Law Council OF AUSTRALIA

Business Law Section

12 December 2019

Mr Matt Miller
Tax Counsel Network, Law Administration and Practice
Australian Taxation Office
Brisbane

By email: Matt.Miller@ato.gov.au

Dear Matt,

Draft Taxation Determination TD 2019/D11

The Taxation Committee of the Business Law Section of the Law Council of Australia (the **Committee**) welcomes the opportunity to comment on draft Taxation Determination TD 2019/D11 **(TD)** entitled "*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?*"

All legislative references in this submission are to provisions of the *Income Tax Assessment Act 1997*, unless indicated otherwise.

Summary

The Committee disagrees with the position expressed in the draft TD because it:

- is not based on a supportable interpretation of the legislation;
- is inconsistent with past Australian Taxation Office (**ATO)** interpretive guidance; and
- would lead to inappropriate outcomes for at least one industry.

If the view in the draft TD nevertheless does become final, the Committee's view is that it ought to be applied prospectively only, rather than both before and after its publication as is currently proposed.

The proposed interpretation of the legislation is untenable

Because the Law Council is the peak body representing the Australian legal profession, the Committee is particularly concerned to monitor draft public rulings from the perspective of the rule of law. It is axiomatic in our system that any interpretation of the tax law proposed to be

Telephone +61 2 6246 3737 • ***Fax*** +61 2 6248 0639 • ***Email*** jessica.morrow@lawcouncil.asn.au
GPO Box 1989, Canberra ACT 2601, DX 5719 Canberra • 19 Torrens St Braddon ACT 2612
Law Council of Australia Limited ABN 85 005 260 622
www.lawcouncil.asn.au

officially adopted by the ATO must be based on a supportable construction of the legislation, especially when the position would adversely affect the interests of taxpayers.

The Committee does not believe that the view in the draft TD is based on a supportable construction of the legislation.

The conclusion in the draft TD is that the amount of an assumed liability that is initially included in the cost base of a CGT asset under section 112-35 is later excluded from cost base if the taxpayer is entitled to a deduction on the discharge of the liability.

The reasoning given in support of this conclusion is in the Explanation section of the draft TD. The reasoning is very brief: paragraph 5 contains the premises and the conclusion of the argument.

The premises of the argument are as follows:

A. An amount of expenditure that is initially included in the cost base can later be excluded due to the operation of a cost base modification provision.
B. Accordingly, cost base is a fluid concept and the intention of Division 110 was that the cost base should be calculable at any particular time. Section 112-35 does not operate to necessarily fix the cost base upon acquisition of the relevant asset.
C. The expenditure in discharging the liability is the "latest representation" of the same liability referred to in section 112-35.

From these premises, it is said to follow that the deductible expenditure causes the initial inclusion of the amount in cost base to be reversed, to the extent of the deduction, under section 110-45(2).

Premises A and B are true, as a general and high-level description of the CGT provisions. Left unstated, however, is that in all cases the CGT provisions specifically say what is included or excluded from cost base.

Premise C is not true, or not in any sense that engages the relevant legislative provisions. The concept of one amount being the "latest representation" of another is unknown and irrelevant to the CGT provisions.

The logical obstacle that the draft TD fails by the metaphorical manoeuvre in premise C to overcome is that what is *included* in cost base under section 112-35 is the amount of the *assumed* liability, whereas all that is *excluded* from cost base under section 110-45(2) is the deductible amount *paid in discharge* of that liability. That outgoing is the expenditure "you have deducted or can deduct". The earlier assumption of the liability is *not* expenditure "you have deducted or can deduct" under section 8-1 or any other provision.

The assumption is a benefit conferred by a buyer on the seller of the asset. When the payment is later discharged, the person who benefits from the discharge is not the same person. In many cases the amount of the payment will be different from the amount assumed. To assert that one "represents" the other or is otherwise related to the other in some way does not establish that they are the same thing.

The conclusion stated at paragraph 5, that the expenditure in discharging the liability is the latest representation of the same liability referred to in section 112-35, does not follow from the premises and has no basis in the text of the legislation.

