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

20 April 2011

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Attention: Keith James

Dear Keith

Review of rights to future income and residual tax cost setting rules

Thank you for the opportunity to provide the industry's views on the consolidation rights to future income and residual tax cost setting rules.

The Property Council is the peak body representing the interests of owners and investors in Australia's $400 billion property investment sector.

The industry supports Government's review of the legislation to ensure that the rights to future income rules do not create unintended consequences and the agreed provisions continue to operate appropriately.

The consolidation rights to future income rules were introduced after an extensive consultation process. To the extent that asset classes are clearly within the scope of the legislation and examples in the explanatory memorandum, the current law should not be changed.

Taxpayers, including those in the construction, property development and retirement village industry and those that perform management services, currently rely on these rules to make real time business decisions.

We consider that the operation of the rules for these asset classes is clear in the legislation.

Any change to retrospectively exclude them will cause significant compliance burdens, potentially impact the viability of property deals and may adversely affect taxpayers' and shareholders' investment decisions.

We recommend that:

1) no changes should be made to the residual tax cost setting rules; and

2) certain transactions that were clearly intended to be covered by the rights to future income rules should remain unaltered (see attached submission):

   a) rights under a long-term construction contract;

   b) rights under a land development agreement;

   c) rights to deferred management fees; and

   d) management rights.

However, we understand that Government may amend other aspects of the rules which are outside the intended scope of the legislation for clarity and certainty.

Any proposed changes to the rights to future income rules should be prospective. Appropriate transitional rules are essential where taxpayers have already "commercially committed" to transactions.

Retrospective legislation to remove rules that are currently relied on by taxpayers is unfair and imposes unnecessary costly compliance burdens on taxpayers.

It will also increase the perceived sovereign risk of Australia for foreign investors. This will adversely impact Australia's ability to attract investment from overseas.

The attached submission outlines our recommendations for appropriately dealing with these issues. We are keen to discuss them with you further at your convenience.

Please do not hesitate to contact Elaine Abery on (02) 9033 1929 or myself if you have any queries.

Yours sincerely

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Property Council of Australia

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Consolidation: Rights to Future Income and Residual Tax Cost Setting Rules

Property Council of Australia
April, 2011

Rights to Future Income

Executive summary

The rights to future income rules ("the rules") were negotiated, agreed and enacted by Parliament after an extensive consultation process. Given that an extensive consultation process has been concluded, the Property Council recommends that the law as it applies from 1 July 2002 to the present should not be disturbed.

If any amendments are proposed to the rights to future income rules:

- No amendments (whether prospective or retrospective) should be proposed in relation to the assets listed in our submission (being rights to future income under long term construction contracts, land development agreements, retirement village contracts and management contracts). This is on the basis that these are the types of assets which were clearly intended to fall within the ambit of the rules when the rules were introduced.
- Any other proposed amendments should be prospective in nature (with appropriate rules to grandfather transactions that have already been implemented prior to the commencement of any proposed amendments).
- If an "asset acquisition approach" is ultimately proposed, the taxation outcome for "work in progress assets" should be broadly consistent with the taxation outcome currently available under section 25-95.

No changes (prospective or retrospective) should be made to the residual tax cost setting rules. These clarifying amendments were announced on 1 December 2005 and there is a clear policy intention of providing for deemed expenditure treatment, which is supported by a number of examples in the *Explanatory Memorandum* to the bill.

For completeness, the Property Council has also made some observations (refer Appendix 1) in relation to the alternate "asset acquisition approach" (whilst acknowledging that it is not a design principle of the tax consolidation regime as currently enacted).

All section references are to the Income Tax Assessment Act 1997.

DISCUSSION

Background – "extensive consultation" process

The Board of Taxation has been requested to examine the operation of the rules with a view to clarifying and proposing changes to limit their scope (if necessary).

The rules were enacted "following extensive consultation with stakeholders". The extensive consultation was considered necessary given the uncertainty that arose in respect of certain assets (such as work-in-progress amounts and unbilled revenue) during the initial years of operation of the tax consolidation regime, which was acknowledged by the Assistant Treasurer (at the time) in *Press Release No.098* on 1 December 2005.

The Government had a number of years to consider the form and scope of the amending legislation (and the revenue impact arising from the rules) and Treasury undertook extensive consultation with stakeholders (including the Australian Taxation Office and industry bodies) and other interested parties.

Government had a clear intention of the type of assets that it envisaged being covered by these rules (see next section of this submission).

Given that there has been an extensive consultative process prior to the enactment of the rules, the Property Council recommends that the law as it applies from 1 July 2002 should not be disturbed.

The intended scope of application of the rights to future income rules

The Press Release notes that "uncertainty" around the operation of the rules has prompted a review of the rules and clarification of their scope.

