of the application of the rights to future income rules, tax deductibility may be argued for types of assets that were not contemplated when the rules were introduced"*;

(b) **Unanticipated revenue costs:** *"there is some evidence that the rights to future income and residual tax cost setting rules may have substantially greater revenue impact than anticipated"*.

The MCA and other interested parties will only be able to lodge relevant and useful submissions if the Government and/or BoT can share with us what they regard as these scope uncertainties and the magnitude of both anticipated and unanticipated revenue costs. Only when we have a sense of the scope and cost magnitude of the proposed problems can we constructively respond.

For this reason the MCA strongly supports the suggestion that, as a matter of urgency, the BoT facilitates a high level briefing for a limited number of key bodies and tax professionals by senior Treasury and ATO officials regarding these issues of uncertain scope and unanticipated cost.

A briefing of this nature was utilised in February 2008 to better articulate the tax concerns of the previous Government which led to a press release on 12 October 2007 (similarly dealing with tax consolidation). This briefing played a very important role in enabling industry bodies and the tax profession to work constructively with Government to formulate an appropriate way to resolve their underlying concerns.

Pending a briefing of this nature being conducted, the following should be seen as preliminary comments only, and if necessary the MCA will then either prepare a supplementary submission or request a meeting with the BoT to raise additional points.

3 Prospective approach – the BoT's "asset acquisition approach"

The Assistant Treasurer's press release of 30 March 2011 seems to suggest that the Government suspects that the issues surrounding scope uncertainty and unanticipated costs might both be addressed if an approach were adopted whereby tax outcomes were determined by reference to outcomes that would 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 the consolidation regime".

This approach appears to mirror the AAA proposed for comment by the BoT in its October 2010 position paper, as per the following statements in that paper:

> 2.71 The Board acknowledges that the acquisition approach offers a clear policy benchmark against which the outcome of the consolidation regime can be compared. That is, outcomes from entering into the regime would replicate as closely as possible outcomes that arise under a direct asset acquisition.
>
> 2.73 As acquisition cases are now the primary focus of consolidation, the Board considers that the adoption of the asset acquisition approach would be a significant improvement for the consolidation regime. This would provide greater consistency between the treatment of assets acquired directly or indirectly, however, the existing treatment of liabilities and the consequences that arise for a consolidated group when an entity leaves the group would be retained.

As the BoT will be more than aware from joint submissions lodged by the MCA and the CTA on 12 March 2010 and 30 November 2010, we strongly support the introduction of an AAA in determining the tax implications for a consolidated group of the tax cost setting amount (**TCSA**) allocated to assets of a joining entity. Attachment 1 contains comments regarding the AAA that were contained in the MCA/CTA submission of 30 November 2010.

Given that we support an AAA as a sound policy-based response to a number of issues facing the consolidation regime (including those now outlined in the Assistant Treasurer's 30 March 2011 press release), we believe that as a matter of urgency an AAA should be implemented and adopted.

We recommend that the effective date for the operation of the AAA be from the date of a subsequent specific announcement from the Assistant Treasurer, or possibly back to 30 March 2011 if interim measures (such as those discussed at 4 below for dealing with these right to future income type issues) are not regarded as totally adequate.

For the following reasons the MCA believes that the AAA should **not** be implemented with retrospective application.

(a) As recognised both in the BoT's October 2010 position paper and the MCA/CTA associated submission, the AAA would represent a fundamental policy change as to how the tax consolidation regime operates, and it is clearly inappropriate to adopt broad policy change on a retrospective basis.

(b) Any attempt to narrow the scope of the AAA so that it only dealt with the very limited issues arising out of the June 2010 legislative amendments (ie subsection 701-55(5C) and subsection 701-55(6) issues) would inevitably lead to new and significant anomalies and distortions. In short, attempting to apply both an AAA and an entry history type approach to the same corporate acquisition is simply not tenable. For example, if the entry history rule were to continue to operate in relation to assets after future joining events, further issues and complexities would arise as to its then scope and application.[1]

[1] As per paragraph 2.51 of the BoT's October 2010 position paper, as the tax values of liabilities are not reset the entry history rule would continue to apply to liabilities but not assets.

In addition, only the comprehensive introduction of the AAA so that it impacted on all asset types (including pre-CGT assets, pre-1 July 2001 mining rights and previously privatised assets) would achieve the key policy objectives and improvements identified by the BoT of providing greater consistency between the treatment of assets acquired directly or indirectly.[2]

(c) Taxpayers have had to wait four and half years from the date of the then Treasurer's press release in December 2005 until eventually this rights to future income package of provisions was enacted in June 2010. Given that these amendments were stated to be correcting anomalies in the initial 2002 consolidation provisions, many taxpayers have had to wait for eight years for the introduction of these provisions. The MCA believes that it is not reasonable to now reactivate uncertainty for all impacted taxpayers back to June 2002.

