Submission to the House of Representatives Economic Committee

Tax Laws Amendment (2012 Measures No. 2) Bill 2012, Schedule 3: tax cost setting consolidation amendments

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1 Introduction

We raise for consideration by the Standing Committee a number of important points in relation to Schedule 3 of Tax Laws Amendment (2012 Measures No.2) Bill 2012 (**the Bill**) which deal with the consolidation tax cost setting and right to future income rules.

The majority of these points were previously raised in our submission of 2 May 2012 in relation to the associated Exposure Draft provisions released on 18 April 2012, but which have neither been addressed in the Bill nor otherwise responded to.

We request that the Standing Committee give particular attention to these issues, as the law in this area has been in a state of flux back as far as a Government announcement in December 2005, and as such we are extremely concerned to ensure that these issues are once and for all clearly and unequivocally addressed by this Bill.

2 General comments

2.1 Retrospectivity

As foreshadowed in the media release of 25 November 2011 and now reflected in the Bill, a number of critically important aspects in the proposed changes will have retrospective application. In many circumstances these retrospective changes override and are totally contrary to quite specific and intended outcomes contained in the consolidation legislative package enacted in June 2010 (including being contrary to quite specific examples contained in the Explanatory Memorandum to that legislation).

To introduce retrospective changes of this nature is not only extremely inequitable, but undermines the confidence of the corporate community in the tax system.

While this submission focuses primarily on technical issues and ambiguities raised by the Bill, we recommend that the Parliament reconsider aspects associated with a number of the retrospective amendments, and in this regard we support the comments contained in other associated submissions to the Standing Committee, including the submission lodged by the Tax Institute.

2.2 Extremely limited period for submissions

While the media release foreshadowing these changes was issued on 25 November 2011, it took almost five months for the Exposure Draft (**ED**) material to be released, and then only two weeks was allowed for public submissions. Further, given that the Bill was introduced into Parliament on 24 May 2012, again only one week has been provided for the purposes of making submissions to the Standing Committee.

These extremely limited periods for comment are extremely disappointing, particularly as the then Assistant Treasurer in his media release stated that the drafting of legislation would be undertaken as a matter of priority. Therefore, we request that the Standing Committee query the delay in making available the ED for public comment.

2.3 Proposed business acquisition approach

The most significant long-term implication of these measures is the introduction (for the prospective period) of a 'business acquisition approach' in the context of the application of the residual tax cost setting provisions of section 701-55(6). This is dealt with in the Bill

only by the insertion of some brief sections in proposed section 701-56, and there is no substantive discussion of issues and implications in the Explanatory Memorandum (**EM**).

As illustrated in some of the basic examples contained in 4.1 of this submission, it is evident that considerably more detailed consideration is required as to the method of implementing the proposed business acquisition approach, including interactions with other components of the consolidation provisions.

It is critical that, to the maximum extent possible, all issues and ambiguities be clarified by the provisions that are ultimately enacted, to avoid creating further confusion and ambiguity.

2.4 Drafting approach

The practice that has been adopted of inserting provisions in relation to the Pre-rules and then repealing them and substituting other sections with the same number in the Interim Rules (and then in some cases repealing them again in the Prospective Rules) causes considerable confusion. Not only does this cause a problem in reviewing the Bill, but we envisage that it will also create considerable ongoing difficulties when enacted, given the way it will no doubt have to be dealt with by publishers of the legislation.

We query whether thought has been given to inserting in the Act the Prospective Rules and dealing with other amendments by way of the *Income Tax (Transitional Provisions) Act 1997*.

3 Pre-rules

3.1 Clauses 1 and 6: section 701-55(5C) WIP deductions via section 716-405(6)

Via section 701-55(5C) and the associated definition of ‘unbilled income asset’ in section 701-63(6), deductions can be claimed in respect of the tax cost setting amount of an asset in respect of, broadly, work, services or goods (other than trading stock) that have been performed or provided to another entity, unless a recoverable debt has yet arisen in respect of that work, services or goods. However, this blanket exclusion for situations where a recoverable debt has arisen is inappropriately broad, in that it will preclude from deductible status work in progress which has given rise to a debt in respect of only a portion of the work in progress amount.

The common examples in this regard are firstly many long-term construction arrangements where work has been undertaken, and where ‘instalment’ debt has arisen in respect of that work in progress but not equal to the full amount ultimately billable in respect of the work performed up to the joining time.

Secondly, this aspect is also more than apparent in relation to a number of service arrangements where the service provider secures a customer for a client and is remunerated by the client under a trailing commission arrangement, based on the period that the client retains the customer. That is, the service has been provided to the client ‘up front’, but the relevant fee becomes a recoverable debt in instalments over time.

