Playing with Fire: Resetting Cost Bases of Assets in Consolidated Groups

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The Story

• Australia’s consolidation regime:
  – Introduced in 2002
  – the first “asset-based model”
  – Regular fine-tunings ever since

• “Fine-tuning” in June 2010:
  – Unintended and unforeseen revenue impact of A$10 billion

• Aims of the research:

What has happened? Why did it happen? The Lessons
What has happened?

The 2010 Amendments

2004: ATO draft tax determination:
- No deduction for WIP of joining subsidiary

2005: Original intention of the government:
- WIP: equal treatment between consolidated and unconsolidated groups

2010: amendments in respect of rights to future income (RTFI) and residual tax cost setting (TCS) rules:
- RTFI: new generous specific deduction *only for consolidated groups* with far wider scope than WIP (e.g. mobile phone contracts)
- Residual TCS provision: confirm treatment of reset cost bases of assets not explicitly stipulated in the tax law (e.g. consumables and revenue assets)

In less than ten months after the 2010 amendments became effective, corporate groups lined up to claim tax refunds amounted to A$10 billion
March 2011: Government asked Board of Taxation to urgently review the 2010 amendments

May 2011: Board of Review produced a report

November 2011: Government announced its intention to amend retrospectively the 2010 amendments

July 2012:
- Retrospective amendments to retrospective legislation
- Complex matrix with 3 sets of rules applying to 3 periods
- Removed the 2010 specific deduction provision for RTFI
- Instead, amended existing deduction provisions to cater for reset WIP amounts of consolidated groups
- Limit scope of assets eligible for TCS
What has happened?

The Unforeseen Revenue Impact

• Original Bill:
  – The 2010 amendments would have “a small but unquantifiable cost to revenue”

• Promptly after the introduction of the Bill to the parliament:
  – Changed the estimated revenue impact to: “a significant but unquantifiable cost to revenue”
<table>
<thead>
<tr>
<th>Category</th>
<th>Types of assets</th>
<th>Amounts claimed</th>
<th>The 2012 amendments</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>RTFI rule</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>WIP</td>
<td>$1.2B</td>
<td>✓ (only for unbilled “already performed” services)</td>
<td>✓ (for both unbilled “already performed” services and non-contingent services)</td>
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<tr>
<td>B</td>
<td>RTFI (other than WIP) covered by examples in EM to 2010 amendments (note 1)</td>
<td>$0.6B</td>
<td>×</td>
<td>✓</td>
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<tr>
<td>C</td>
<td>Lease and service contracts</td>
<td>$9.7B</td>
<td>× (note 4)</td>
<td>× (note 4)</td>
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<tr>
<td>D</td>
<td>RTFI not covered by EM</td>
<td>$2.5B</td>
<td>×</td>
<td>×</td>
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<tr>
<td>Residual TCS rules</td>
<td></td>
<td></td>
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<tr>
<td>E</td>
<td>Consumable stores</td>
<td>$0.5B</td>
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<td>✓</td>
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<tr>
<td>F</td>
<td>Residual TCSR assets covered by EM examples (note 2)</td>
<td>$0.8B</td>
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<tr>
<td>G</td>
<td>Revenue assets, including derivatives and insurance contracts</td>
<td>$11.6B</td>
<td>✓ (except certain insurance contracts)</td>
<td>✓</td>
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<tr>
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<td>Goodwill-like assets (note 3)</td>
<td>$3.2B</td>
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<tr>
<td>Total</td>
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<td>$30.1B</td>
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</table>
Why did it happen?

The unique consolidation model

- **Joining**
  - Sub
  - Asset with original cost base

- **Parent**
  - Sub
  - Subsidiary deemed to have “disappeared”
  - Asset with reset cost base

- **Leaving**
  - Sub
  - Asset with reset cost base
  - Asset with original cost base

Consolidation: Asset-based model
Why did it happen?

• Single entity rule
  – A fiction detached from the reality
  – Creates uncertainties and controversies
  – ATO still struggling to understand fully its implications

• Difficult interactions with other parts of the income tax system
  – ATO draft determination: reset cost bases of WIP not “incurred” or “paid” by the head company
    • Against the *purpose* of the consolidation regime
The “minor” Issue: RTFI

- Tax policy principle 101: preferential provisions should be carefully drafted to ring fence its scope.
- Simplicity: revise existing provisions instead of creating new ones to minimise risk of unintended/unforeseen interactions with the notoriously complex consolidation regime.
Meaning of “asset” for TCS purposes

– Original meaning: economic concept
  – “anything of economic value”

– 2010 amendments: further encouraged taxpayers to separately recognise goodwill-like assets such as:
  – Expected future profits from insurance contracts;
  – Customer relationship, customer lists;
  – Know how, trade secrets

– 2012 amendments:
  – Under prospective rules, scope of TCS rules is limited to assets recognised by other parts of the tax law
  – However, not the most significant item in the Table...
The Lessons

Playing with Fire: the Structural Issue

• Treatment of “revenue assets”: untouched
  – Structural issue: *a deemed cost of a deemed acquisition* of an asset based on the market value of the asset at the joining time
  – Ignore legal facts to create “economically equivalent” fictions
  – Expose to manipulations fuelled by:
    • Ingenuity of taxpayers and tax advisers
    • Market valuation: an art more than a science
    • Time lag between share acquisition and joining time: e.g. the acquisition of St. George Bank by Westpac Bank

• Resetting cost bases
  – Tax arbitrage opportunities among different classes of assets