(d) Even after the Government announced that an AAA approach would commence to operate, for a number of the reasons outlined in Attachment 1 it would take some months to consider and carefully craft the necessary legislative provisions. Further time delays of this magnitude are not appropriate in a retrospective application context.

(e) As discussed more fully at 4 below, from information currently available it does not appear that the Government believes the June 2010 provisions are fundamentally flawed, and therefore it is likely that more limited and targeted measures might operate as a short-term "fix" to deal with past issues.

As to the potential revenue implications of the adoption of the AAA, the MCA does not have information available to it by which it can provide any indicative estimates, etc.

[2] Paragraph 2.73 of the BoT's October 2010 position paper.

4 Possible interim approaches (including productive consultation)

4.1 Key issues under consideration

As outlined in 3 above, the MCA believes that the AAA should be adopted as the “go forward” response to the problems identified in the Assistant Treasurer’s 30 March 2010 press release, and also to address other longstanding problems and TCSA issues (including the inappropriate post-joining time treatment of pre-1 July 2001 mining rights).

However, subject to getting a more detailed briefing regarding the concerns of Government (see 2 above), it appears that the more pressing problems that may be generating the unanticipated revenue impacts relate to uncertainties as to the scope of the application of the relevant provisions that were not contemplated when the rules were introduced.

Therefore, this suggests that these “uncertain scope” issues are not a problem in relation to assets/arrangements that were either outlined in the Explanatory Memorandum (**EM**) to *Tax Laws Amendment (2010 Measures No.1) Act 2010* (**June 2010 Act**) or in associated previous exposure draft material. In relation to these assets/arrangements as summarised below, Treasury would have considered possible tax outcomes under the measures (even if some of these examples were not actually contained in the final EM).

The specific examples in the EM to the June 2010 Act were:[3]

- Rights to future income under a long-term construction contract (Example 2.1).
- Rights to receive trailing commissions (Example 2.2).
- Land development agreement (Example 2.3).
- Rights to unbilled income for the supply of gas (Example 2.4).
- Consumable stores (Example 5.1).
- Assets held on revenue account (Example 5.2).
- Traditional securities (Example 5.3).
- Australian dollar trade receivables (Example 5.5).
- Foreign currency trade receivables (Example 5.6).

Further, the formulation of the 2010 provisions and the associated EM material make it clear that it was anticipated that the TCSA could result in section 40-880 deductions in respect of relevant assets.[4]

While goodwill and goodwill related assets are not commonly the focus of the MCA or its members, we understand from discussion with other groups that a major issue of concern to the Government may well be the precise parameters of what constitutes goodwill as compared to other intangible assets. In particular, we understand that issues are arising as to whether certain intangibles that are now required to be separately recognised under accounting standards are technically/legally components of goodwill (eg non-contractual

[3] Further examples relating to “rights to deferred management fees” and “land carrying trees” were included in the initial EM to Tax Laws Amendment (2010 Measures No.1) Bill 2010 but were deleted from the EM that ultimately related to the enacted June 2010 provisions. The issues associated with these types of assets/income streams were therefore well-known to Treasury prior to the enactment of the June 2010 Act.

[4] The fact that it was contemplated that by virtue of these legislative amendments deductions could be claimed under section 40-880 is evidenced by the following: (i) paragraph 701-56(3)(d) prevents subsection 701-55(6) from applying to “Subdivision 40-I (capital expenditure that is deductible over time), other than section 40-880 (business related costs); (ii) the EM at paragraph 5.20 states “section 40-880 is excepted because it does not have this limitation. However the tests in section 40-880 need to be satisfied for an amount to be deductible for business related costs. If these tests are satisfied, the amount of the deduction will be based on the tax cost setting amount for the relevant asset”.

customer relationships). Further, we understand that similar issues are arising as to whether or not non-contractually committed extension or renewal arrangements in a number of service agreements are “contingent rights” that should be encompassed under the right to future income provisions of section 701-90, or whether their value should be regarded as forming part of goodwill.

Normally, interpretational issues of this nature are best dealt with by the courts, but if it is these issues that are leading to significant and unanticipated potential revenue costs then we appreciate that the Government may feel the need to clarify these matters legislatively, possibly on a retrospective basis.

4.2 Mine Improvement Assets

Background

In the course of undertaking mining activities, mining companies construct many assets which are improvements to land. These assets are the subject of complex engineering and design, are costly to construct and are essential to both access the working face of the mine and to ensure the safe and efficient operation of the mine. These assets have a limited effective life and decline in value over time.

These assets have been recognised by the tax system in one form or other for decades.

The costs of construction of these assets are in some cases immediately deductible as overburden removal. Where those assets are constructed other than via the removal of overburden, it is the MCA’s position that these assets are depreciable assets pursuant to section 40-30. Some residual items of mining capital expenditure would be eligible for deductibility via a project pool.

In an asset acquisition scenario it is the MCA position that the purchase price attributable to the vase majority of mine improvements should be deductible under section 40-30 on the basis that these assets constitute depreciable assets. Where items of mining capital expenditure do not constitute a depreciating asset, these amounts should be deductible over the life of the project via the project pool provisions.