Amendments should ensure that these ‘classic’ WIP situations are not excluded from the ‘unbilled income asset’ definition.

3.2 Section 701-63 goodwill treatment

(a) Section 701-63(2) indicates that deemed goodwill/single asset treatment is only to be mandated ‘for the purposes of this part’ – ie only for the purposes of the consolidation provisions of Part 3-90.

Neither the fact that this treatment only applies for Part 3-90 purposes nor the implications of this limited application are acknowledged or discussed in the EM. Is it proposed that this deemed treatment of goodwill primarily only applies for asset cost base setting purposes, but not for the ongoing normal application of the CGT provisions in relation to subsequent dealings with such assets? Or is it contemplated that for the 'purposes of this part' it is intended to apply to all subsequent dealings in assets of the subsidiary (but not a head company), given that the single entity rule will be relevant in such cases?

In short, it appears that technical complications could well arise where this deemed goodwill/single asset treatment is assumed to apply for some purposes of the Act but not others, particularly where the demarcation is not clear.

(b) The scope of the definition of a 'right to future income' in section 701-63(5) is wide enough to include trade debts that have already been included in the joining entity's assessable income. Applying deemed goodwill treatment to such amounts is clearly inappropriate.

Similar issues arise in the context of section 705-25(5)(d), and in this regard would be most relevant where a foreign currency trade receivable is involved.

(c) The use of the term 'Division 230 financial arrangement' in section 701-63(5)(c) is ambiguous, given that Division 230 will generally only apply to a taxpayer from 1 July 2010. This is however subject to a taxpayer making an un-grandfathering election for TOFA purposes. The effect of making an un-grandfathering election is to (i) apply the TOFA provisions to financial arrangements that a taxpayer held on entry into TOFA and (ii) effectively recognise gains/losses from the financial arrangement under the TOFA provisions for the period that the taxpayer held the financial arrangement prior to 1 July 2010 (by virtue of the transitional balancing adjustment provisions). As such, a taxpayer that makes an un-grandfathering election will in effect apply the TOFA provisions to financial arrangements on a historic basis.

We therefore submit that, not only to address ambiguities but also to avoid unintended anomalies, it should be clarified that if, because of an un-grandfathering election, Division 230 subsequently applies to an asset of a joining entity that joined a consolidated group at an earlier point of time (i.e. prior to TOFA starting to apply to the taxpayer – generally, 1 July 2010), then in respect of that earlier period (i.e. at the joining time) the asset should be regarded for section 701-63(4)(c) purposes as a Division 230 financial arrangement.

Although we assume that this is the intent of the provisions, this should be clarified within the explanatory memorandum.

3.3 Clauses 50(5) and (6): RTFI/goodwill – assessments issued before 12 May 2010

(a) The 25 November 2011 media release indicated that in respect of assessments issued prior to 12 May 2010 the amendments only operate to disallow deductions that have been claimed under section 701-55(6) in respect of customer relationships assets, know-how and other accounting intangibles, but other Pre-rule restrictions disallowing deductions in relation to non-WIP RTFI will not apply (refer item 2 of Table 2).

However, the way in which this aspect is dealt with in clauses 50(5) and (6) means that if a taxpayer were now to seek an amendment to an original assessment that had issued before 12 May 2010 to claim deductions for WIP amounts under section 701-55(5C) and/or consumable stores under proposed section 701-55(5D), then it would appear that this could be an amendment that 'relates to the application of subsection 701-55(6) of the original 2002 rules' such that the 'protection' otherwise available under clause 50(5) in relation to any previous claims in respect of RTFIs would be lost. Similarly, if a taxpayer

makes a 'voluntary disclosure' request for an amended assessment to disallow deductions previously claimed for section 701-63(2)(b) customer relationship etc assets, then this would appear to erode the protection otherwise available under clause 50(5) in respect of previous claims relating to RTFIs.

We request that these clauses be modified to ensure that this outcome does not arise.

(b) Paragraph 3.118 of the EM states that:

> If an arrangement or transaction is covered by a notice of assessment which was served on the head company by the Commissioner before 12 May 2010, **the original 2002 rules will apply to the arrangement or transaction** unless:
>
> - the head company requests an amendment or the amendment relates to the application of section 701-55(6) of the original 2002 rules in respect of the joining entity; or
> - the amendment of the assessment relates to an asset that is customer relationship, know-how or another accounting intangible asset and would be inconsistent with the treatment of those assets under the pre-rules. [**Emphasis** added.]

