THE TAX INSTITUTE

12 November 2020

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Dear Mr Miller,

Draft Taxation Determination TD 2019/D11

The Tax Institute appreciates the Commissioner of Taxation (**Commissioner**) allowing additional time to lodge this submission in relation to Draft Tax Determination TD 2019/D11 *Income tax: where a liability is assumed on acquisition of a CGT asset, is the assumed liability excluded from the cost base of the asset if expenditure on discharge of the liability is deductible?* (**Draft Determination**) which was published for consultation on 30 October 2019.

Overview

The Tax Institute provides the following comments and observations for your consideration in order to help improve the final Draft Determination, including its explanations. All legislative references in this submission are to the *Income Tax Assessment Act 1997* (Cth) (**the 1997 Act**).

1 Understanding the relevant law

Our understanding of the relevant law is as follows:

- Section 112-15 provides that '*If a cost base modification replaces an element of the base of a CGT asset with an amount, this Part [Part 3-1] and Part 3-3 apply to you as if you had paid that amount.*'
- Section 112-35 provides that '*If you acquire a CGT asset from another entity that is subject to a liability, the first element of your cost base and reduced cost base of the asset includes the amount of the liability you assume.*'
- Subsection 110-37(1) provides that '*If a later provision of this Subdivision says that (a) certain expenditure does not form part of the cost base of a CGT asset; or (b) the cost base is reduced by certain expenditure; the expenditure is initially included in the cost base, which is then reduced by the amount of the expenditure just before a CGT event happens in relation to the asset.*'
- Subsection 110-45(2) is a later provision and it says that certain expenditure does not form part of the cost base. It provides that: *'Expenditure … does not form part of the cost base to the extent that you have deducted or can deduct it for an income year …*'

2 Background to the above

Subsection 110-45(2) was introduced following an announcement by the then Treasurer in the 1997–98 Budget[1]. Section 160ZJA of the *Income Tax Assessment Act 1936* (Cth) (**the 1936 Act**) was amended in the 1936 Act at the same time subsection 110-45(2) was introduced into the 1997 Act. That is, Parliament amended the 1936 Act and the 1997 Act to address situations that occurred both before and after the transfer of the CGT provisions from the 1936 Act to the 1997 Act. The Explanatory Memorandum to amend the legislation (including retrospectively in section 160ZJA) is referenced in the Draft Determination[2].

Subsection 160ZJA(1) provides that [the cost base of an asset is reduced by]:

> *any part of the consideration or of the expenditure that has been allowed or is allowable as a deduction to the taxpayer in respect of any year of income …*

When the then Treasurer announced in 1997 that the law would be amended, he said:

> *In principle an item of expenditure should either be deductible for income tax purposes, or included in the capital gains tax cost base of an underlying asset, but not both. However, anomalies in current tax treatment have given rise to double deductions in respect of certain capital items. A taxpayer can effectively claim the cost of the capital expenditure twice — first under the capital allowance (amortisation) provisions, and second from inclusion in the cost base of the underlying asset resulting in a reduction in capital gains when the asset is sold. One example is the building depreciation provisions. The Government has therefore decided to amend the law to ensure that expenditure can be included in the cost base of an asset only to the extent that deductions are not allowable, and the cost base of an asset must be calculated by reducing the expenditure on the asset by any deductions.*

When *Taxation Laws Amendment Act (No. 1) 1999* (16 of 1999) implementing subsection 110-45(2), was introduced, the Treasurer announced that:

> *The Bill will ensure that taxpayers will no longer be able to include amounts as part of the cost base of an asset to the extent the expenditure is deductible… The amendments are consistent with the principle that an item should be either deductible for income tax purposes or included in the capital gains tax base of an asset, but not both.*

The Explanatory Memorandum which accompanied the amending legislation provided that:

> *In principle, an item of expenditure should either be deductible for income tax purposes or included in the cost base of an underlying asset for CGT purposes, but not both. The amendments are designed to prevent taxpayers from including an amount of expenditure in the cost base of an asset to the extent that they would be able to claim a deduction for that expenditure.*

Respectively, the Explanatory Memoranda state:

- in the case of section 160ZJA — that expenditure will be reduced to the extent of any deductions that are allowable to the taxpayer in respect of those amounts; and
- in the case of section 110-45 — that some costs are not included in cost base, as an example of expenditure which is an allowable deduction.

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1 1997–98 BUDGET PAPER No. 2, Budget Measures 1997–98.