In 2007 the ATO released ATOIDs 2007/11 and 2007/12 which conclude for certain types of mine improvements that whilst these assets are designed and constructed for specific purposes integral to the operation of the mine, and whilst they are acknowledged to represent improvements that should be treated as separate to the land, they are not depreciating assets for the purposes of section 40-30. The MCA is currently in dialogue with the ATO in relation to their technical view in this regard and as at the date of this submission, ATO Chief Tax Counsel is reviewing the ATO technical position.

Consolidation Treatment of Mine Improvements

It is the MCA’s position that tax consolidation should likewise recognise mine improvement assets and that the TCSA referrable to mine improvement assets should be treated in a manner consistent with the outcomes that should apply in an asset acquisition. In other words, the ACA allocated to the vast majority of mine improvements would be depreciable under 40-30 over the effective lives of those assets. Where section 40-30 does not apply, the TCSA should result in a project amount deductible under the project pool provisions over the life of the project.

In the context of the mining industry we are aware of a concern related to one technical interpretation as to the treatment of mine improvements under 701-55(6). The issue in question is whether the TCSA referrable to mine improvements that have arisen as a consequence of the earlier removal of overburden should result in an immediate deduction pursuant to subsection 701-55(6), on the basis that the previous removal of that overburden would have been a deductible revenue outgoing.

The MCA can see the technical merit in this interpretation. The MCA also has sympathy for the fact that some taxpayers have felt the need to turn to this technical interpretation in order to gain tax recognition for the TCSA referrable to mine improvement assets due to the position taken by the ATO under the ATOIDs referred to above and in light of the fact that there is what we believe to be a technical anomaly in sub-section 701-56(3) which currently excludes project pools from the operation of section 701-55 (this is discussed at 4.3 below). The combination of the ATO technical position on section 40-30 and the project pool technical anomaly means that taxpayers must find another mechanism by which to gain recognition for the TCSA referrable to mine improvement assets.

The MCA believes that there would be merit in providing legislative clarity to ensure that the TCSA referrable to mine improvement assets is treated appropriately as either forming the cost of a depreciating assets pursuant to section 40-30 or as a project amount deductible over the life of the project pursuant to the project pool provisions. This would require:

- confirmation of the operation of section 40-30 in the context of mine improvement assets (in absence of a change in the ATO position); and
- a technical amendment to correct the anomaly we have identified below in relation to the exclusion of project pools pursuant to sub-section 701-56(3).

In association with these legislative clarifications, additional clarification may then also be required to confirm that the TCSA referrable to the prior removal of overburden is not immediately deductible by virtue of the interaction between subsection 701-55(6) and section 8-1.

The MCA would appreciate the opportunity of working collaboratively via consultation sessions with the BoT or Treasury in resolving all these interrelated issues, both on a retrospective and a prospective basis.

4.3 Other issues that should be under consideration

If the Government is going to introduce specific provisions as a short-term “fix” to what it sees as problems with the June 2010 legislation, the MCA submits that the following additional problems and inherent anomalies in that legislation that are now apparent should also be addressed.

(a) Subsection 701-56(3) and project pools

Subsection 701-56(3) was introduced with the June 2010 legislation to ensure that subsection 701-55(6) did not inappropriately apply in respect of a range of a deductions that are not impacted by changes in the ownership of a relevant asset (eg building capital allowance deduction being the classic example). However, through an apparent policy error/oversight subsection 701-56(3) also encompasses the specific mining-related project pool mining capital expenditure and transport capital expenditure provisions of section 40-830 to section 40-875 of Subdivision 40-I.

The inclusion in the scope of subsection 701-56(3) of assets for which sections 40-830 to 40-875 are relevant is predicated on an <u>incorrect</u> assumption, as in these provisions the acquirer of the assets <u>does not</u> receive an opening balancing adjustment equal to the closing pool value of the previous owner. The previous owner is subject to a balancing adjustment and for the new owner a new project pool arises in respect of their capital expenditure on relevant items, ie these outcomes are similar to the balancing charge outcomes relevant to “standard” items of depreciable plant under section 40-285.

Therefore, with retrospective effect back to 1 July 2002, the MCA believes it is also both appropriate and necessary to correct this error so that subsection 701-56(3) does not preclude the application of subsection 701-55(6) in the context of sections 40-830 to 40-875.

Attachment 2 contains a more detailed submission on this issue which is also separately being forwarded to Treasury.

(b) CGT straddles – application to intra-group shareholdings

By way of a legislative oversight, it has become apparent that the "CGT straddle" amendments contained in section 716-860 as introduced in the June 2010 Act inappropriately do not apply to intra-group assets, including intra-group shareholdings.[5] This limitation is inconsistent with the proposed scope of this measure, as evidenced from the Government's announcement of 8 May 2007, and creates significant policy inequities. Therefore the BoT is requested to recommend that as part of the package of amendments to the June 2010 Act provisions this issue also be corrected with retrospective application back to its commencement date of 8 May 2007.