This statement suggests that unless an amended assessment is requested or customer relationship/know-how/accounting intangible assets are involved, then the original 2002 rules will continue to apply to the arrangement or transaction and hence the Pre-rules, Interim Rules and Prospective Rules will have no application.

However, it is somewhat ambiguous from the provisions themselves as to whether this outcome is achieved. In particular, it would appear that, notwithstanding that a notice of assessment may have been served in relation to the arrangement before 12 May 2010, if deductions under the original 2002 rules are ordinarily deductible over a period that extends past 10 May 2010 then in respect of those later periods it is unclear whether the Pre-rules or the Interim Rules could also apply.

It is submitted that the intention of this rule needs to be clarified and the provisions need to be revised to ensure the intention is achieved.

3.4 Clause 50: two or three sets of rules applying over time to the same RTFI

It is unclear whether subsection 50(1) provides that different provisions (as provided in subsections (2),(3),(4) or (5)) could apply to the same RTFI assets in different years of income.

Although the words are also unclear, the 25 November 2011 announcement (in paragraph 30) did indicate that application of the changes to the pre-12 May 2010 period would depend on the time of the relevant assessment or amended assessment.

In addition, the possibility of multiple rules applying to one RTFI asset is not mentioned in the EM.

It is submitted that clarification is required in respect of this 'tail' issue, by amending the provisions to clearly reflect the position and also document the position and its consequences in the EM.

If it is the intention that an RTFI asset could be subject to multiple sets of rules, then it is far from clear what the tax outcomes will be for an RTFI arrangement that is subject to two sets of rules (and it is likely to even lead to more uncertainty and complexity if three sets of rules apply to the arrangement).

If it is intended that RTFI arrangements will straddle more than one RTFI deduction regime, it is critical that the potential outcomes are correctly dealt with in the legislative provisions to ensure there is not a loss or duplication of deductions. It is also very important that the EM provides taxpayers with guidance as to how to apply these provisions in common scenarios.

4 Prospective Rules

4.1 Clause 31: section 701-56 business acquisition approach

The approach adopted in relation to the application of the business acquisition approach has been to simply add section 701-56(2) without otherwise amending section 701-55(6) (other than to delete Note 1).

In the limited time available we have not had the opportunity to fully consider all the related implications, but we are concerned that the approach adopted will further confuse the operation of these provisions, particularly in the context of the application of the entry history rule. In this regard, by virtue of section 701-56(1B) the asset acquisition approach in section 701-55(6)(2) applies 'despite the entry history rule', but otherwise the entry history rule will continue to apply notwithstanding the deemed acquisition of the relevant asset.

Paragraph 3.99 of the EM does not discuss these aspects in any detail.

Therefore, the provisions appear to operate for section 701-55(6) purposes only to deem the head company as acquiring the assets of the joining entity by way of a business acquisition, but in other contexts other factors relevant to determining tax outcomes are to be determined by reference to the entry history rule.

Just one extremely common example of ambiguities that will arise in this regard relates to the treatment of trade debts of the joining entity that subsequently are written off as bad.

When the Board of Taxation discussed the business acquisition approach in its October 2010 Position Paper (at paragraph 2.56), it observed that the acquiring group will only be able to 'deduct trade debts held by a joining entity that are written off as bad only if the group is a money lender'. The Board recognised that this could create anomalies, given that trade debts are commonly regarded as retained cost base assets, and then suggested that an appropriate measure to rectify this outcome could be to treat trade debts as being reset cost base assets (footnote 22).

However, the approach adopted in the Bill is not to totally negate the entry history rule in this context, but rather to modify its application. Further, in the context of bad debts the fact that Note 2 to section 701-55(6) cross-references to Subdivision 716-S, that deals with COT/SBT aspects, indicates that it is anticipated that bad debt deductions will be available under the amended provisions.

A range of other important issues will arise in relation to the interaction of the entry history rule, because the direction in this regard that was provided by the June 2010 version of section 701-56(1) will no longer apply, given the repeal of this provision. For example, it is unclear as to whether, in determining tax outcomes in respect of such assets held at the joining time, regard is to be had to whether deductions have been claimed prior to the joining time by the joining entity in respect of such assets.

Further, in determining CGT outcomes in respect of an asset, the deemed acquisition under the business acquisition approach will not apply, but for other purposes it will apply. Therefore, careful consideration will be required to determine whether unintended consequences will arise when the entry history rule is disregarded for some purposes but not others in respect of an asset (including its pre-CGT status).

In short, the adoption of a business acquisition approach in this context is a very important development that is intended to have significant implications. In the very limited

time that we have had to review the Bill, it is far from clear that the full implications of the proposed method of adopting the business acquisition approach have been fully considered. If they have, they have certainly not been explained in the accompanying EM.