"The Board raised concerns with the Assistant Treasurer that, due to uncertainty in the scope of 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. This could result in the rules having a substantially greater revenue impact than anticipated."

A threshold question arises as to what assets were contemplated when the rules were introduced. Clearly, if the assets were contemplated when the rules were introduced, it would not be appropriate to later change the rules so that these assets are no longer covered by the rules.

a) Rights under long-term construction contracts and land development agreements

The *Supplementary Explanatory Memorandum* to the *Tax Laws Amendment (2010 Measures No. 1) Act 2010* includes various examples (two of which are listed below) which illustrate that the rights to future income rules explicitly apply to:

- rights under a long-term construction contract; and
- rights under a land development agreement.

There is therefore no reasonable basis to exclude these types of assets from the rules (whether prospectively or retrospectively).

These examples in the *Supplementary Explanatory Memorandum* are very strong persuasive authority in ascertaining how the legislature itself envisaged that the rules would operate in respect of these assets.

In addition, these particular rights (which concern work-in-progress amounts and unbilled revenue) are within the ambit of the types of rights that were announced by the Assistant Treasurer (at the time) in the Press Release No.098 on 1 December 2005 (concerning work-in-progress amounts and unbilled revenue)[1].

b) Rights to deferred management fees

As with the rights to future income under long-term construction contracts and land development agreements, the application of the rules to rights to deferred management fees under retirement village contracts is contemplated by the original *Explanatory Memorandum* and *Supplementary Explanatory Memorandum*:

"[the application of the rules] *depends on the terms of the contract between the operator and the retirement village resident. … As there are many different contractual arrangements offered by retirement village operators, the basis on which deferred management fees may arise also varies widely.*

Whether a right to deferred management fees is an asset covered by subsection 701-90(1) will depend on the facts (including the terms of the particular contract) in each case."

Based on Example 5.10 of the original *Explanatory Memorandum* and the comments in the *Supplementary Explanatory Memorandum*, it is clear that certain rights to deferred management fees (DMF) are clearly envisaged by the rules. Accordingly no amendments should be made impacting DMF rights which are covered by the current subsection 701-90(1).

c) Consistency with section 25-95

Under the currently enacted rights to future income provision in section 716-405 a deduction is available in respect of work in progress amounts that meet the requirements of being valuable contracts in respect of the performance of work or services. The policy objective of introducing section 716-405 was to ensure the same economic amount would not be taxed twice and therefore a deduction should be available to overcome this effect. This policy objective is the same objective behind the introduction of section 25-95 which applies where a purchaser directly acquired the work in progress asset via a direct asset acquisition.

The Property Council therefore believes the ability to claim deductions in respect of work in progress amounts should not be disturbed by any modifications ultimately made by the Board of Taxation's review. In other words, the ability to claim a deduction for rights to future income

[1] Although the Press Release referred to the amendments being made to treat rights to future income (such as work-in-progress amounts and unbilled revenue) as retained cost base assets where the rights accrued to a head company, by implication, it inferred that such rights that did not accrue (i.e. acquired rights) would be treated as reset cost base assets.

should be preserved to achieve consistency with the outcome available under section 25-95 for direct asset acquisitions.

d) Management rights

Whilst management rights are not explicitly listed as examples in the *Supplementary Explanatory Memorandum*, the rules are not limited by reference to the specific examples in the *Explanatory Memorandum* (ie these examples are not exhaustive).

Management rights were contemplated to be within the scope of the rules when the rules were introduced.

- Section 701-90 prescribes that contractual rights will only fall within the ambit of the rules if they represent a right to receive an amount for the "performance of work or services or the provision of goods".
- Section 701-90(1) specifically includes contingent rights. Property entities perform management services (such as funds management and asset management) under management right contracts. These management right contracts are executory contracts (the right to receive income is contingent on its performance of services).
- Paragraph 2.10 of the *Supplementary Explanatory Memorandum* reveals an intention from Parliament to limit the ambit of the rules to rights that result in the derivation of active income or trading income (as opposed to merely passive income). In this regard, the provision of management services is, in the context of the property industry, and (more generally) in most cases, a part of the ordinary business activities of a property business and thus, gives rise to active or trading income.
- Management rights are assets which are capable of being specifically identified, valued and assigned.

In this context, management rights refers to assets held by the relevant subsidiary member at the joining time (being the right to manage particular funds under agreements in place at that time and refers to business in force at the time of consolidation rather than extending to the expectation of future business) and thus, can be separately identified.

The rights under these contracts have a value that is separate and distinct to that of the goodwill of the business of the relevant subsidiary member. Furthermore, and most importantly, the management rights are capable of being transferred, or dealt with, independently of the goodwill of the business of the relevant subsidiary member. Accordingly, pursuant to the decisions of *FCT v Murry* (1998) 193 CLR 605; 39 ATR 129, and *FCT v Just Jeans Pty Ltd* (1987) 16 FCR 110; 18 ATR 775; 87 ATC 4373 the Property Council believes that such rights should be treated as separate and distinct assets, such that any element of goodwill should not be included in the concept of management rights for these purposes.