As a result of the requested briefing by Treasury and the ATO discussed at 2 above, the MCA may become aware of additional issues which might warrant specific legislative clarification.

[5] Refer the minutes to the 15 October 2010 NTLG Consolidation Sub-Committee meeting, at 5.6.

5 Broader tax design issues

Given that the BoT is concurrently undertaking a post-implementation review of the Tax Design Review Panel recommendations, the background to the formulation of this June 2010 Act should be seen as an important case study.

While the MCA was not directly involved in industry/professional body consultation in relation to the June 2010 amendments, it is more than apparent that Treasury was not sufficiently resourced to undertake this task. This is evidenced by the fact that it not only took four and a half years to introduce these provisions, but even then, as is now apparent, these provisions did not provide the required technical or revenue outcome certainty.

We understand that the Treasury team on this project was led by an extremely competent and conscientious officer, but unfortunately it is understood that over the relevant period the officer had a number of other pressing legislative responsibilities and did not have a sufficiently large and experienced support team.

These problems could have been thoroughly addressed had Recommendation 12 of the Tax Design Review Panel been adopted:

> The Treasury should engage external experts to ensure tax design is better informed by practical knowledge of the tax law, industry structure and commercial practice.

In formulating this recommendation the panel made the following statement:

> Treasury could increase the use of external consultants to bring in more expertise on tax legislation, industry structure and commercial practice. Although the greater use of consultants would be worthwhile, it can be costly and resource constraints may be an issue in routinely engaging private sector advisers for all substantive tax measures. However, in line with Recommendation 1, the Review Panel considers that the use of paid private sector consultants to assist in policy design prior to the Government announcement is an appropriate investment.

In relation to these June 2010 Act issues, given the significant amount of tax involved, and the fact that on the enactment of the provisions the Government recognised that these measures had a “substantial but unquantifiable” tax cost, it is extremely disappointing that the resources of Treasury were not augmented by specialist external consultants.

The MCA recommends the BoT propose that in the future Treasury is provided with substantial additional funding to ensure that this Review Panel recommendation is implemented. Also, the MCA believes that there should be more transparency about how revenue costings are undertaken for major tax measures. This would enable external parties to provide input to Treasury if they thought that the costing model being utilised may be flawed.

Attachment 1

Extract from the MCA/CTA joint 30 November 2010 submission to the Board of Taxation

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BoT POSITION 2.1

The Board considers that the asset acquisition approach should be adopted.

SUBMISSION

The CTA/MCA support the BoT's proposed asset acquisition approach as it would provide future clarity as to the objectives of tax outcomes in relation to tax cost setting amounts allocated to assets of a joining entity, and in so doing would address a number of anomalous current issues. The asset acquisition approach would also substantially reduce tax differentials in respect of assets of a joining entity between transactions undertaken as an asset acquisition as compared to an entity acquisition.

The proposal to limit the asset acquisition approach only to the tax treatment of assets of a joining entity and not seeking to extend it to liabilities of a joining entity and leaving events is pragmatic and appropriate, as to do otherwise would raise very significant technical issues (particularly in relation to the treatment of liabilities) and very substantial additional compliance costs (particularly in relation to leaving events).

The CTA/MCA also submit that in association with recommending the asset acquisition approach to Government, it will be necessary for the BoT to provide recommendations regarding some matters of detail that must be addressed to ensure that the asset acquisition approach operates efficiently and as intended. These aspects are outlined below.

ADDITIONAL KEY POINTS

1 *Division 40 aspects – specific BoT confirmation*

It is submitted that the BoT, in association with recommending the asset acquisition approach, should also specifically confirm that to address existing anomalous treatments this acquisition approach should consistently apply to all Division 40 depreciating assets of a joining entity (subject to 2 below) such that:

(i) the 200% diminishing value uplift rate would be applicable;

(ii) pre-1 July 2001 mining rights would become depreciable;

(iii) Division 57 treatment would be terminated;

(iv) future depreciation amounts would be determined based on new effective life rates; and

(v) a prime cost/diminishing value option would be available to the acquiring group.

2 *No change of majority beneficial ownership*

In the detailed discussion of the asset acquisition approach, the Position Paper contains two identical footnotes (numbers 20 and 26) which, it has been confirmed with the BoT secretariat, contain a minor typographical error. It is understood that these footnotes were intended to state:

> For example, modifications may be required for the treatment of pre-CGT assets and depreciating assets (including pre-July 2001 mining rights) in formation cases or in cases where there is **not** a change in ownership of a joining entity.

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[**Correction/inclusion confirmed by BoT secretariat**.]

While the CTA/MCA concur that from a policy perspective the scope and application of the asset acquisition approach may need to be limited where there has not been a change of majority underlying ownership, the application of these modifications should be restricted and targeted so that they have very limited application. It would create unnecessary complication if these continuity of majority underlying ownership (**CMUO**) modifications had broader application. In particular, the following points are noted.

