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OTHER REFS: Section 22

CATEGORY:
○ Pre policy approval
● Legislative measures development
○ General

ISSUE DATE: 27 October 2010	RESPONSE DATE: Section 38

SUBJECT: Section 22 the consolidation regime

Introduction

Section 22

This minute relates to the Consolidation provisions Section 22 Specifically, it relates to recent ‘technical’ amendments to the cost-setting provisions .

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Commissioner of Taxation

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The amendments

The amendments in question to the cost-setting rules greatly extended the range of circumstances in which capital expenditure on shares will be converted into revenue deductions.

These amendments have their origin in two draft public rulings issued in 2004[5]. In 2005 Treasury recommended a change of law to reverse the effect of the law as explained by these rulings, the change to be retrospective to the commencement of Consolidation. In recommending the change, Government was advised that there would be a “small but unquantifiable” cost to the revenue on the basis of an assumption that, in self-assessing, taxpayers would take a position contrary to the ATO’s draft rulings. In fact taxpayers were following them. Government approved the change and announced it late in 2005. Somewhat later (2009) during the course of consultations Treasury recommended that the scope of the amendments should be expanded.

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We now have 34 cases to hand, and the estimate of the cost to revenue Section 22 We expect it to continue to increase as taxpayers come forward with more claims. We have intelligence that, unsurprisingly, accounting firms are actively promoting their services to consolidated groups to conduct reviews to establish entitlements to refunds of tax. Because this measure is retrospective in effect to 2002, apart from the unknown cost to the revenue from refunds, there is also a considerable cost in interest.

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[5] TD 2004/D74; TD 2004/D85.

[6] As observed in footnote one, this is before allowing for the impact on franking. It is difficult to estimate the impact on franking, depending as it does on the extent of the franking surplus of the company in question. In the case of Section 38 referred to above the impact is zero.

[7] Section 22

Attachment B

THE LAW

When the members of a consolidated group acquire all the membership interests (loosely, non debt-like shares) in a company (‘the joining entity’), the cost of the assets of the joining entity are “re-set” under section 701-55 of the *Income Tax Assessment Act 1997*. The cost setting process, broadly speaking, takes the price paid for the joining entity and adds to it the accounting liabilities of that entity, and then allocates that cost to the various assets of the entity on the basis of their market values. As originally conceived, this process furnished a cost approximating to the cost of buying the assets directly, and was intended to put the acquiring company in the same position it would have been in, had it purchased business and the assets of the joining company directly. (There is no corresponding process for adjusting liabilities to put the acquiring company in the position it would be in if it assumed those liabilities directly.) In its original state, the section restated the cost of trading stock, depreciating assets, qualifying securities, and CGT assets under specific provisions. The provisions appropriately interacted with the basic provisions of the Act regarding these categories of asset, and, in substance, did put the acquiring company in much the same position as if it had purchased them directly.

Section 701-55 contained a further subsection enacting that if any other provision of the Act was to apply to an asset, its cost was to be restated as well. The ATO ruled that this section did not have the effect of creating notional expenditure that might be deductible under provisions applying to expenditure, such as section 8-1. By way of example, if the joining entity carried on the business of trucking and had unconsumed petrol in the tanks of its trucks, we ruled that s.701-55(6) did not have the effect of deeming the acquiring company to have incurred expenditure in buying petrol that might be deductible under s.8-1. Also, we ruled that if a joining entity’s assets included unperformed contracts for work productive of assessable income, s.701-55(6) did not have the effect of deeming there to have been expenditure to buy these contracts. It is to be noted that when a company directly acquires a business and its assets, no deduction is available under s.8-1 for the cost of acquiring those assets, with the exception of trading stock. Even the cost of acquiring an unperformed contract for the purchase of trading stock is not deductible[8]. This is because such expenditure is on capital account. Thus s.701-55(6) in this respect also placed the acquiring company in the same position it would be in if it made a direct purchase of the assets.

The amendments to subsection 701-55(6) altered the operation of the provision so that it deemed the acquiring company to have acquired assets and to have incurred expenditure in so doing. The amendments do not, however, provide that the acquisition or expenditure is to have any particular character or to deem any particular circumstances to exist. Rather, they rely upon the so-called entry history rule[9] to supply whatever additional facts may be necessary to apply a particular provision. The entry history rule deems everything that happened to a joining entity to have happened to the head company. (The entry history rule is modified by disregarding the fact that a deduction has been allowed to the joining entity.) The assumption on which the legislation appears to rest is that the deemed purchase of which the subsection

[8] *John Smith & Son* v. *Moore* [1921] 2 A.C. 13

[9] Section 701-5

speaks is a purchase deemed to have occurred in the course of the business of the joining entity.[10] Broadly speaking, then, the effect of the amendments[11] is to duplicate revenue deductions for items acquired by the joining entity on revenue account, produce revenue deductions for items acquired on revenue account but not at a deductible cost, and, it would seem, revenue deductions for items not acquired at all, but which would be acquired on revenue account if they were acquired. The amendments also produce notional capital expenditure which will enliven deductions under provisions for capital expenditure. It may be that any notional expenditure produced by the section that is not deductible under any other provision will be deductible under s.40-880, the so-called "black hole" expenditure provision.

An associated amendment allows deductions for the cost allocated to contracts for work, services or goods. The effect of this deduction is, in effect, to eliminate a liability for future income to the extent that it is earned under contracts subsisting at the date of a takeover.

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[10] There was (and is) some doubt as to whether s.701-55(6) should be applied as if the acquiring entity notionally purchased the assets and business of the joining entity, as its original form might suggest, which would supply a capital character with the consequence that no deductions would be allowable under s.8-1. However, it is our understanding that was not the intention of the amendments.

[11] Having regard to the absence of any countervailing conversion of capital receipts for the sale of membership interests into income. While it may be argued that the acquiring entity has actually "paid" the notional outgoing, the subject of the duplicated deduction, in the form of the price paid for shares in the joining entity, it cannot be argued that this payment results in offsetting assessable income, except in the very rare case where the vendor of shares is liable to CGT at the rate of tax applicable to ordinary income.

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The amendments may have the unintended effect of attracting the operation of s.40-880 (the ‘black hole’ deduction) for notional capital expenditure not otherwise deductible. The measures could operate as a de facto five year depreciation regime for intangibles as a result. The deduction for income streams[16] may extend to ‘passive’ income arising under contracts, *e.g.*, for wet leases of boats, because the limitations expressed in the explanatory memorandum do not appear in the statute.

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[16] Section 701-90

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