Suggested date of effect – rights to future income rules

Any proposal to retrospectively limit the scope of the rules would be unfair and inappropriate given that taxpayers (and their investors) have relied on the rules as currently enacted. Furthermore, any proposal to retrospectively amend the rules may add to the perception that Australia is prone to sovereign risk.

Retrospective changes will have significant impacts that are unfair and inappropriate, including:

- Some entities have now prepared and issued financial statements which include the impact of rights to future income ("RTFI") deductions in tax expense and current tax liability/asset. A subsequent reversal could force taxpayers to change their accounts, which has flow-on implications for investors who rely on the financial statements.
- Under consortium arrangements it is not uncommon for consortium members to share the income tax exposures of a bid vehicle / representative. We are aware of an example where one consortium member has paid (to another consortium member) a portion of a significant income tax refund attributable to RTFI deductions. If the law is retrospectively amended, this may adversely affect the viability of property deals as it may not be possible to recover this income tax refund from the other consortium members.
- Taxpayers may already have committed to investment decisions on the basis of a particular tax profile for an entity. If the law is retrospectively amended, this may materially impact the financial viability of the investment decision because the expected deductions are no longer available. Taxpayers may not be able to proceed with investments.
- Taxpayers have already incurred significant valuation and advisory fees in relation to the identification and quantification of RTFI deductions under the existing law.
- The first time recognition of RTFI deductions may give rise to profits which may have been distributed by corporate taxpayers as dividends. Prior decisions regarding dividend policy (including franking percentages) may have been impacted by the availability of RTFI deductions.

If any amendments are proposed to the RTFI rules:

- no amendments should apply to:
    - rights under a long-term construction contract;
    - rights under a land development agreement;
    - rights to deferred management fees under retirement village contracts; and
    - management rights;

  these assets were clearly intended to fall within the ambit of the rules when the rules were introduced; and
- any other potential amendments should be prospective in nature, with appropriate transitional provisions for transactions that have already been "commercially committed" to.

The Board of Taxation proposed a number of dates of application. We strongly believe that all legislation should be prospective to assist taxpayers to apply the proposed changes.

Residual tax cost setting rules

No changes (prospective or retrospective) should be made to the residual tax cost setting rules in subsection 701-55(6) and section 701-56.

Policy intention

The clarifying amendments contained in subsection 701-55(6) and section 701-56 were announced on 1 December 2005 and there is a clear policy intention of providing for deemed expenditure treatment, which is supported by a number of examples in the *Explanatory Memorandum* to the bill.

The 1 December 2005 press release clearly set out that the proposed amendments would provide that the head company will be taken to have incurred expenditure at the joining time. As acknowledged in the Board of Taxation's additional guidance material, the scope of these rules was always intended to cover consumables, revenue assets and particular rights to future income. This original intention was then taken up in the *Explanatory Memorandum* by the inclusion of specific examples in relation to subsection 710-55(6) covering:

- consumable stores;
- assets held on revenue account;
- traditional securities; and
- foreign currency trade receivables.

There is therefore no need to clarify the scope of the operation of the residual tax cost setting rules. The rules operate as intended following the amendments made by *Tax Laws Amendment (2010 Measures No. 1) Act 2010*.

The intended operation of these rules is further evidenced from the *Explanatory Memorandum* to the bill introducing this Act, which describes the issue being addressed regarding the previous law as follows:

"The tax cost setting rules set the tax cost setting amounts for assets held by an entity that joins a consolidated group. ***When a tax consequence arises in relation to an asset for a head company, the tax cost setting amount is intended to be used by the head company to determine those tax consequences.*** *However, for the purposes of applying certain provisions in the income tax law, the head company is unable to use the tax cost setting amount of an asset.* [emphasis added]*"*

The amendments are then explained:

"5.11 ***Subsection 701-55(6) is modified to ensure that it gives effect to its policy intent.*** *Under these modifications, subsection 701-55(6) will apply where a provision of the income tax law, other than a provision specifically mentioned in subsections 701-55(2) to (5C), is to apply in relation to an asset by including an amount in assessable income, or by allowing 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 to the asset.* [emphasis added]"

The 1 December 2005 press release and the *Explanatory Memorandum* clearly articulate the policy intention. The amendments to subsection 701-55(6) in *Tax Laws Amendment (2010 Measures No. 1) Act 2010* implemented this intention.

Therefore, no changes should be made to subsection 701-55(6) or section 701-56.

