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RESPONSE DATE:

SUBJECT: The application of consolidation to swaps and certain other intangibles

RECOMMENDATION

Please note our advice on the application of subsection 701-55(6) of the *Income Tax Assessment Act 1997* to swaps and certain non-contractual intangible assets.

BRIEF OVERVIEW OF ISSUE

When an entity becomes a subsidiary of a consolidated group (called the joining entity) the price paid by the consolidated group for the joining entity's shares and the value of the joining entity's liabilities is allocated to the joining entity's assets. Subsection 701-55(6) and section 701-90 stipulate how the amount allocated to certain of the joining entity's assets, called the tax cost setting amount, is used by the head entity for the purposes of determining its income tax liability.

The issue is the interpretation and operation of subsection 701-55(6) to set the tax cost of assets that either were acquired by the joining entity for no cost, or were not acquired by any taxpayer but internally generated by the joining entity.

The application of subsection 701-55(6) to 'in the money' swaps converts part of the capital cost of acquiring shares into notional expenditure of acquiring swaps which, if notionally acquired in deductible circumstances results in deductions under section 8-1.

Section 22

The problem may continue to exist for swaps under Division 230. Section 715-375 does not appear to deem the receipt of a financial benefit equal to the value of the liability assumed.

BACKGROUND & EXPLANATION

The purpose of this minute is to respond to a request for Tax Office advice from Treasury on the application of subsection 701-55(6) to swaps and certain non-contractual intangible assets. The minute also discusses some of the issues around the interaction between consolidation and Division 230 as they apply to swaps. The minute briefly canvases some of the issues around the application of section 701-90 to rights to future income.

The advice is attached at Appendix A.



Appendix A swaps
and certain other inta

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Consolidations: swaps and certain other intangibles

This appendix first makes some observations about the operation and effect of subsection 701-55(6) and section 701-90 of the *Income Tax Assessment Act 1997*¹. It then discusses how subsection 701-55(6) applies to swaps and certain non-contractual intangible assets. It also discusses interaction issues between consolidations and Division 230 as they apply to swaps.

The Tax Cost Setting Process

When a consolidated group acquires a subsidiary (the joining entity) the tax cost of all of the joining entity's assets are reset. The purpose of doing so is to align the tax cost of the assets of the joining entity with the tax cost of the shares in the joining entity. The cost setting process takes the price paid for the shares in the joining entity and adds to it the accounting liabilities of that entity and then allocates that cost to the assets of the entity on the basis of their market values.

Section 701-55 provides that this amount, called the tax cost setting amount, is to be used by the head entity for the purposes of determining its income tax liability. Different subsections of 701-55 deal with the application of different provisions of the ITAA 1997 or ITAA 1936. The recently amended subsection 701-55(6) is the residual provision and has significantly expanded the range of assets whose tax cost setting amount is used in determining the head entity's assessable income or allowable deductions.

Subsection 701-55(6) only applies if a previous subsection of section 701-55 does not apply. Subsection 701-55(6) applies to assets that are accounted for under the ordinary income provisions (and therefore effectively not taxed under the Capital Gains Tax (CGT) regime). These assets are sometimes called revenue assets and may include swaps, other derivatives, and potentially any contract that is entered into by the joining entity in the ordinary course of its business. It may also apply to certain things that are not CGT assets but have been recognised in accounting as constituting assets (such as know how, customer relationship assets and core deposit intangibles).

Section 22

¹ All references are to the ITAA 1997 unless otherwise indicated.

Section 22

Subsection 701-55(6) converts capital into revenue

Subsection 701-55(6) takes what is generally a capital value, being part of the cost of acquiring the joining entity's shares, and converts it into revenue by requiring that the head entity use this value in calculating its assessable income or allowable deductions from the joining entity's assets.

Other subsections in 701-55 have the same effect. In the case of depreciating assets, trading stock or assets acquired for the purpose of making a profit by realisation an existing tax cost is restated, and generally increased.

In the case of contracts, such as swaps, that are entered into for no cost and in respect of which income is made from holding them and not from disposing or realising them, a cost will be attributed to them that shelters future income made under the contract.

If certain non-contractual intangible assets are recognised under the consolidations regime, a cost will be attributed to them in circumstances where arguably no asset was acquired by anyone, including the joining entity and for no cost. If the notional expenditure is able to be characterised as being on capital account, it will be deductible over 5 years under section 40-880.

The amendments to subsection 701-55(6) have greatly extended the range of circumstances in which capital expenditure on shares will be converted into revenue deductions. This is a problem because assets held on capital account, such as shares, are taxed differently from assets held on revenue account.

