19 October 2012

The Board of Taxation
c/The Treasury
Langton Crescent
PARKES ACT 2600

E-Mail: taxboard@treasury.gov.au

Dear Mr Jordan,

Submission: Board of Taxation's Post Implementation Review of Certain Aspects of the Consolidation Tax Cost Setting Process

Thank you for the opportunity to provide our comments on the Board of Taxation's Discussion Paper titled "Post Implementation Review of Certain Aspects of the Consolidation Tax Cost Setting Process" (the **"Discussion Paper"**).

The Property Council of Australia is the peak body representing the interests of owners and investors in Australia's $670 billion property investment sector. The Property Council serves the interests of companies across all four quadrants of property investment debt, equity, public and private.

The Retirement Village Association is Australia's peak body for the retirement village industry. With an underlying strength of over 800 village and associate members nationally, the RVA continue to play a critical role in the ongoing growth and sustainability of the retirement village industry.

The Property Council and the Retirement Village Association support the Board of Taxation's drive to review aspects of the tax cost setting process. The Discussion Paper correctly identifies a range of issues that need to be resolved.

The Key Issues

We have provided comments on the following issues that specifically affect the retirement village industry (refer **Appendix A**):

1. The treatment of certain types of liabilities held by an entity joining a tax consolidated group;
2. Deferred tax liabilities;
3. Adjustments to liabilities under the tax cost-setting rules; and
4. Assets and liabilities recognised on different bases.

For the first issue, there are two key types of liabilities in the retirement village industry that can give rise to future tax deductions.

These are:

1 Resident Loan Liabilities that represent the obligation to pay amounts to residents upon their departure from a retirement village for which a tax deduction is available (these liabilities are referred to as "Resident Liabilities"); and

2 Potentially, payments to residents of a retirement village that have a loan/ lease arrangement with the retirement village operator that reflect a portion of the increase in value of the resident's retirement village unit over the resident's tenure in the village (these payments are referred to as capital growth payments or "**CGPs**").

As Resident Loan Liabilities give rise to the inclusion of amounts in assessable income, they are unique and do not appear to have been contemplated by the Board. The discussion on these liabilities in the submission also covers the third and fourth issues identified above.

Deferred tax balances can give rise to complexities in the tax cost setting process, particularly in relation to retirement villages. We support their removal from the process.

The main problems we have identified in the submission with the current law and the proposed solutions in the Discussion Paper, revolve around the treatment of deductible liabilities.

The Problem – Resident Loan Liabilities

For Resident Loan Liabilities, mismatches currently arise between tax outcomes should a retirement village be sold via asset sale, as opposed to selling a subsidiary member that holds a retirement village asset. These mismatches are caused by the treatment of deductible resident liabilities under the tax cost setting rules.

These issues arise due to the resident liabilities being future deductible accounting liabilities that also give rise to assessable income when first recognised for accounting. Liabilities of this type are not contemplated by any of the current tax cost setting rules, nor are they considered in the Discussion Paper.

The Board proposes four options to address the issues identified with the treatment of deducible liabilities under the current tax cost setting rules. However, as the Discussion Paper does not contemplate liabilities that also give rise to assessable income, none of these options are appropriate.

The Solution – Resident Loan Liabilities

The following recommendations are made in the submission:

- Amend ss 711-45(3), (5) and 705-75(1) such that they do not apply to the extent that an accounting liability has given rise, or will give rise, to the inclusion of an amount in any entity's assessable income prior to the leaving/ joining time; and
- Should any of the four options raised by the Board be recommended to Government, that recommendation be qualified to ensure that any amendments to give effect to these options not apply to deductible liabilities to the extent that those liabilities have given rise to, or will give rise to, the inclusion of amounts in the assessable income of a joining entity prior to the joining time.

The Problem – Capital Growth Payments

For CGPs, the ATO holds a view – contrary to the industry and the decision of the Administrative Appeals Tribunal in *Tricare Group Pty Limited v Commissioner of Taxation*[1] - that CGPs are non-deductible capital expenditure. The submission highlights that, should such a view be upheld, economic and tax outcome mismatches arise in a tax cost-setting context. Mismatches do not arise should the CGPs be treated as deductible revenue expenditure of a retirement village operator.

[1] [2011] AATA 298

The Solution – Capital Growth Payments

Should the ATO be correct, the mismatches can be solved by amending the law to treat CGP liabilities as if they were deductible for the purposes of the tax cost-setting rules.

We look forward to further discussion with you to address these issues.

Please contact Andrew Mihno on 0406 45 45 49 or Mark Bird on (03) 8682 6004 if you have any queries or to set up a time to meet.

