ATO MINUTE	**117/2011**	7 MARCH 2011	
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Australian Government
Australian Taxation Office

ATO MINUTE

FILE REF: [FILE NO.]

TO:	, General Manager, Business Tax Division
COPIES TO:	, FAC Corporate Relations, Australian Taxation Office; , Manager, Business Tax Division, Treasury , Second Commissioner, ATO , Second Commissioner, ATO , Deputy Chief Tax Counsel, ATO , Deputy Commissioner, Large Business & International, ATO Treasuryatogateway@treasury.gov.au Atotreasurygateway@ato.gov.au
TREASURY REF:	

FROM:	, Chief Tax Counsel		
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OTHER REFS:	ATO minutes Section 22 091/2011		

CATEGORY:	**Pre Policy Approval**

ISSUE DATE:	7 March 2011	RESPONSE DATE:	8 March 2011
SUBJECT:	Consolidation – problems with the rights to future income and residual cost setting rules		

RECOMMENDATION

1. We recommend that you:

   - modify your draft advice to the Assistant Treasurer to recommend support for the Board of Taxation's advice to urgently announce a review of the rights to future income and residual cost setting provisions (sections 701-90, 701-55(6) and related provisions); and

   - provide any comments on our draft minute to the Assistant Treasurer on this matter by 2pm, 8 March 2011.

BRIEF OVERVIEW OF ISSUE

Section 22

3. On 24 February 2011 the Board of Taxation wrote to the Assistant Treasurer recommending that the Government announce its intention to review the rights to future income rules to clearly define and limit their scope of operation with effect from 1 July 2002 and that this announcement be made urgently. The Board took this action because they are concerned that the revenue cost of the rules could be substantially greater than anticipated.

4. The Board noted the aggressive activities of some tax practitioners who have been offering tax services on a contingency fee basis to review their clients' tax returns back to 2002 to find deductions for rights to future income. Also the Board had heard that purchase price negotiations for company acquisitions had begun to factor in the deductibility of such rights with substantial market value.

5. Your draft advice to the Assistant Treasurer on this issue, sent to us on 3 March 2011, recommends seeking advice from the Commissioner on the nature and timing of any announcement of his interpretation of the consolidation rights to future income rules before taking any action.

6. The Assistant Treasurer's office has also sought the ATO's views on these issues. A draft of the minute we intend to send to the Assistant Treasurer tomorrow is attached.

EXPLANATION

7. The attached draft ATO minute to the Assistant Treasurer sets out our views on this matter, and our current understanding of the revenue impact. We do not consider that the delay recommended in your draft minute is warranted, nor do we think any announcement of the Commissioner's interpretation of the relevant provisions will do anything to resolve the significant risks highlighted previously by us and also in the Board's letter to the Assistant Treasurer.

8. You should note that the rights to future income and residual provisions affect a wide array of circumstances, such that it would not be possible for the Commissioner to announce a general view at one time that would deal with the interpretation of the provisions. In any event, it is most unlikely that the ATO will be able to adopt a general interpretation of the provisions that protects the revenue – there is no administrative fix available. In many cases we will have to allow taxpayers' claims. Fundamentally, there is a problem with the legislation.

9. In our view there is a window of opportunity now for the Government to make an announcement before more claims are lodged. Because of the risks that are building, it is not appropriate to defer any action or announcement until the ATO has finalised its view on the interpretation of the rules. Because of the complexity of the issues, we have so far been taking a neutral stance in public discussion on this issue. That incidentally gives the Government time to act. However, we are obliged to process taxpayer claims in accordance with the law.

Chief Tax Counsel

AUSTRALIAN TAXATION OFFICE

MINUTE PAPER

NO.

Date: 7 March 2011

Assistant Treasurer and Minister for Financial Services and Superannuation
Parliamentary Secretary to the Treasurer

TAXATION ADMINISTRATION: CONSOLIDATION –PROBLEMS WITH THE RIGHTS TO FUTURE INCOME AND RESIDUAL COST SETTING RULES

Action required by: Urgently.

Recommendation:

That you note the contents of this advice.

Signature ________________________ **Date** _____/ _____/ ______

KEY POINTS

1. This minute provides advice requested by your office about the problems with the rights to future income rules as well as their revenue impact. The rights to future income rules allow a consolidated group deductions for certain assets held by an entity that joins the group. They were enacted in June 2010 with effect from 1 July 2002.

2. On 24 February 2011 the Board of Taxation wrote to you recommending that the Government announce its intention to review the rights to future income rules to clearly define and limit their scope of operation with effect from 1 July 2002 and that this announcement be made urgently. The Board took this action because they are concerned that the revenue cost of the rules could be substantially greater than anticipated.

3. The Board noted the aggressive activities of some tax practitioners who have been offering tax services on a contingency fee basis to review their clients' tax returns back to 2002 to find deductions for rights to future income. Also the Board had heard that purchase price negotiations for company acquisitions had begun to factor in the deductibility of such rights with substantial market value.

4. Although the Board's focus is on the rights to future income rules, the risk to revenue cannot be addressed by simply narrowing and clarifying the operation of these rules. This is because, if a deduction is denied under the rights to future income rules, the deduction may then be allowed under the residual tax cost setting rule (the residual rule), with an even higher cost to revenue in some cases. The current residual rule was introduced as part of a legislative package with the rights to future income rules enacted in June 2010.

5. Therefore, to reduce the revenue impact of the rights to future income rules it is also necessary to review the residual rule. In any event, the residual rule is itself having a much higher than anticipated impact on the revenue: indeed, it is unclear which will prove the more expensive measure. Future company acquisitions will exacerbate this revenue impact. (Refer to Attachment A for additional information.)