Section 22

Section 22

The interpretation of subsection 701-55(6)

The basic interpretative problem in applying subsection 701-55(6) is whether the notional outgoings are to be given a revenue or capital character. This is a factual question; and the asset itself is not sufficient to determine whether, for instance, section 8-1 applies or not. Rather, whether section 8-1 applies to the asset will depend on how the asset is used in the taxpayer's business, and therefore will require recourse to various facts specific to the taxpayer's business. This then raises the question of which facts should be considered; and further should recourse be had to whether, in fact, section 8-1 applies to the asset in history rather than using the facts to determine whether section 8-1 could theoretically apply to the asset if it had been acquired for a cost.

The terminology in subsection 701-55(6) suggests that the purpose of the words 'as if the cost, outgoing, expenditure or other amount had been incurred or paid to acquire the asset' is to first, deem the relevant taxpayer to have incurred or paid an amount ('the notional expenditure'), and second, to provide a particular context to the notional expenditure. In other words, the notional expenditure has the nature of an expenditure or cost made to acquire the relevant asset. The acquisition does not otherwise have any tax effect, that is, the head entity is not taken to have acquired the relevant asset for income tax purposes.

The note to subsection 701-55(6) explains that the function of subsection 701-55(6) is to modify the application of the provision only for the purposes of determining the amount included in assessable income or the amount of the deduction. Furthermore, subsection 701-56(1) suggests that the function of subsection 701-55(6) is to replace the cost or expenditure originally incurred or paid by the joining entity to acquire the asset with the asset's tax cost setting amount. That subsection clarifies that only the amount expended on the acquisition of the asset and that this amount has been deducted are affected by subsection 701-55(6). Therefore, for instance, the date of acquisition of the asset will still be the date when the joining entity acquired it³.

This creates a situation where there is a notional expenditure incurred at the joining time, but in respect of an acquisition that occurred in history. In the case of internally generated assets, such as customer relationship assets and core deposit intangibles, there will be no relevant history because no asset was actually acquired by anyone. In the case of contractual assets, such as swaps, there is a history of acquisition⁴ but no amount was expended on that acquisition, and therefore no amount has been deducted or taken into account in determining the gain or loss from the swap.

Section 22

³ Paragraph 5.14 of the Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No.1) Act 2010.

⁴ The entry into the swap contract is an acquisition of the swap within the ordinary meaning of that word: *Allina Pty Ltd v. FCT* (1991) 21 ATR 1320; 91 ATC 4195.

Alternatively, subsection 701-55(6) could be construed as deeming there to be an acquisition of the asset at the joining time in the course of the business of the joining entity. This deemed acquisition only occurs for the purpose of enabling a deduction for the asset's tax cost setting amount; the date of acquisition of the asset remains unaffected. Therefore, this would result in the restatement of revenue deductions for assets acquired on revenue account, the creation of revenue deductions for assets acquired on revenue account for no cost and also the creation of revenue deductions for assets not acquired at all, but which would be acquired on revenue account if they were to have been acquired⁵. If these assets were acquired on capital account, or would be acquired on capital account if they were to have been acquired, and they are not CGT assets, the section produces notional expenditure that may be deductible under section 40-880.

Sections 701-90, 716-405 and 716-410

Sections 701-90, 716-405 and 716-410 provide deductions for rights to future income over a period of ten years or the term of the contract, whichever is lesser.

Where section 701-90 applies, a revenue character is given to the notional expense, but the deduction is spread over 10 years. It thus acts to reduce costs to the revenue where section 701-55(6) would give an outright deduction in the year of consolidation, but increases it where the character of the notional expense would be on capital account.

The interpretation of section 701-90

Section 701-90 regulates which rights are eligible for deduction under section 716-405. Eligibility essentially rests on whether there is a valuable right 'to receive an amount for the performance of work or services or the provision of goods (other than trading stock)'.

The Tax Office has not finalised its views in relation to the meaning of the various phrases appearing in section 701-90. However, it should be noted that many of the phrases are capable of being construed widely such that the valuable rights comprehended by section 701-90 may cover everything except for trading stock and land. In particular, it is unlikely that section 701-90 will be able to be construed in a manner that gives effect to the distinction identified at paragraphs 2.10 to 2.12 of the Supplementary Explanatory Memorandum between rights that result in passive or active income. The limitations expressed in the Explanatory Memorandum do not appear in the provision. The issues currently under consideration follow:

- What is a *valuable* right? Wide view: can you sell the right and if so, it is valuable and the question is what would you get for it. Narrow view: right is not valuable unless accountants would give a value separate from some other asset, which occurs only if it is in-the-money and adds to the value of the asset. Thus if I own goods which I have leased, I do not value the lease unless the goods are leased for more than their value.

