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SUBJECT:	Advice regarding the rights to future income provisions contained in the consolidation legislation

Purpose

To provide advice about emerging problems with the rights to future income provisions contained in the consolidation legislation Section 22
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Background

The income tax law taxes consolidated groups of companies in common ownership as if they were one company. Australian rules for consolidation are unique: unlike other countries' we do not work out the tax liabilities of each member of the group in the usual way and then simply consolidate the tax and losses of each company in the consolidated group. Rather, we have special rules for consolidated companies, among the most complicated in the law anywhere, which displace the usual rules.

Relevantly, when a consolidated group acquires all the shares in another company ('the joining company') the actual capital cost of acquiring those shares is added to the accounting liabilities of the joining company to work out a notional amount, called the Allocated Cost Amount (or 'ACA'). This amount is then allocated to all the assets of the joining company (but not the liabilities) and displaces their historic or actual cost. This process is called 'setting the tax cost' of the assets. The rationale, again to speak generally, for this approach is that it seeks to assimilate buying shares in the joining company to buying its underlying assets and business.

Before recent amendments to the law were made, tax cost setting was confined, broadly speaking, to trading stock, depreciable assets such as plant and equipment, and CGT assets (basically, property held on capital account). Re-setting the tax cost of trading stock and depreciable plant could, and did, result in increasing the allowable deductions of the joining company because the ACA might exceed the historic costs of the relevant underlying assets.[1] However, the tax cost setting process did not result in deductions arising in respect of other kinds of revenue assets.

The failure of the provisions to result in deductions in respect of other kinds of revenue assets was considered by Treasury to be contrary to policy, and amendments were made last year, to apply retrospectively from 2002, to cause deductions to arise in respect of all kinds of assets. The section amended is s.701-55(6).

This amendment is proving to be very expensive. (Because it is retrospective, the reductions in tax it effects must be refunded, and with interest.)

Among other kinds of assets, the amendments apply to rights to future income from the performance of work or services and the provision of goods other than trading stock. These rights include contingent rights. A special rule, s.701-90, applies to these assets. Where ACA is allocated to assets of this kind, the tax cost setting amount is made deductible over ten years. The rule extends deductibility because it extends to capital amounts, but it also defers deductibility because it spreads the deduction over ten years instead of allowing it in the year of acquisition.

[1] Generally speaking, the amount received by the seller of shares is on capital account. Owing to the many concessions regarding capital gains, tax payable by the seller, if any, will rarely offset the reduction in tax for the buyer.

It has come to light that deductions claimed under this provision in particular are proving to be very expensive indeed. We understand that accounting firms are now marketing "grave-digging" services to companies (for fees contingent on success) to claim deductions in respect of previously unrecognised kinds of assets (see further below). In many cases the tax cost allocated to these previously unrecognised assets was allocated to the company's goodwill. In effect, deductions are being claimed for part of the value of goodwill. However, it should be appreciated that to some extent the rule is reducing the cost of the main amendment by spreading deductions over ten years.

Advice

The rights to future income rules apply to both partially performed and yet to be performed contracts for the performance of work or services or the provision of goods (other than trading stock).

Based on information received to date (in private binding rulings, objections, etc) the revenue risk from the rights to future income rules arises principally in relation to yet to be performed contracts. This is due to the following:

- the extremely close relationship customer contracts have with goodwill and the difficulty in determining the difference between contract value and customer relationship or goodwill value. Uncertainties regarding the scope of the rights covered by the rights to future income rules (see footnote[2]) contribute to this problem which has been greatly exacerbated by accounting standards introduced in 2005;
- the potentially very wide ambit of the term "performance of services or provision of goods" in the rights to future income rules meaning rights to future interest, insurance, leasing, licence, royalty income may also be covered (subject of course to the contract containing the right having a market value);

[2] The most important issue arising out of the operation of the rules is the meaning of the phrase "valuable right (including a contingent right)" in section 701-90. Contingent can mean different things depending on the context; it could have a broad meaning. The meaning of contingent right affects the identification and consequently the valuation of the right. Many contracts are renewable or terminable at will by customers. Advisors are interpreting this phrase as allowing value attributable to the expectancy or propensity of customers to stay where they are (value that is part of goodwill or akin to it) to be attributed to the right. In particular it is argued that the contingency of cancellation or renewal is covered by the phrase. The probability of cancellation or renewal can be calculated based on experience, and the value included as a contingent right to income. The outcome of such an approach is essentially that the taxpayer obtains a deduction in part for goodwill.

Another significant issue is what category of rights is covered by the rules. Section 701-90 is expressed to apply to valuable rights "to receive an amount for the performance of work or services or the provision of goods (other than trading stock)". The various phrases may be construed broadly. 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 and 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 rules.

The revenue impact of the rules depends on the extent to which value that would otherwise form part of goodwill is able to be attributed to the right, and also on what proportion the value of the rights comprise the joining company's assets. By attributing the customer relationship value to particular contracts a false impression of a wasting asset is created. In an on-going business customer based assets as a whole are self-regenerating, some customers leave but new customers are gained. However, there is a risk that some or all of the value said to be attributable to the asset as defined under the rules may be attributable to assets recognised under subsection 701-55(6), for example the contract or the customer relationship asset. A customer contract and the related customer relationship may represent two distinct intangible assets

- the valuation risks which exist in respect of any contract containing a right (including a contingent right) to future income, for example, the risk that taxpayers will value the right in isolation from the related obligations under the contract.

The risk may be addressed by narrowing and clarifying the operation of the rights to future income rules in respect of such contracts: however this alone will not solve the problem but will simply shift it from the rights to future income rules to the residual tax cost setting rule (subsection 701-55(6)).

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The value of such accounting assets is not attributable to any enforceable right the taxpayer holds under the contract to perform the services or provide the goods. Rather the value is based on the expectation of future income from existing customers irrespective of the fact the customer may terminate the contract at any time. These accounting assets are in the nature of goodwill and should form part of goodwill for tax purposes. However, without amendments to clarify this, taxpayers will continue to separately recognise and attempt to claim these assets for tax purposes. As a significant component of the value of a joining entity is made up of these accounting assets the revenue risk, if not dealt with, is extreme.

In another case a taxpayer has identified and valued a lease for consolidation purposes on the basis of the gross future lease receipts, ignoring completely the related obligations (such as the cost of supplying the underlying leased property). The taxpayer has advised that if the rights to future income rules do not apply they will apply the residual tax cost setting rule and deduct the tax cost of the lease asset under the general deduction provision.

Therefore the revenue risk is not solely a rights to future income one but is a more fundamental consolidation asset recognition one. (One way of looking at it is to regard it as a question of how to define and value goodwill in a way that does not permit value to "leak" into other assets.) Section 22

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