Mr William Potts
The Treasury
Langton Crescent
Parkes ACT 2600

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Contact Edgar Baltins, 02 9335 8254

1 March 2006

Dear Sir

Taxation Laws Amendment (Taxation of Financial Arrangements) Bill 2006

On behalf of Retirement Village Association Limited (**RVA**), we make the following submissions in relation to the Exposure Draft (**Exposure Draft**) of the Taxation Laws Amendment (Taxation of Financial Arrangements) Bill 2006 (**TOFA Bill**).

Submission

The stated objects of the TOFA Bill are to minimise the extent to which the tax treatment of financial arrangements distorts trading, financial and investment decisions; in other words, to reduce opportunities for tax deferral and tax arbitrage. The features of distortion, deferral and arbitrage are not currently present in the tax treatment applicable to retirement village arrangements.

For this policy reason and for the reasons discussed further below, RVA submits that the tax timing rules proposed in the TOFA Bill should not apply to retirement village arrangements covered by Taxation Ruling TR2002/14.

To avoid any doubt and confusion in the industry, RVA requests Treasury to confirm that:

- Retirement village arrangements [within the meaning of ‘arrangements’ to which TR2002/14 applies – refer paragraph 3] are not considered to be covered by the definition of ‘financial arrangement’ for the purposes of Division 230 and will therefore not be affected by the TOFA rules;

Or, alternatively,

- If retirement village arrangements [within the meaning of ‘arrangements’ to which TR2002/14 applies – refer paragraph 3] are considered to be covered by the definition of ‘financial arrangement’ for the purposes of Division 230, the TOFA Bill will be amended to include a specific exception to ensure that retirement village arrangements will be an exception to which Division 230 will not apply.

Background

Since the early 1990s, the Retirement Village industry has had two extensive rounds of consultation with the Australian Taxation Office regarding the income tax treatment of the arrangements entered into between retirement village owners/operators and the village residents. Those consultations resulted in:

- The issuance of Taxation Ruling TR94/24 effective from 1 July 1994,
- The withdrawal of TR 94/24 on 19 April 2000, and
- The issuance of TR2002/14 on 28 June 2002.

The three year period before 1 July 1994, and the intervening period after withdrawal of TR 94/24 and the issuance of TR2002/14 were periods filled with fiscal uncertainty within the industry. This was not assisted by TR2002/14 prescribing a fundamentally different (albeit fundamentally technically correct) income tax treatment to the position established by TR94/24. Already, this has added significant costs to ensure accurate transition into and out of TR94/24.

Retirement village projects are large capital projects extending over 30 to 50 years and industry participants generally do not enter the industry without prudent analysis of the financial profile of their proposed investment. The industry does not welcome and does not wish to be impacted by a third substantial shift in the income tax treatment of their arrangements given:

- the long term nature of the assets required to operate a retirement village business,
- the lengthy average term of each resident’s occupancy, and
- the second of the tax rulings is not yet 4 years old.

Application of TOFA Bill

It is not clear from the Exposure Draft whether this will be the outcome under the final TOFA Bill. In particular, the industry is concerned that some aspects of the typical retirement village arrangements may be caught up in the TOFA rules, thereby introducing a new tax timing mismatch that does not currently exist.

Deferred management fees

A large number of operators in the “for profit” sector, which comprises about 50% of the retirement village industry, are small business operators. The other half of the industry comprises “not-for-profit” and charitable retirement village operators. Both sectors use similar Deferred Management Fee (**DMF**) structures.

DMF are payable by an outgoing resident (or their estate) to the retirement village owner/operator on termination of the resident's occupancy. Such DMF may be calculated as a specified percentage (usually based on the term of occupancy) of either:

- the outgoing resident's total ingoing, or
- a subsequent resident's total ingoing.

In either case, the DMF generally cannot mature into a recoverable debt before the resident ceases to reside in the village and certain conditions precedent have been fulfilled by the village owner/operator. DMF calculated by reference to the subsequent resident's total ingoing generally cannot mature into a recoverable debt until the subsequent resident has entered into an occupancy agreement with the village owner/operator.