(i) Modified treatment should be restricted to CMUO situations and therefore in formation cases it should only apply where a CMUO exists in relation to a joining entity/assets. As such, it should not apply on formation to a joining entity/assets where prior to electing to consolidate the forming group had acquired the particular entity from unrelated parties such that there is not a CMUO situation.

(ii) Modified treatment should only apply if CMUO has applied for an extended period (say, three years). For example, it would clearly be inappropriate to apply a modified CMUO treatment to a progressive acquisition where the acquiring group will inevitably own a very substantial interest in the joining entity immediately prior to acquiring the balance of outstanding shares (as would be the case in an on-market takeover where more than 90% of the shares in the target entity are first acquired, followed by a compulsory acquisition of the remaining shares under section 606 of the *Corporations Act*).

(iii) Where there is a CMUO, rather than applying a totally separate regime which would add a further layer of unnecessary complexity, as a general principle the asset acquisition approach should continue to apply but with modifications in relation to particular types of assets considered necessary from a policy or integrity perspective. This 'targeted asset' approach is currently successfully applied in CMUO cases in relation to trading stock[6] and certain 'internally generated assets'[7].

(iv) An additional advantage of applying a modified CMUO approach only to limited types of targeted assets is that the CMUO testing can then be by way of reference to those assets themselves (eg as is currently the case in relation to pre-CGT status under Division 149), rather than applying more broadly to a joining entity. [This would also address integrity concerns which could otherwise arise under recommendation (ii) above in circumstances where assets were transferred to a newly incorporated company within an associated consolidated group, with that newly incorporated company then being transferred to the acquiring group.]

Related issues as to the appropriateness of the asset acquisition approach will also arise where, under the BoT's proposed SME concession and other limited duration formation concessions, assets of a joining entity can retain their existing tax cost bases (ie 'stick entities'). These aspects are separately discussed in that context at H on page 26 below.

3 <u>*Deemed asset acquisition treatment*</u>

Paragraph 2.50 of the Position Paper broadly describes the objectives of the asset acquisition approach as being that 'the outcomes for assets would broadly replicate the outcomes that would arise if there was a direct acquisition … of the underlying assets of an entity by a consolidated group, rather than the acquisition … of membership interests in the entity'.

It will be important to specify the context of this deemed asset acquisition so that resulting tax outcomes can be ascertained. Therefore, there are three possible approaches that could be adopted in this regard:

(i) a deemed acquisition of <u>each individual asset</u> of the joining entity separate from other assets of the joining entity (ie an acquisition of an individual asset);

(ii) a deemed simultaneous acquisition of <u>all the assets of the joining entity</u> or a joining

[6] Section 701A-5 of the *Income Tax (Transitional Provisions) Act 1997*.

[7] Section 701-A-10 of the *Income Tax (Transitional Provisions) Act 1997*.

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consolidated group under Subdivision 705-D (ie an acquisition of the businesses of the joining entity);

(iii) a deemed simultaneous acquisition of all the assets of the linked group of entities where Subdivision 705-D applies.

It is submitted that the BoT's policy objectives could be best met if the relevant contexts as applicable in (ii) and (iii) above were stated to apply.

4 *Clarity as to tax outcomes in respect of certain assets*

One of the major advantages of the asset acquisition approach is that it will provide a consistent context in which to determine outcomes in relation to tax cost setting amounts allocated to assets of a joining entity. However, unfortunately, in relation to a limited class of assets even in a direct asset acquisition scenario under current tax law there can be some uncertainty as to the tax outcome. Therefore, in relation to some very specific classes of asset it would be appropriate to provide some direction as to post-joining time tax outcomes (either by way of legislation or explanatory memorandum (**EM**) guidance). This would build on the substantial amount of work undertaken in developing some of the provisions and EM guidance contained in *Tax Laws Amendment (2010 Measures No.1) Act 2010* (**2010 Measures Act**).

This limited class of assets in respect of which specific guidance is provided could include:

(i) consumable stores – clarify that their deductible status would apply where the acquiring group adopts an 'incurred' basis in relation to consumables;

(ii) rights relating to the performance of work or services – guidance regarding a 'profit emerging' type outcome, similar to that previously provided in the 2010 Measures Act in relation to the right to future income under:

- a long-term construction contract;
- rights to receive trailing commissions;
- land development agreements; and
- the rights to unbilled income for the supply of gas.

5 *Doubtful debts*

Paragraph 2.37 and the associated footnote (14) raise related issues in relation to trade debts, and in this regard the CTA/MCA note the following points.

(i) The statement is made in the Position Paper that under the asset acquisition approach trade debts held by a joining entity that are written off as bad after the joining time will only be deductible if the group is a money-lender.