4.2 Section 25-95 WIP scope

Given that section 25-95 is now to have far wider application, we strongly submit that consideration be given to updating it, not only in its application in a non-consolidation environment, but also now in a consolidation environment. Particularly relevant in this regard is its reference only to 'work' rather than clarifying that it also extends to 'services'.

The term 'work' traditionally has a connotation of physical endeavour (ie exertion/labour/toil) which can raise ambiguity and uncertainty in the context of the present digital environment such as in relation to computing and telecommunication activities. Similarly, ambiguities will arise as to whether 'work' encompasses document/warehouse storage and security arrangements etc.

To not provide clear direction in this regard would be extremely inappropriate, particularly given the history of this package of legislation and the fact that it is intended to provide certainty with retrospective application back to 1 July 2002.

5 Other RTFI application aspects (including interest and penalties)

5.1 Clause 51 and its impact on 'tails' of pre-12 May 2010 claims

The original 2010 rules allowed deductions over up to 10 years for the tax cost-setting amount allocated to RTFIs.

As outlined at 3.4 above, it is unclear whether the current wording in the Bill provides protection for 'tails'. This requires further consideration, given that the 25 November 2011 announcement contemplated that the application of the law would depend on the time of the relevant assessment or amended assessment and in some cases, these times could straddle the three distinct rule periods.

Clause 51 deals with the remainder of RTFI claims that are currently available under the 2010 amendments, but which are yet to be fully realised by the taxpayer due to potential for such claims to stretch over a number of years. Broadly, clause 51 provides protection where the relevant taxpayer has received a private ruling or written advice from the Commissioner under an Annual Compliance Arrangement issued before 30 March 2011.

It is submitted that providing protection for the circumstances outlined in clause 51 only produces iniquitous results. For example, assume a taxpayer that has a RTFI claim for an asset of a subsidiary that joined their consolidated group on, say 1 January 2006 (i.e, after the 1 December 2005 Press Release – thus, the taxpayer may have a reasonable expectation that a tax deduction will be made available for an RTFI asset of that subsidiary). That claim is effectively confirmed by the passing of the original 2010 rules. Further assume that the claim is completely uncontroversial (due to the RFTI being specifically included in the 2010 Explanatory Memorandum examples), such that the taxpayer merely lodges an amendment request and claims five years' worth of deductions in the period between 12 May 2010 and 30 March 2011, which the ATO agrees is uncontroversial and processes quickly. Such a taxpayer may lose the final five years' worth of deductions due to the changes in the Bill (if the tail is unprotected). By contrast, assume a taxpayer is in the same circumstances but with a more controversial RTFI claim (e.g. one that is not on all-fours with one of the examples in the 2010 Explanatory Memorandum). Due to that taxpayer's claim being controversial, the taxpayer seeks a private ruling. Should that taxpayer obtain a positive private ruling or

written advice from the Commissioner, that taxpayer's remaining five years of claims would be protected.

If the Bill, when enacted, does not provide protection for tails more generally, an improved transitional rule will be needed for those taxpayers whose RTFI claims were uncontroversial (in light of the examples contained in the 2010 Explanatory Memorandum). This will need to ensure that taxpayers whose circumstances are such that their RTFI claim did not require a private ruling will not 'lose their tail' while taxpayers whose RTFI claim was more controversial, and thus required a private ruling, can 'keep their tail'.

5.2 Clause 4: four year amendment period

In relation to the Pre-rules, paragraphs 31 to 33 of the 25 November 2011 media release in effect specify that the normal four year amendment period will continue to apply in relation to ATO activated amendments, but that an additional two year amendment period will apply to specific taxpayer activated amendment requests. Similarly, the Assistant Treasurer's media release of 25 November 2011 stated:

> Corporate acquisitions that took place before 12 May 2010 will be affected by the changes subject to the application of normal amendment periods.

It is of concern that clause 4 of the Bill provisions and paragraph 3.134 of the EM do not reflect this treatment, but rather would allow the ATO to go back more than four years in activating amended assessments to increase tax payable.

5.3 Interest and penalties

Paragraph 3.131 of the EM indicates that no interest or penalties will be imposed where additional tax becomes payable where the ATO amended assessment issued before 31 March 2011, to give effect to these new provisions. By omission, this suggests that interest or penalties may be imposed for adjustments relating to assessments issued after 30 March 2011.

Through various statements the ATO have indicated that for original assessment issued prior to the enactment of the revised law they will not seek to impose interest or penalties for adjustments resulting from the revised law, provided taxpayers make the necessary amendments within a reasonable period. It is suggested that some reference to this practice be added in the EM to avoid any confusion in this regard.

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