Paragraph 6 of the draft TD supplements the main argument by a general assertion of policy principle taken from extrinsic materials: "*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.*"

Whatever the appeal of that statement as a general and high-level description of the legislation, it is not a substitute for identifying a specific legislative basis for including or excluding particular amounts from cost base in particular cases. The amount of a liability assumed and an amount paid later in discharge of it are not the same "item" of expenditure. Subsection 110-45(2) allows only what has been deducted to be excluded from cost base; not some distinct item that is thought to be related to or connected with what has been deducted.

The error implicit in paragraph 6 and in the draft TD as a whole is that it starts with a pre-conceived notion of what the policy outcome "should" be, and tries to force that outcome onto a set of legislative rules that do not by their terms allow. The High Court has repeatedly warned against committing this error:

> "This Court has stated on many occasions that the task of statutory construction must begin with a consideration of the [statutory] text"... So must the task of statutory construction end. The statutory text must be considered in its context. That context includes legislative history and extrinsic materials. Understanding context has utility if, and in so far as, it assists in fixing the meaning of the statutory text. Legislative history and extrinsic materials cannot displace the meaning of the statutory text. Nor is their examination an end in itself.[1]

To illustrate the problem with relying on the general principle in paragraph 6, if that principle were a good basis for interpreting the provisions in the way suggested, a taxpayer selling an asset could equally say that *in principle, an item of income or gain should either be assessable as a revenue item or included in the capital proceeds for the disposal of a CGT event, but not both*. It would follow that the assumption of liability rule for capital proceeds in section 116-55[2]

---

[1] *Federal Commissioner of Taxation v Consolidated Media Holdings Ltd* [2012] HCA 55; (2012) 87 ALJR 98, 107 [39] (the court).

[2] The text almost exactly mirrors section 112-35 and the provisions have a common predecessor, being section 160S of the *Income Tax Assessment Act 1936*.

should not apply if a sold asset is subject to a liability to repay an amount that was included in the seller's ordinary income. The draft TD however is silent about capital proceeds.

An additional problem with the view expressed in the draft TD is that, in any event, amounts paid in discharge of liabilities to which an asset is subject would likely be better characterised as costs of *owning* the asset; not as costs of *acquiring* the asset. Merely discharging the liability does not improve or perfect the acquisition; the acquisition is already complete. But for deductibility, these outgoings would form part of the third element of cost base; not part of the first element. That being so, they would be excluded from the third element of cost base by section 110-45(1B). The same expenditure could then not also be excluded from the first element of cost base under section 110-45(2). The draft TD does not address this point.

The legislative history does not support the conclusion in the draft TD

The legislative history does not support the view in the draft TD. It supports a plain reading of the statutory text.

Section 112-35 (along with section 116-55 for capital proceeds) was a rewrite of section 160S of the *Income Tax Assessment Act 1936*. This provision in turn was closely modelled on a rule from the United Kingdom's capital gains tax legislation.[3] Section 160S relevantly read as follows:

> (2) For the purposes of this Part:
> (a) an asset shall be treated as having been acquired free of any interest or right by way of security subsisting at the time of acquisition and as having been disposed of free of any such interest or right subsisting at the time of disposal; and
> (b) where an asset is acquired subject to any such interest or right—the full amount of the liability thereby assumed by the person acquiring the asset forms part of the consideration for the acquisition of the asset by that person, and for the disposal of the asset by the person from whom it was acquired, in addition to any other consideration paid or given for the acquisition and disposal.

The effect of this rule was that the "full" face value amount of the liability was to be brought to account on disposal for both seller and buyer, and the underlying "security" was otherwise to be ignored. This prevented debate about the market value, if any, of an assumption of a liability and ensured equal treatment as between seller and buyer.

The term "full" was not included in the rewritten rules in the 1997 Act, but there is nothing to suggest that this omission was intended to effect a change in the meaning of the provisions.[4]

Accordingly, paragraph 4 of the draft TD is only partly correct to say that section 112-35 "extends" the cost base rules to cover assumptions of liability. The normal cost base rules might

[3] See the *Capital Gains Tax Act 1979* (UK), ss 23 and 32.
[4] See s1-3 of the 1997 Act.

have covered them anyway but would have required the buyer to determine the market value of the “property”, if any, given by way of contractual assumption of the liability (e.g. by considering whether the face value ought to be discounted to reflect the time value of money or the possibility that the liability might never be fully paid).