While in many situations this will be the case, the CTA/MCA would be concerned about confining the availability of bad debt deductions to only this case as in certain circumstances debts acquired on the acquisition of a business that are subsequently written off as bad may be deductible under the general provisions of section 8-1.[8]

In addition, the CTA/MCA request legislative acknowledgement that to minimise associated compliance costs a 'reasonable estimate' approach can be taken in seeking to subsequently identify those bad debts that may have arisen before the joining time.[9] This concern has been raised by members who have practical experience of acquiring entities and businesses with hundreds of thousands of trade debts.

(ii) Footnotes 14 states that 'a consequential amendment may be required to ensure that trade debts are not retained cost base assets'. The CTA/MCA would be concerned about any general approach by which Australian dollar trade debts and other Australian dollar receivables would cease to be retained cost base assets, for the following

[8] For example, in situations as outlined in TR 2001/9.

[9] An example of legislative endorsement of an estimation approach in the consolidation context is subsection 705-90(9).

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reasons:

- this could significantly increase compliance costs if an evaluation had to be made of the market value of individual trade debts;
- in an asset acquisition, trade debts are normally acquired at their face value (equating to retained cost base asset status), with any differential in market values being in effect allocated to goodwill; and
- via the ACA cost base resetting principles, this could result in taxable gains being triggered in respect of trade debts collected at their face value, and such an outcome would not reflect commercial expectations and hence would distort decision-making.

6 *Leaving entities*

Paragraph 2.61 suggests that under the asset acquisition approach, when an entity leaves a group it will be taken to acquire all its assets at that time, at their then tax values, and prior history in relation to those assets would no longer apply.

The CTA/MCA do not concur with this approach, in that they do not believe that it is consistent with an asset acquisition approach, and are also concerned that it would lead to unnecessary technical complexity etc.

The CTA/MCA concur that under the asset acquisition approach, where the tax values of assets are reset at a joining time, it is appropriate that the prior history in respect of those assets ceases to apply. However, the tax values of assets of the leaving entity are not reset when an entity leaves a group, and may only be reset if that entity subsequently joins another tax consolidated group. As such, it is thought that it would be more appropriate for the leaving entity to continue to inherit and apply the past history in respect of its assets until it joins another tax consolidated group and the tax value of its assets are then reset.

7 *Liabilities and non-asset deductions*

The CTA/MCA agree with the proposal in the Position Paper that the asset acquisition approach not apply to liabilities and non-asset deductions, and hence the entry history rule would continue to apply in relation to associated subsequent tax outcomes in respect of such liabilities and non-asset deductions. While no problems are currently envisaged, further consideration should be given as to whether this limited ongoing application of the entry history rule to liabilities and non-asset related deductions could raise any specific technical or practical issues that may require specific legislative modifications. Therefore, it is recommended that this be a matter which is further considered in the course of preparing the legislative provisions to implement the asset acquisition approach.

8 *Previous private binding rulings*

CTA/MCA members request that the BoT acknowledge that private binding rulings that relate to the tax status of liabilities and/or non-asset related deductions should not be rendered invalid by a joining event, because the entry history rule should continue to apply in these contexts. Further, it would be beneficial if it could also be confirmed that private binding rulings in respect of an asset should not be invalidated if the ruling relates to factors other than the tax value, acquisition or holding status of the asset. For example, rulings relating to the Division 974 debt/equity status of an asset held by a joining entity should not be impacted by the asset acquisition approach.

Attachment 2
Submission

MINERALS COUNCIL OF AUSTRALIA

Subsection 701-56(3) and project pools – legislative correction required

18 April 2011

1 Executive summary

The Minerals Council of Australia (**MCA**) has identified an apparent policy error/oversight in the way that the recently enacted provisions of *Tax Laws Amendment (2010 Measures No.1) Act 2010* (**TLAA 2010**) operate in the context of the tax consolidation regime's interaction with the specific mining-related provisions of sections 40-830 to 40-875 of Subdivision 40-I of the *Income Tax Assessment Act 1997* (**ITAA 1997**).

Unless this matter is speedily addressed by legislative amendment, it will cause very significant inequities and anomalies, particularly as the relevant provisions have a retrospective application back to 1 July 2002.

As outlined below, the MCA believes that this issue can be readily addressed by excising sections 40-830 to 40-875 from the application of newly enacted subsection 701-56(3) so that subsection 701-55(6) is not precluded from normal operation in relation to relevant mining-related assets that may be Project Pool Mining Capital Expenditure (**MCE**) (section 40-860) or Transport Capital Expenditure (**TCE**) (section 40-865).

By implementing this very short and straightforward legislative amendment, subsection 701-55(6) and subsection 701-56(3) would continue to operate as intended in respect of deductions that are <u>not impacted by changes in the ownership of the relevant assets</u> but would no longer inappropriately apply in a tax consolidation context in respect of deductions that <u>can change in relation to a change of ownership of relevant assets</u>.