2 Explanatory Memorandum to the *Taxation Laws Amendment Bill (No. 2) 1998*.

Putting aside the particular words in each of the two new provisions inserted, the intention was for expenditure to be included in the cost base of an asset only to the extent that revenue deductions were not allowed as a result of the expenditure. The Treasurer's announcement went further in explaining the decision to amend the cost base rules, by saying:

> *In principle an item of expenditure should either be deductible for income tax purposes, or included in the capital gains tax (CGT) cost base of an underlying asset, but not both ...*
>
> *However, anomalies in the current tax treatment have given rise to double deductions in respect of certain capital expenditure items ...*
>
> *Examples where this problem can arise include in respect of expenditure on: extending telephone lines; connecting mains electricity; traveller accommodation; and buildings and structural improvements covered by Division 10D of the Income Tax Assessment Act 1997.*

3 Observations and recommendations

The general intention of the law as outlined above is understood. However, the Draft Determination is brief in its analysis and we believe it can be improved. The comments below take into account observations that have been made by our members and of which you may wish to take into consideration.

Paragraph 4

In Paragraph 4 of the Explanation in the Draft Determination, it is noted that in the absence of an assumed liability encumbrance, the cash consideration paid by a purchaser would have been higher. While this is likely to hold as a general proposition, it cannot necessarily be assumed that the cash consideration would be reduced by the full face value of the assumed liability. There are a range of arm's-length circumstances that may affect the cash consideration for the sale of an asset, including the fact that the purchase price may take into account the after-tax cost to a purchaser of paying out an assumed liability.

Paragraph 5

We would suggest that Paragraph 5 of the Explanation in the Draft Determination be reconsidered to take the following comments into account.

Paragraph 5 says that section 112-35 '*does not necessarily operate to 'fix' the cost base upon acquisition*'. We would agree that fixing the cost base is not the role of section 112-35. Rather, it applies so that an assumed liability can be included in the first element of cost base. The cost base is then reduced by section 110-45, if the circumstances of that subsection apply. Accordingly, perhaps the cost base is not best described as a 'fluid concept'. Rather, we would suggest that the cost base may be subject to subsequent increases (for example, because of improvements) or decreases (for example, because of deductions allowed) and this may be a better expression of the law.

Relevantly, Paragraph 5 also states that:

- the discharge of a liability will '*change the constituent components*' of the first element of an asset's cost base; and
- *'This is because the expenditure in discharging the liability is the latest representation of the same liability referred to in section 112-35*'.

The explanation in the Draft Determination of the expenditure in discharging an assumed liability being the '*latest representation of the same liability*' referred to in section 112-35 should be reconsidered or further explained. As it stands, the reference to the '*latest representation of the same liability*' is open to criticism as being unsupported or without legal precedent.

The Draft Determination risks oversimplifying the tax treatment of commercial arrangements between two sets of separate taxpayers, one between a purchaser and a vendor (for the assumption) and the other between a purchaser and a financier (for the discharge). The assumption and the discharge of a liability often occur between different parties and would be undertaken for different purposes (initially to secure the asset and later to release the encumbrance). This is true whether the expenditure to discharge the liability is deductible or not. It can be argued that the law does not allow for an amount originally included by section 112-35 in the cost base under the assumption of liability rule to later be replaced with a different amount of expenditure.

The use of the additional words '*any part of the consideration'* to the term '*expenditure*' may be argued to be relevant, in that by omitting the words in the 1997 Act, Parliament suggested a different approach and outcome. The use of the terminology seems to reflect the statutory conventions employed by draftspersons in the respective Acts. The 1997 Act uses '*expenditure'* as a general term, encompassing the result of many cost base and cost base adjustment rules. The 1997 Act does not use the term '*consideration'*. However, we note that the Explanatory Memoranda covering the amendments to the 1936 Act and the 1997 Act were in virtually identical terms.

Accordingly, we believe that greater explanation of the Commissioner's analysis of the relevant '*expenditure*' for the purposes of section 110-45 is necessary.

Further, the Commissioner's interpretation may be seen to be incongruous with his earlier published view on earnout arrangements in Draft Taxation Ruling 2007/D20 (withdrawn): *Income Tax: capital gains: capital gains tax consequences of earnout arrangements* (TR 2007/D20). Although withdrawn, TR 2007/D20 continues to represent the Commissioner's view on a range of transactions.