More importantly, the conclusion in paragraph 5 of the draft TD is not supported by the legislative history. The explicit intention was to include the “full” amount of the liability in cost base without reference to subsequent events or other considerations. That was the effect of paragraph 160S(2)(a) combined with the reference in paragraph 160S(2)(b) to the “full” amount.

The quote from the extrinsic materials in paragraph 6 of the draft TD is from the Explanatory Memorandum to the 1998 Bill[5] that inserted section 110-45 (and an equivalent rule for the 1936 Act, section 160ZJA). Reading these extrinsic materials as a whole, the focus of the 1997 amendments was to remove from cost base amounts of initial expenditure in respect of which deductions arose under the depreciation rules (contrary to the position that had stood from 1985 until then). That is what the amendments by their terms achieved. The general statement made in that context, which paragraph 6 of the draft TD identifies as a “principle”, is not a warrant to impute *further* deeming provisions into the legislation that were not in fact inserted, so as to conflate assumed liabilities with their subsequent discharge. There is nothing to indicate that the legislature turned its mind at that time to the particular case of assumptions of liability, and therefore no reason to assume that the 1997 amendments were intended to do more than what was specifically stated to be their effect.

The draft TD is inconsistent with the ATO view on earnouts

Eliding the assumption of a liability with its later discharge on the ground that the latter “represents” the former contradicts the existing ATO view on so-called “earnout” arrangements. This view is set out in TR 2007/D10. TR 2007/D10 was withdrawn after legislation was enacted to stipulate different outcomes for some small business earnout arrangements, but the withdrawal notice[6] states that the view in the draft ruling continues to apply to earnout arrangements that pre-dated or are not covered by that legislation. Hence the ATO view outlined in the draft ruling continues to have practical effect.

Under a typical earnout arrangement, the buyer of a business, in addition to paying an initial money price, becomes subject to a future liability to pay amounts to the seller, depending on the performance of the business. The Ruling took the view that it was necessary to include in cost base (and in the seller’s capital proceeds) the market value of the earnout right on inception and that any actual subsequent payments in discharge were simply irrelevant to that enquiry.

TR 2007/D10 said as follows:

[5] Taxation Laws Amendment Bill (No 2) 1998
[6] TR 2007/D10W issued on 7 December 2016.

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.***..

[emphasis added]

The view in the draft TD and the view in TR 2007/D10 cannot logically stand together. The ATO cannot in one public ruling say that the amount paid to discharge an earnout right has no “particular connection” with the creation of the right and thus no effect on cost base, but at the same time in another public ruling say that an amount paid to discharge an assumed liability is merely the “latest representation” of that liability which changes the elements originally in the cost base. Given that TR 2007/D10 has represented the ATO’s considered view for 12 years and has resulted in the Government in 2016 enacting a substantial piece of legislation to reverse its effects in certain cases, it would be concerning, and disruptive, for the ATO to contradict it now.

The draft TD would cause economic double taxation

The view in the draft TD would appear to lead to economic double taxation in some practical situations.

Example - retirement village operator

For example, the Committee is aware that in the retirement living industry, the view is taken by the ATO and industry that amounts of lease premiums received from incoming residents by village operators are assessable income. When corresponding amounts are repaid (including as possibly augmented by any capital growth components), the operator is allowed a deduction under section 8-1.[7]

Separately, a village operator who sells a village includes in the capital proceeds amounts of liabilities assumed by the buyer in accordance with section 116-55. The buyer for its part includes in cost base the same amount assumed. (Section 112-35 and section 116-55

[7] See TR 2002/14.

correspond very closely in their drafting and have a common heritage in section 160S of the 1936 Act.)

In overall effect, the ATO collects the correct amount of tax, taking into account both the CGT side and the ordinary income/deduction side. The apparent effect of the draft TD, by contrast, would be to eliminate cost base recognition of the liabilities, where a deduction is later claimed, without any corresponding relief on the capital proceeds side, despite the assessability of the receipt to which the liability relates. The ATO then will collect tax on both the cash payment received from the resident and the transfer of the corresponding liability to the new owner, but will allow relief only for the cash payment back to the outgoing resident.