Yours sincerely

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Property Council of Australia

Mark Bird
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Retirement Village Association

Board of Taxation Discussion Paper: post implementation review of certain aspects of the consolidation tax cost setting process

Submission

Property Council of Australia &
Retirement Village Association
October, 2012

Appendix A

1 Executive Summary

The Board of Taxation ("**BoT**") released the Discussion Paper in September 2012 on its review of the tax treatment of liabilities in the tax cost-setting process in the consolidation regime. A particular focus of the Discussion Paper is the treatment of deductible accounting liabilities.

There are two types of deductible accounting liabilities relevant to taxpayers in the retirement village industry, being:

1. The part of the "Resident Loan Liability" accounting item that represents the obligation to pay amounts to departing residents under lease premium, licence, and loan/ lease occupancy arrangements subject to Taxation Ruling 94/24. Payments to outgoing residents under these arrangements are treated as deductible on revenue account; and
2. Potentially capital growth payments under loan/ lease arrangements subject to Taxation Ruling 2002/14, representing the amount that a retirement village resident may be entitled to receive as a result of the capital growth in the value of the underlying unit occupied by that resident. The Administrative Appeals Tribunal ("**AAT**") has held that capital growth payments made by a retirement village operator to its departing residents were deductible under s 8-1. However, it is also noted that the Australian Taxation Office ("**ATO**") has expressed a contrary view in respect of capital growth payments paid under occupancy arrangements covered by Taxation Ruling 2002/14, and has released a Decision Impact Statement which purports to limit the AAT's decision to its facts.

For Resident Liabilities, mismatches currently arise between tax outcomes should a retirement village be sold via asset sale, as opposed to selling a subsidiary member that holds a retirement village asset. It would seem that these issues arise due to the resident liabilities being future deductible accounting liabilities that also give rise to assessable income when first recognised for accounting. Liabilities of this type are not contemplated by any of the current tax cost setting rules, nor are they considered in the Discussion Paper.

The BoT proposes four options to address the issues identified with the treatment of deducible liabilities under the current tax cost setting rules. However, as the Discussion Paper does not contemplate liabilities that also give rise to assessable income, none of these options are appropriate.

Accordingly, the following recommendations are made in the submission:

- Amending ss 711-45(3), (5) and 705-75(1) such that they do not apply to the extent that an accounting liability has given rise, or will give rise, to the inclusion of an amount in any entity's assessable income prior to the leaving/ joining time; and
- Should any of the four options raised by the Board be recommended to Government, those recommendations be qualified to ensure that any amendments to give effect to these options not apply to deductible liabilities to the extent that those liabilities have given rise to, or will give rise to, the inclusion of amounts in the assessable income of a joining entity prior to the joining time.

For capital growth payments ("**CGPs**"), should the ATO be correct in that CGPs are non-deductible capital expenditure, this view results in economic and tax outcome mismatch issues. Mismatches do not arise should the CGPs be treated as deductible revenue expenditure of a retirement village operator. However, should the ATO persist with its view and/or that view be affirmed in the Courts, then the mismatches highlighted in the submission may arise. These mismatches can be solved by amending s 711-45(5) to read as follows:

*If, for income tax purposes, an accounting liability, or a change in the amount of an accounting liability, (other than one owed to a *member of the old group) ~~is taken into account~~ gives rise to, or would but for subsection 8-1(2)(a) give rise to, a *deduction at a later time than is the case in accordance with the leaving entity's *accounting principles for tax cost setting, the amount to be added for the accounting liability is equal to the payment that would be necessary to discharge the liability just before the leaving time without an amount being included in the assessable income of, or (on the basis that subsection 8-1(2)(a) is ignored) allowable as a deduction to, the *head company.*

2 Introduction

As the Discussion Paper correctly points out, the treatment of liabilities under the tax cost setting rules gives rise to a number of ambiguities and unintended anomalies.

Accounting liabilities are of particular significance in the retirement village industry. As will be shown below, where Investment Property accounting is used, retirement village entities will recognise a significant liability for amounts owed by that entity to residents of the entity's retirement village when those residents depart that village.

When the Investment Property accounting method is overlayed with the unique tax environment provided by Taxation Rulings 2002/14 ("**TR 2002/14**")and 94/24 ("**TR 94/24**"), and the consolidation tax cost setting rules, then an incredibly complex environment is created which gives rise to the potential for significant anomalies and mismatches between tax, accounting and economic outcomes.

The significant amount of liabilities recognised by a retirement village operator under the Investment Property accounting method that are the subject of the matters addressed in the Discussion Paper, and the complexity and ambiguity that exists under current law, has prompted the Professional Bodies to make this submission on behalf of its affected members.