2 Rationale for this legislative correction

Subsection 701-55(6) is a residual or catch all provision that operates to treat the tax cost setting amount (**TCSA**) as the cost of an **asset** where the other subsections of section 701-55 do not apply. It is understood that, but for subsection 701-56(3), subsection 701-55(6) would have applied to assets for which sections 40-830 to 40-875 are relevant. Pursuant to subsection 701-56(3), subsection 701-55(6) does not apply to assets for which these sections are relevant.

The purpose of section 701-55 is to reset the tax cost of an asset based on its TCSA rather than to use its original cost.

It is against this background that the Explanatory Memorandum to TLAA 2010 provides the following rationale for the exclusion of certain capital allowance provisions from subsection 701-55(6) contained in subsection 701-56(3):

> 5.19 The deductions allowed under these capital expenditure provisions are, in most cases, based on:
>
> - the original capital expenditure incurred by a taxpayer to construct or create the asset, rather than on the amount paid (by a subsequent or different taxpayer) to acquire the asset; or
> - the amount of capital expenditure incurred that is not associated with an asset.
>
> …
>
> 5.21 If a joining entity is entitled to a deduction under the capital expenditure provisions, the head company of the group may be entitled to a deduction because of the operation of the single entity rule (subsection 701-1(1)) and the entry history rule (section 701-5). The amount of the deduction is based on the remaining balance of the capital expenditure, rather than the tax cost setting amount allocated to the asset.

The exclusion of assets for which sections 40-830 to 40-875 is relevant from the operation of subsection 701-55(6) appears therefore to be predicated on an incorrect assumption that either a subsequent purchaser inherits the undeducted Project Pool balance on acquisition or alternatively, that all amounts included within the Project Pool represent capital expenditure that is not associated with an asset. We comment on each of these matters at 2.1 and 3.2 below.

Because of these incorrect assumptions on which subsection 701-56(3) appears to have been based, not surprisingly this is leading to inappropriate and anomalous outcomes (with retrospective effect back to 1 July 2002) that are of significant concern to the MCA and its members.

2.1 Project Pools and asset acquisitions

Pursuant to subsection 40-830(4), a vendor of a mining operation for which a Project Pool has been created will upon sale of the underlying assets which form the basis of the "Project" and "Project Amount" will receive a deduction for the Project Pool's closing pool value for the previous income year, together with any Project Amounts for the current year. Any consideration received by the vendor for the relevant assets will be included in the vendor's assessable income. This applies to the full balance of the Project Pool irrespective of whether Project Amounts relate to MCE, TCE, or to a subsection 40-840(2) amount.

Importantly, there is no assumption by the acquirer of the mining operation of the undeducted value within the Project Pool. The acquirer does not receive an opening balance of the closing pool value for Project Pools associated with that

mining operation by reference to the expenditure incurred by a previous owner. The Project Pool balance of the previous owner of a mining operation is irrelevant to a new owner.

For the new owner, where the capital expenditure on acquisition is on an item for which sections 40-830 to 40-875 are relevant, that expenditure will be capable of forming a new Project Amount for the acquirer and a new Project Pool arises (i.e. where there has been 'consideration' for the Project, the Project Amount that is allocated to a Project Pool, will create a new Project Pool for the acquirer). This will particularly be the case where it is on MCE or some forms of TCE. This outcome is similar to the balance charge outcomes relevant to "standard" items of depreciable plant under section 40-285.

Clearly therefore, the Project Pool amount of the new owner is determined entirely by reference to the amounts paid by the new owner in respect of assets for which sections 40-830 to 40-875 are relevant.

For instance, MCE is defined as follows under section 40-860:

> **40-860(1) Mining capital expenditure** is capital expenditure you incur:
>
> (a) in carrying on *mining operations; or
>
> (b) in preparing a site for those operations; or
>
> (c) on buildings or other improvements necessary for you to carry on those operations; or
>
> (d) in providing, or in contributing to the cost of providing:
>
> (i) water, light or power for use on the site of those operations; or
>
> (ii) access to, or communications with, the site of those operations; or
>
> (e) on buildings for use directly in connection with operating or maintaining *plant that is primarily and principally for *treating *minerals, or quarry materials, that you obtain by carrying on such operations; or
>
> (f) on buildings or other improvements for use directly in connection with storing minerals or quarry materials or to facilitate *minerals treatment of them (whether the storage happens before or after the treatment).
>
> **40-860(2)** Capital expenditure you incur on *housing and welfare in carrying on*mining operations (except quarrying operations) is also **mining capital expenditure**, but only if: …

Clearly on acquisition of a mine site the capital expenditure incurred on acquiring buildings, improvements to land and housing necessary to carry on mining operations would form a Project Amount (where they are not excluded on the basis of being depreciable assets and already depreciable under Subdivision 40-B).