Consistency with Work in Progress Assets – Section 25-95

The *Explanatory Memorandum*[2] that introduced section 25-95 examined how an amount paid to an exiting partner of a partnership was assessable to the extent the payment was in respect of work in progress amounts and then subsequently, when the work became a recoverable debt and the partnership billed for the work, the amount became assessable to the partnership. The same economic amount had therefore been treated as assessable income to two different parties. Consequently, it was considered appropriate to give a deduction to the acquirer of the work in progress amount in recognition they would subsequently be taxed on the income once a bill was raised in respect of the work in progress amount.

If there is any proposal which seeks to modify the consolidation regime to follow an asset acquisition model, the Property Council submits that any such proposal should respect the stated objective that the same economic amount should not be taxed twice. Therefore, the adoption of the asset acquisition model should result in the same tax outcome for the head company as a direct acquisition of the work in progress assets currently available under section 25-95.

[2] *Taxation Laws Amendment Act (No. 5) 2002*

Appendix 1: asset acquisition approach

The Board of Taxation has also requested stakeholders to comment on the taxation 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 of the tax consolidation regime.

We understand that this question is raised in the context of the "asset acquisition approach" currently being considered by the Board of Taxation.

The "asset acquisition approach" is not currently a design principle in the tax rules. Accordingly, a proposal to implement an "asset acquisition approach" should only be prospective in nature (in order to ensure that the existing design principles in the tax legislation operate as intended and acknowledging that moving to an asset acquisition model would be a fundamental change).

The Property Council expects that the taxation outcomes (in respect of obtaining a tax deduction) should, in many cases, be conceptually similar where rights to future income under long term construction contracts, land development agreements, retirement village contracts and management contracts are acquired directly by an entity as part of a business acquisition outside of the tax consolidation regime and an acquisition in a tax consolidation environment.

Although not without doubt, the Property Council submits that in the case of a direct acquisition of the asset types outlined above, the cost paid to acquire these types of assets should, in many cases, be deductible.

- Such rights are typically on revenue account given that they are typically acquired in the ordinary course of a business carried on by the relevant taxpayer[3] to obtain regular returns (see for example Sun Newspapers v FCT (1938) 61 CLR 337) and therefore the costs incurred to acquire these types of rights should be deductible (the timing of the deductions depending on the particular facts and circumstances).
- The tax outcomes reflect the fact that in real economic terms, the purchaser has provided economic consideration to secure a future assessable income stream.

The existing approach in the rights to future income rules conceptually reflects the above outcomes by assessing taxpayers on the net income by allowing a deduction in relation to rights to future income assets over the life of the contract (with a cap of 10 years).

The Property Council acknowledges that the position outlined above in respect of the deductibility of the cost to acquire a right to future income asset is not without doubt under an asset acquisition model.[4] Further uncertainty arises given that direct business acquisitions of the asset types outlined above are not necessarily common practice in the market. Rather, the usual manner in which such rights are acquired would typically be via entity acquisitions. The industry practice of adopting entity acquisitions being driven primarily by various

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[3] This is consistent with the conclusion of the Full Federal Court in *National Australia Bank Limited v FC of T* 97 ATC 5153 where the court held that a lump sum payment for the exclusive right to make subsidised loans was revenue in nature given that it was a regular business outlay that was paid to expand the NAB's home loan customer base.

[4] Where a purchaser acquires all of the assets of the business (including the goodwill), it is arguable that the full amount paid to acquire the business assets is capital in nature.

commercial, GST and legal impediments that are associated with these asset acquisitions, rather than any income tax drivers.

As pointed out in the terms of reference, this particular consideration is raised given that it is broadly consistent with the "asset acquisition approach'" which the Board of Taxation is considering as part of its *Post-Implementation Review into Aspects of the Consolidation Regime*.

In the Board of Taxation's *Position Paper* on this review, the Board makes the following comments regarding the "asset acquisition approach":

"2.46 A key advantage of the acquisition approach is that it would offer a clear policy benchmark against which the outcomes of the consolidation regime can be compared. That is, outcomes from entering into the regime would replicate as closely as possible outcomes that would arise under a direct asset acquisition.

2.47 As a result, the acquisition approach would reduce tax induced distortions in the decision making process of a consolidated group and increase efficiency in the tax system."

If an "asset acquisition approach" is ultimately proposed as part of any tax consolidation reforms, the amendments need to be prospective in nature (in order to ensure that the existing design principles in the tax legislation operate as intended). In addition, in light of the fact that asset acquisitions listed above (intended scope of application of the rights to future income rules) are not typical practice in the property industry, the following legislative rules should be included:

- amounts paid to acquire the type of assets identified above are deemed to be on revenue account; and
- clear legislative rules/guidance as to the timing of such eligible deductions.

We are keen to discuss or expand on any of the above comments.

Contact

Please contact the following about any aspect of this submission:

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