6. The current revenue cost of the rights to future income rules and the residual rule is approximately $3.5 billion for the forward estimates period. Of this amount about $1 billion relates to rights to future income and $2.5 billion to the residual rule. (The ATO is considering further claims for an additional $2 billion in tax and many of these are expected to become a cost to revenue under one of the two rules.) This is a minimum cost to revenue based on known cases and does not include interest payable by the ATO on claims backdated to 2002.

7. A large number of claims relating to rights to future income and the residual rule involve financial institution acquisitions that occurred during the global financial crisis. Section 22 Section 22

   We are concerned that future company acquisitions, for example in the finance industry, are likely to result in substantial additional claims.

8. Under the current rules consolidated groups have until June 2012 to have their prior year tax returns, going back to 2002, amended for rights to future income claims (or alternatively claims under the residual rule). We understand tax practitioners have been holding off lodging claims for clients until the ATO expresses a view on the scope and interpretation of the rules.

9. In our view there is a window of opportunity now for the Government to make an announcement before more claims are lodged. Because of the risks that are building, it is not appropriate to defer any action or announcement until the ATO has finalised its view on the interpretation of the rules. It is most unlikely that the ATO will be able to adopt a general interpretation that protects the revenue. In many cases we will have to allow taxpayers' claims. Because of the complexity of the issues, we have so far been taking a neutral stance in public discussion on this issue. That incidentally gives the Government time to act. However, we are obliged to process taxpayer claims in accordance with the law.

10. Even in cases where we deny claims, given the significant revenue involved and the reasonable arguments available to taxpayers, the issues will be contested in the courts. This process could take some time and taxpayers may ultimately win. In the meantime company acquisitions may generate further significant deductions with a very substantial impact on the revenue. Retrospective amendments will then be difficult.

11. Accordingly, we support the Board's recommendation that you announce a review of the rights to future income rules (and the residual rule) to clarify and limit their scope with effect from 1 July 2002. This might have the effect of curbing the current industry activities the Board highlighted in their letter and it would alert the market so that future company acquisitions do not factor these tax benefits into their pricing negotiations. It would enable the significant revenue impact of the rules to be redressed.

12. If you decide to announce a review of the rules the ATO would work with Treasury to urgently develop legislative options to address these issues.

Second Commissioner

ATTACHMENT A

ADDITIONAL INFORMATION

Background to the rights to future income rules and residual rule

1. The income tax law taxes consolidated groups of wholly owned companies as if they were one company. 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 tax amount. This amount is then allocated to all the assets of the joining company and replaces their historic or actual cost. This is called the tax cost setting process. The rationale for this approach is that it seeks to assimilate buying shares in the joining company to buying its underlying assets and business.

2. 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 assets 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 new tax cost might exceed the historic costs of the relevant underlying assets. However, the tax cost setting process did not result in deductions arising in respect of other kinds of revenue assets.

3. 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 in June last year, to apply retrospectively from 2002, to cause deductions to arise in respect of all kinds of assets.

4. The main amendment, the residual tax cost setting rule (the residual rule), ensured that the tax cost setting process would result in an immediate deduction arising in respect of these other kinds of assets, particularly revenue assets.

5. However, a specific amendment was made for one class of assets, rights to future income from the performance of work or services and the provision of goods other than trading stock. Where tax cost is allocated to assets of this kind, the tax cost is generally made deductible over ten years.

6. It has come to light that deductions claimed under the rights to future income rules in particular are proving to be very significant. 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. 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 rights to future income rules are reducing the cost of the residual rule by spreading these deductions over ten years. That is, in the absence of the rights to future income rules, the residual rule may provide an immediate deduction for the full tax cost of the asset.

Problems with the rights to future income rules and the residual rule

7. The rights to future income rules apply to contracts for the performance of work or services or the provision of goods (other than trading stock). Based on information to

date (in private rulings, objections, amendment requests, etc) the main revenue risks are due to:

- Amounts that were previously included in goodwill being claimed as separate rights to future income assets. Section 38

- The potentially wide scope of the rights that may be covered meaning rights to interest, insurance, leasing, license and royalty income may be covered; and the valuation risks which exist in valuing contracts containing a right to future income, such as the risk that taxpayers will value the right in isolation from the related obligation under the contract. For example, 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). Again, the taxpayer has advised that if the rights to future income rules do not apply they will apply the residual rule and deduct the full tax cost of the lease asset immediately.

8. The risk to revenue cannot be addressed by simply narrowing and clarifying the operation of the rights to future income rules: this will just shift the problem to the residual rule. The risk to revenue is not solely a rights to future income one, but is a more fundamental asset recognition one.

Revenue implications of the measure

9. While much of the focus so far has been on the rights to future income rules, the residual rule is itself giving rise to a very significant cost to revenue. The revenue cost for the residual rule for the forward estimates period is approximately $2.5 billion. In addition, the revenue cost of the rights to future income rules is about $1 billion (with further claims of $2 billion in tax currently being considered by the ATO). This is a minimum cost to revenue based on known cases and does not include interest payable by the ATO on claims backdated as far as 2002, which is also likely to be significant. We have anecdotal evidence that accounting firms are gearing up to lodge further significant claims in the coming months.

10. The effect of the residual rule in relation to financial institution acquisitions is of particular concern. A large number of claims relate to financial institution acquisitions that occurred during the global financial crisis. Section 22

Section 22