Similarly TCE and Transport facility are defined under sections 40-865 and 40-870 as:

> **40-865(1) Transport capital expenditure** is capital expenditure you incur, in carrying on a business for a *taxable purpose, on:
>
> (a) a *transport facility; or
>
> (b) obtaining a right to construct or install a transport facility…; or
>
> (c) paying compensation for any damage or loss caused by constructing or installing a transport facility or part of one; or
>
> (d) earthworks, bridges, tunnels or cuttings that are necessary for a transport facility.
>
> …

40-870(1) A transport facility is a railway, a road, a pipe-line, a port facility or other facility for ships, or another facility, that is used primarily and principally for transport of:

(a) *minerals or quarry materials obtained by any entity in carrying on *mining operations; or

(b) *processed minerals produced from minerals or quarry materials.

For example upon the acquisition of a mine site the capital acquisition cost can be appropriately allocated to buildings (including housing) and improvements necessary to carry on the mining operations. As such it would be capital expenditure on MCE which would form the Project Amount for a Project Pool (assuming it is not a depreciable asset or otherwise deductible).

3 Practical implications of requested amendments

3.1 Project Pool assets

If the requested legislative amendments are introduced, then where an asset for which sections 40-830 to 40-875 are relevant has a TCSA established under Division 705 so that subsection 701-55(6) would apply, this would override the entry history rule in relation to that asset.

Accordingly, the MCA considers that the buildings, facilities and improvements to land which meet the definition of MCE in section 40-860 and TCE in section 40-865 are assets which should have their tax cost base reset for the purposes of section 701-55 so that post-joining time Project Pool deductions are calculated based on this reset amount.

3.2 Project Pool amounts with no underlying asset

Project Pool Amounts of a company can be incurred in circumstances where no resulting underlying asset exists for the taxpayer – for example, contributions to community infrastructure (subparagraph 40-840(2)(d)(i)). In such circumstances, upon the company joining a consolidated group, these “non-asset improvements” will not have a TCSA, and even with the requested legislative amendment section 701-55 will not apply to these Project Pool Amounts. As such, in relation to such “non-asset improvements” the inherited history rule will apply under section 701-5 and the acquiring entity will inherit the remaining balance of the relevant Project Pool value.

In this regard, Project Amount is defined in subsection 40-840(2) as:

> **40-840(2)** Another amount of capital expenditure you incur is also a **Project Amount** so far as:
>
> (a) it does not form part of the *cost of a *depreciating asset you*hold or held; and
>
> (b) you cannot deduct it under a provision of this Act outside this Subdivision; and
>
> (c) it is directly connected with a project you carry on or propose to carry on for a *taxable purpose; and
>
> (d) it is one of these:
>
> (i) an amount paid to create or upgrade community infrastructure for a community associated with the project; or
>
> (ii) an amount incurred for site preparation costs for depreciating assets (except, for *horticultural plants, in draining swamp or low-lying land or in clearing land); or
>
> (iii) an amount incurred for feasibility studies for the project; or
>
> (iv) an amount incurred for environmental assessments for the project; or
>
> (v) an amount incurred to obtain information associated with the project; or
>
> (vi) an amount incurred in seeking to obtain a right to*intellectual property; or
>
> (vii) an amount incurred for ornamental trees or shrubs.

Therefore, subsection 40-840(2) can encompass specific categories of activities or preliminary expenditure not likely to be associated with an asset owned by the taxpayer. For example, a mining company donates money to upgrade a school in the community that is associated with a mine site the expenditure qualifies as a Project Amount. As this Project Amount does not involve an underlying asset of the joining entity, on acquisition of a company, the inherited history rule will apply. As mentioned previously there will be no TCSA as there is no asset in respect of which a TCSA can be calculated. In principle, MCA believes the inherited history rule, will apply to all capital expenditure under subsection 40-840(2) where there is no underlying asset and that this is an appropriate outcome.

As such, MCE and TCE Project Amounts should not be excluded from subsection 701-55(6) by the provision of subsection 701-56(3) to the extent that there is an underlying asset. Where there is no underlying asset in respect of the Project Amount, there will be no TCSA to which section 701-55 will apply and the inherited history rule will simply continue to directly apply to this balance of the Project Pool value even if the requested legislative amendments are introduced.

4 Implications of the current Board of Taxation review of the tax consolidation regime

The Board of Taxation (**BoT**) is currently undertaking a review of the tax consolidation regime, and has outlined its current thoughts on a number of issues in a Position Paper issued in October 2010. The MCA, jointly with the Corporate Tax Association, lodged a detailed submission in relation to this Position Paper on 30 November 2010.

We note that the BoT's current stated position that an "asset acquisition approach" should apply in future would not be inconsistent with the proposed Project Pool amendments sought by way of this submission. This is due to the fact that, as outlined at 2.1 above, Project Pool deductions are not inherited from a prior owner of the project in the context of an asset acquisition, but rather separately apply to the acquirer of such assets based on the associated acquisition costs.

However, it is still necessary that the requested amendments to subsection 701-56(3) be implemented as soon as possible because these provisions currently have retrospective application back to 1 July 2002. In addition, it is thought most likely that any legislative amendments resulting from the BoT review may take some years to implement, and then may only have prospective application.