There does not appear to be any basis for interpreting the provisions affecting capital proceeds, including section 116-55, in a way that corresponds to the interpretation proposed in the draft TD. That is, when a lease premium payment is included in an operator's assessable income, no provision would prevent section 116-55 from later including a corresponding amount in the operator's capital proceeds on sale of the village. The resulting mismatch would considerably and adversely affect the economics of investing in retirement villages involving lease premium resident payments. This is a powerful contextual reason for not taking the strained construction advanced in the draft TD. It tells against the appeal to policy and context in paragraph 6 of the draft TD.

Simplified example

Suppose the following facts:

- an operator buys a village for $900 cash and assumes a resident liability to repay a lease premium of $100;
- the resident leaves and the operator pays that resident $100 cash;
- a new resident replaces the old and pays the operator a new lease premium of $100;
- the operator sells the village for $900 cash and the buyer assumes the second resident liability in the amount of $100.

In this example, the net cash and economic position of the operator at the end is nil. The tax deduction for the discharge of the liability offsets the assessable income comprising the incoming payment. But there is a capital gain of $100, on the view expressed in the draft TD. This is because the deduction later claimed for discharge of the first liability causes the amount of $100 originally included in cost base by section 112-35 to be excluded, but nothing causes the capital proceeds of the sale to be reduced by the amount previously assessable.

The operator therefore is taxed on a gain it never economically makes. This is inappropriate.

(For simplicity, this example assumes only a single resident at one time, and no capital growth. But the same principle would apply in an example with more complex facts.)

The draft TD for its part does not identify any examples or practical cases of concern, so it is difficult to assess the broader impact of the draft TD or whether it leads to appropriate outcomes in other cases.

The draft TD would lead to surprising outcomes

If the discharge of a liability "changes the constituent components"[8] of an asset's cost base, a variety of surprising results would follow. None of these is identified or explored in the draft TD.

If the liability were denominated in a foreign currency, then between assumption and discharge the currency will often have fluctuated. Similarly, if the liability were to provide some non-cash property, the market value of that property might fluctuate over time. In these cases, is the proposed ATO view that the later amount replaces the original amount as the cost base? In the case of foreign currency, how would this interact with the rules for foreign exchange gains and losses in Division 775?

If the liability is not discharged until after the relevant CGT event, is the taxpayer expected to monitor this and potentially seek an amendment of its assessment (subject to time limits)? What if the liability is assumed from the taxpayer by a third person and later discharged by that person? Must the taxpayer keep track of this somehow? Is the discharge payment in this case a "representation" of both the first and the second assumptions of the liability?

What if the liability is discharged in part? Does the cost base then consist of part of the original assumption amount and partly of the discharge payment(s)? If any remaining part is never to be discharged, is cost base reduced accordingly? And if so, how does that interact with the commercial debt forgiveness rules, which might also capture such a gain?

If any of the above consequences were an intended feature of the legislation, it might be expected that a clear legislative basis would be present to support them. That there is not tells against the analysis in the draft TD.

The draft TD is a U-turn

The draft TD is proposed to apply both before and after its date of effect. If the ATO does proceed with the current view (which it is submitted it should not), then it ought to apply only to transactions occurring after the date of publication, consistently with the Commissioner's practice on "U-turns" as set out in Law Administration Practice Statement PS LA 2011/27.

At a minimum, participants in the retirement living industry are likely to have taken a view contrary to the view in the draft TD. In doing so, they would reasonably have assumed from TR 2002/14 (which is a comprehensive statement of the income tax regime for retirement village operators), TR 2007/D10 (which contradicts the draft TD) and possibly other ATO interactions in

[8] Para 5 of the draft TD.

which the concern in the draft TD was not raised, that the ATO did not have a concern with the industry practice and was not going to later announce a view that results in retrospective double taxation of the industry.

To the extent that the draft TD would impact other industries or sectors, similar considerations might apply.

Conclusion

There are strong reasons for not proceeding with the view in the draft TD. The Committee recommends that it be withdrawn and that the ATO instead undertake targeted consultations with those to whom the draft TD was directed, with a view to better understanding the problem and designing a more balanced and legally defensible approach. The Committee would be happy to be involved in any such process.

Thank you again for the opportunity to comment on the draft TD. If you wish to discuss further any aspect of this submission, please contact Clint Harding, Chair of the Committee (charding@abl.com.au or 02 9226 7236).

Yours sincerely,

Greg Rodgers
Chair, Business Law Section