The industry's concern is that the DMF may be caught up in the definition of a 'financial arrangement' and, on that basis, the retirement village owner/operator may be required to recognise some amount of DMF after each anniversary of the commencement of the occupancy arrangement. In other words, the industry considers it totally inequitable for a situation to arise where tax is payable on DMF before there is any legal entitlement to receive it. This issue was fundamental in the abovementioned ATO negotiations. Possible adverse consequences include:

- The price of retirement village accommodation may have to be increased so that such tax may be funded;
- The retirement village owner, having insufficient funds to pay such tax and therefore facing insolvency, may be forced to either sell the retirement village or place his company into liquidation: the flow-on impact to aged residents who have invested a significant proportion of their life savings is obvious;
- The value of retirement villages (as investments) may decline, thereby reducing the incentive for new villages to be constructed given no matching reduction in construction costs;
- Professional valuations of expected future cash flows are used in the industry as Bank Security for current working capital borrowings to operate retirement villages and to fund further staged development. If these cash flow valuations are impaired, due to tax on DMF being assessed and paid in advance several years before actual receipt of the DMF, then Bank Security for current borrowings will be lowered, with a corresponding cutback in some resident services and probable financial distress for many small business in the "for-profit sector". If for-profit sector retirement village cash flows are taxed early but charitable operators using the same DMF structure do not have to pay tax (for other reasons), then the TOFA Bill will introduce competitive disequilibrium.

It also seems unreasonable to apply the TOFA Bill to retirement village contracts given that DMF:

- is assessable income in the hands of the recipient, but
- not deductible in the hands of the payer (resident).

In other words, there is no tax timing mismatch between payer and payee.

Sharing of capital gain

In lease/licence style arrangements, it is not uncommon for an outgoing resident (or his or her estate) to become entitled to a share of a capital gain (that arises on the subsequent re-sale/re-lease/re-licence of the unit of accommodation following termination of the outgoing resident's occupancy).

The industry would be most concerned if assessability could apply on the DMF income side, but deductibility over time would not be available for the payment of any capital gain component. As it could not be said that an actual net loss for the capital gain component is reasonably likely at any point in time until actual re-sale/re-lease/re-license, this would have the effect of creating a tax timing mismatch where no such mismatch exists under the current application of the law. This seems entirely at odds with the objects underlying the TOFA rules to the extent that they are to apply.

In strata title arrangements, an outgoing resident whose lot is sold may be required to pay a share of any capital gain to the retirement village operator. RVA requests that Treasury confirm the TOFA Bill will not apply to change the current tax treatment applicable to this aspect of retirement village arrangements.

Notwithstanding our specific comments, RVA submits that the TOFA Bill should not be applied to any payments under retirement village contracts.

Lease termination payments

It is becoming increasingly common for the relevant occupancy arrangement to provide for a Lease Termination Payment (LTP) to be payable by either the outgoing resident (or his or her estate) or the retirement village owner/operator. The LTP is typically calculated as the net of DMF and capital gain calculation components such that:

- the resident pays the LTP if the DMF component exceeds the capital gain component, and
- the owner/operator pays the LTP if the capital gain component exceeds the DMF component.

In other words, who pays and how much they pay cannot be determined with any certainty before the end of the occupancy arrangements. To attempt to apply the TOFA Bill in such circumstances would be highly impractical and are most likely to give rise to tax timing adjustments over the term of an arrangement varying between annual assessable and deductible amounts. Such an occurrence would be totally unreasonable in the context of retirement village operations!

Alternatively, one interpretation of the TOFA Bill is that retirement village arrangements involving LTPs should not be affected by the tax timing rules until the income year in which the outgoing resident's occupancy arrangement terminates provided the fair value treatment does not apply. Under this interpretation, for each income year prior to that last income year, it would not be possible to conclude that it was reasonably likely that an actual net gain will be made or that an actual net loss would be made.

Though RVA submits that the TOFA Bill should not apply to any retirement village contracts, please confirm that Treasury agrees with this alternative analysis if it decides to apply the TOFA Bill to these contracts.

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We look forward to your favourable consideration of these submissions and to receiving your responses.

Please contact us if you have any questions. We would be happy to arrange a meeting to discuss the matters raised in these submissions further should you consider it appropriate.

Yours faithfully

Edgar Baltins
Partner