2.1 Types of contracts

In order to better understand the issues that arise under the tax cost setting rules, and how those issues are driven by Investment Property accounting treatment, and the tax rules that apply to retirement villages under TR 94/24 and 2002/14, the following summary is provided on the types of residence agreements that may exist in retirement village.

Strata/ Purple Title

Under this arrangement:

- residents purchase a freehold interest in a retirement village unit (for strata title), or a freehold interest in the retirement village itself as a tenant-in-common (for purple title), from the retirement village operator;
- the resident will enter into a management agreement with the retirement village operator;
- during the resident's occupation of the unit, the resident will pay regular service fees to the retirement village operator to cover the operator's costs of day-to-day operation and management of the village (these rights and obligations will be contained in the management agreement);
- when the resident leaves the village, the resident sells their freehold/ tenant-in-common interest to a new resident;
- the retirement village operator is entitled to a percentage of either:
    - the sales price achieved by the outgoing resident upon their disposal of the unit/ interest to the incoming resident; or
    - the amount the outgoing resident paid to purchase the unit upon their entry into the village;

  as a fee, which is commonly referred to as a Deferred Management Fee ("**DMF**") (this entitlement is embodied in the management agreement);
- the contract with the resident will usually contain a clause which only permits the outgoing resident to sell the unit/ interest to an incoming resident that satisfies certain requirements and who will agree to enter into a management agreement with the retirement village operator on identical terms to that existing between the outgoing resident and the retirement village operator – in this way, inter alia, the retirement village operator's right to receive DMFs from future residents of the village unit is preserved within the arrangement with the current resident;
- in some cases, the retirement village operator will have an obligation to repurchase the unit/ interest from the outgoing resident (or their personal

representative), where the relevant unit/ interest has not been sold within a certain timeframe.

Long-term assignable leases

Under this arrangement:

- residents are granted a long-term leasehold interest in a retirement village unit from the retirement village operator in consideration for the payment of an ingoing contribution to the retirement village operator (which usually takes the form of a lease premium);
- the resident will enter into a management agreement with the retirement village operator;
- during the resident's occupation of the unit, the resident will pay regular service fees to the retirement village operator to cover the owner's costs of day-to-day operation and management of the village (these rights and obligations will be contained in the management agreement);
- when the resident leaves the village, the resident sells their long-term leasehold interest to a new resident;
- the retirement village operator is entitled to a percentage of either:
    - the sales price achieved by the outgoing resident upon their disposal of the leasehold interest to the incoming resident; or
    - the amount the outgoing resident paid to purchase the leasehold interest upon their entry into the village;

  as DMF (this entitlement is embodied in the management agreement);
- the contract with the resident will usually contain a clause which only permits the outgoing resident to sell the leasehold interest to an incoming resident that will agree to enter into a management agreement with the retirement village operator on identical terms to that existing between the outgoing resident and the retirement village operator – in this way, inter alia, the operator's right to receive DMFs from future residents of the village unit is preserved within the arrangement with the current resident;
- in some cases, the retirement village operator will have an obligation to repurchase the leasehold interest from the outgoing resident (or their personal representative), where the leasehold interest in the relevant unit has not been sold within a certain timeframe.

Lifetime (non-assignable) leases/ licences

Under this arrangement:

- residents are granted a leasehold interest in, or licence to occupy, a retirement village unit from the retirement village operator which terminates when the resident leaves the village, on the condition that the resident pays to the operator a lease premium (in the case of leasehold interest villages), a licence fee (in the case of licence villages) or an interest-free loan (in the case of either leasehold interest or licence villages) of an amount equal to the market value of the retirement village unit at that time;
- the resident will enter into a management agreement with the retirement village operator;
- during the resident's occupation of the unit, the resident will pay regular service fees to the retirement village operator to cover the operator's costs of day-to-day operation and management of the village (these rights and obligations will be contained in the management agreement);
- on the resident's departure from the village:
    - where the departing resident's incoming contribution was paid by way of lease premium or licence, the departing resident is entitled to an amount calculated as:
        - the amount of the ingoing contribution; plus

- a percentage (anywhere from 0% to 100%) of any difference between the amount of the ingoing contribution paid by that departing resident and the amount of the ingoing contribution paid by any new incoming resident; less
- the amount the retirement village operator is entitled to, being either a percentage of:
  - the lease premium/ licence fee paid by the new incoming resident to the operator; or
  - the lease premium/ licence fee paid by the departing resident upon their entry into the retirement village unit;

  as DMF; and

- where the departing resident's incoming contribution was paid by way of an interest-free loan:
  - the departing resident is entitled to:
    - the repayment of the interest-free loan; and
    - a percentage (anywhere from 0% to 100%) of any difference between the amount of the ingoing contribution paid by that departing resident and the amount of the ingoing contribution paid by any new incoming resident; and
  - the retirement village operator is entitled to a separate payment, being a percentage of:
    - the interest-free loan paid by the new or incoming resident to the operator; or
    - the interest-free loan paid by the departing resident upon their entry into the retirement village unit;

    as DMF.