⁵ If the asset was internally generated, and not acquired, it would have no date of acquisition because this can only be supplied by history.

- What is a right (including a *contingent* right)? By way of illustration, a phone contract generally lasts for only two years but will continue unless the customer elects not to roll it over. The continuation of the rights of a phone company are thus contingent on the customer's decision. Do I value the two year contract or punt that the customer will continue. (The latter view is more expensive to the revenue.) As a matter of law there is obviously a contingent right, but this takes value from goodwill, because the propensity of customers to stay where they are is part of goodwill. If contingent is given a broad meaning the head entity will effectively obtain a deduction for goodwill, or something akin to it.
- What is the performance of work or services? Is insurance a service? (Not sure.) Is a phone contract a service? (Probably) Is a franchise a service? (Depends on what the franchisor does.) What about an actively managed lease of a shopping centre? (Unlikely). Here the essential question is whether the performance of services has a broad, GST-like meaning, or means something like personal services. Note that including insurance as a service reduces the cost of the measures, but the other examples probably increase it.
- What are goods? Tangible chattels or anything goods in law, like trademarks and copyright? Goods might mean tangibles, making the provision narrower and more active. But in the provision as a whole it looks as if all is comprehended except trading stock and land. We incline to read 'goods' as tangibles.
- What is the *provision* of goods? Does it include a lease? Most likely, although this is contrary to what the explanatory memorandum says.

It is also to be noted that the Tax Office anticipates that it will have disagreements with taxpayers about the identification and valuation of the asset recognised under section 701-90. How successful the Tax Office will be in this regard will depend on how the requirements in section 701-90 to take into account all the obligations and conditions relating to the right are construed.

Section 22

Section 22

Section 701-55(6) will deem a payment to have been made as if the 'in the money' swaps had been acquired. The Tax Office is of the view that this notional expenditure is deductible on maturation or expiry of the swaps (the majority of which expire within five years). However, it should be noted that if the issue were to be tested in court there is an even chance that it could be considered deductible at the joining time.

Section 22

Section 22

Section 22

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Intangible assets that are not CGT assets

Assets that are not ordinarily recognised under the Tax Act, such as know how, relationship assets or core deposit intangibles, may be eligible for deduction under section 40-880. These assets are not ordinarily dealt with separately from the business, and in fact may not have any value separate from the business or particular assets of the business.

Subsection 701-55(6) deems a payment to have been made as if the non-contractual intangible asset had been acquired. If the intangible asset would be acquired on capital account if it were to be acquired this may be sufficient to satisfy the requirement of subsection 40-880 that there be 'business capital expenditure'.¹⁰

In TR 2004/13 the Tax Office provides that it will recognise assets that may not be tax assets when they are distinct from, and in addition to, the tax assets, their value being additional to, rather than part of, the value of the tax assets. This is to ensure that ACA is not over-allocated to the tax assets. The result is that there will be some 'wastage' of ACA to the extent that it is allocated to these non-tax assets. However, if section 40-880 applies to notional expenditure produced by the ACA process this would frustrate the policy of wastage of ACA.

Gaining a deduction under section 40-880 for what is, in essence, expenditure on acquiring an asset seems inconsistent with the policy underlying section 40-880. The notional expenditure secures an asset of enduring value; there has been no black-hole expenditure. However, the exclusions in section 40-880 may not be expressed widely enough to prevent a deduction.

The Tax Office is currently of the view that customer relationship assets and core deposit intangibles are a conceptualisation of an aspect of other tax assets, and in particular represent part of the legal and tax conception of goodwill. However, these matters are untested and without precedent, so there is a risk that the court may not agree.

Goodwill is a CGT asset that must have ACA allocated to it in accordance with subsection 701-55(5). It is our assumption that, first, goodwill as recognised for tax purposes must be valued as such, and not disaggregated into component parts even when such parts are otherwise recognised for accounting purposes, and second, that no duplication is permissible when applying subsection (6). Accordingly rights or non-CGT assets properly seen as part of goodwill are not allocated ACA under subsection 701-55(6) and cannot attract s.40-880 via that subsection. (It also follows that section 701-90 can have no operation in regard to such rights.) However this assumed priority of application is not explicitly stated by the Act. On another view, goodwill being a residual asset, subsection 701-55(6) is applied first, and ACA is allocated to goodwill only insofar as not already allocated under subsection (6).

¹⁰ There is however an issue of the extent of the deeming in subsection 701-55(6) and whether the notional expenditure is able to be characterised in the absence of real facts as to acquisition and expenditure.