The expenditure to discharge a liability (whether assumed or otherwise) may itself be capable of inclusion in the cost base of an asset and subject to the necessary consideration as to whether section 110-45 applies. However, as is the established approach with earnout arrangements, any actual amount paid requires a separate tax inquiry.

Under a typical earnout arrangement, the buyer of a business, in addition to paying an initial monetary price, becomes subject to a future liability to pay amounts to the seller, depending on the performance of the business. An earnout arrangement is in many ways analogous to acquiring an asset subject to a liability. In both situations a taxpayer legally agrees with the purchaser to take on a future obligation (as part of acquiring an asset) and the quantum of that future obligation may or may not be known. An earnout is generally settled with the vendor, whereas an assumed liability could be with any number of other parties. The difference, however, does not change the fundamental principles the Commissioner outlines in TR 2007/D20 in relation to the cost base consequences of such an arrangement:

> *137. The payment by the buyer of an amount or amounts by way of discharge of an earnout right, or the expiry of an earnout right without payment, has no effect on the buyer's cost base for the original asset.*
>
> *138. To qualify for inclusion in the cost base of an asset, an item of expenditure is required to have a particular connection with the asset that is the subject of the CGT event. The amount paid by the buyer to discharge the earnout is not included in the buyer's cost base for the original asset under any of the five elements.*
>
> *139. Although the earnout right is given in respect of acquiring the original asset, the same is not true of amounts paid to discharge an earnout obligation. Such amounts are incurred to discharge a liability that is independent of an obligation to pay the purchase price of the original asset.*

TR 2007/D20 takes the view that it is necessary to include in the relevant asset's cost base (and in the seller's capital proceeds) the market value of the earnout right on inception of the arrangement. The fact that the quantum of liability assumed is later discharged — even by a different amount or even by a deductible amount — does not affect what is originally included. If this position is correct, and consistent with the Commissioner's administration of the law in relevant earnout arrangements, the preliminary view in the Draft Determination might be seen to be difficult to reconcile. Of course, any subsequent discharge event may, of course, trigger its own tax considerations, with reference to the appropriate tax provisions which may include adjustments to cost base.

Other potential applications of the interpretation in the Draft Determination

The ATO could consider providing separate guidance on how the concept articulated in the Draft Determination is intended to operate in other situations such as the following:

- What happens if the liability is subject to a deduction because of the application of TOFA (for example, because of a subsequent increase in the amount of the liability)?
- What happens if the liability is in a foreign currency and is subject to a deductible foreign exchange loss?
- How would the Draft Determination apply to a debt defeasance arrangement which replaces one liability with another?
- The tax treatment of a liability to rehabilitate a mine which has not arisen (but is inherent in the asset), and where the liability has arisen.
- Interactions with the consolidation regime and ACA calculations under subsection 705-70(1AC) of the 1997 Act.

No Double Taxation

We also note the following issue which will be a general concern for some taxpayers who are subject to the application of section 110-45.

Section 116-55 is the mirror of section 112-35. Whereas section 112-35 includes an assumed liability in the cost base for a purchaser, section 116-55 increases the capital proceeds of a vendor if the purchaser takes over a liability, and applies as follows:

> *The capital proceeds from a CGT event are increased if another entity acquires the CGT asset (the subject of the event) subject to a liability by way of security over the asset. They [the capital proceeds] are increased by the amount of the liability the other entity assumes*

Section 118-20 reduces a capital gain to the extent it is brought to tax under another section. Subsection 118-20(1) provides that:

> *A capital gain you make from a CGT event is reduced if, because of the event, a provision of this Act (outside of this Part [Part3-1]), includes an amount in your assessable income…*

This provision, while potentially wide in application, in this context could be described as a cousin of section 110-45. Subsection 110-45(2) denies a deductible amount being included in cost base. So, while one section stops double relief (deduction and inclusion in cost base), this section prevents double taxation.

Subsection 118-20(1A) expands the circumstances in which subsection 118-20(1) will apply, and it:

> … *applies to an amount that, under a provision of this Act (outside of Part 3.1), is included in your assessable income or exempt income in relation to a CGT asset as if it were so included because of the CGT event referred to in that subsection if the amount would also be taken into account in working out the amount of a capital gain you make.*

Care needs to be taken that the practical implications of any view expressed in the Draft Determination do not impact the relief from double taxation to sellers of assets in the many circumstances where subsection 118-20(1) can be applied.

Should you wish to discuss the above further please do not hesitate to contact me on 02 8223 0000.

Yours faithfully,

Peter Godber

President