2.2 Accounting Treatment

As stated above, the majority of retirement village operators adopt the Investment Property accounting method contained in AASB 140 in preparing their financial statements.

Investment Property

Under AASB 140, "Investment Property" is defined as properties held for long-term income yields and capital growth and is not occupied by the entity. This includes property being developed for the purposes of being held as an investment property. The retirement village operator will make a determination, on a property by property basis, as to whether a property should be considered an investment property. Factors taken into account include:

- whether the property generates property related cash flows largely independent of other services provided to residents of the properties;
- whether the property is held for long-term capital appreciation rather than for short-term sale in the ordinary course of business; and
- the probable future use of land that is not currently generating cash flows.

Broadly, the Investment Property asset line consists of land, buildings, and rights to collect future income (in the form of Deferred Management Fees) from current and future retirement village residents. Initially, investment properties are measured at cost including transaction costs. Subsequent to initial recognition, investment properties are stated at fair value each balance date, which is based on active market prices where available, otherwise management uses valuations based on discounted cash flow projections of all cash-flows directly related to the underlying retirement villages on a standalone basis. These represent internal valuations, with the investment properties subject to independent valuations on a rolling basis. The valuations determine the fair value of the

"Net Investment Property" (or Net IP). Due to the requirement under AASB140 to separately recognise the Resident Liabilities (refer below), the Investment Property asset is "grossed-up" for the Resident Liabilities balance, so as to ensure that the net carrying value of each underlying retirement village on balance sheet, represents its fair value or Net IP. This is referred to as the Gross Investment Property.

For completeness, it is noted that for accounting purposes, although village operators do not retain legal title to strata title units sold to incoming residents, they are still eligible to be accounted for on the statement of financial position as Investment Properties pursuant to AASB 140, on the basis that these strata title units are deemed to be held for long term capital appreciation and the economic benefits (e.g. deferred management fees and share in capital appreciation) associated with the units are seen to flow to the village operators.[2]

Resident Liabilities

This represents an amount paid by residents to occupy apartments and units classified as investment property. Resident Liabilities are measured at face value, representing the principal amount plus the resident's share of capital gains based on market values of the underlying property at balance date, less the amount of deferred management fees payable to the retirement village operator by the current residents in the retirement village that have accrued under the contractual terms at balance date. Resident Liabilities are non-interest bearing and are, in practice, paid out of the amounts paid by the next incoming residents.

Income Statement – Revaluations

Gains or losses arising from changes in the fair values of investment properties are included as other income in the income statement in the period in which they arise.

Income Statement – Deferred Management Fees (DMF)

Deferred Management Fees (DMF) are earned from residents across the retirement villages. A typical DMF contract provides for an annual retainer for a fixed period (e.g. 3% per annum of purchase or resale price for a period up to 12 years, for a maximum 36% in total). DMF income is recognised for accounting purposes on an annual accrual basis with the % DMF recognised as DMF income per annum being determined on a straight lined basis over the actual length of stay to date using estimated market values. Both the % DMF and capital gain share are DMF income and are measured based upon the expected term of the residents licence and estimates of capital growth since the resident first occupied the unit. The resulting DMF accrual is offset against the resident loans balance in current liabilities.

2.3 Tax treatment

General

TR 94/24 was issued on 30 June 1994 and withdrawn on 19 April 2000 and replaced with TR 2000/D5, finalised as TR 2002/14 on 28 June 2002 (collectively, the "**Rulings**"). Both TR 94/24 and TR 2002/14 concern the taxation treatment of the following items in respect of various occupancy arrangements:

- lump sum payments (i.e. the Resident Liabilities) received under the terms of various arrangements used by owners of commercial retirement villages to grant occupancy rights to village residents, and subsequent repayments of the Resident Liabilities upon termination of the occupancy arrangements;
- DMF;
- acquisition and development/construction costs incurred by a developer;
- share of capital appreciation and depreciation of a village unit; and
- sale of a retirement village.

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[2] Paragraph 16 of AASB 140 *Investment Property* states that "Investment property shall be recognised as an asset when, and only when:

a) it is probable that the future economic benefits that are associated with the investment property will flow to the entity; and
b) the cost of the investment property can be measured reliably."

Treatment of Resident Liabilities under TR 94/24 and TR 2002/14

Under both TR 2002/14 and TR 94/24, the treatment of the Resident Liability depends on the type of the contractual arrangements that the village operator has with the village resident.

Under either ruling, where units are sold to village residents on a strata title basis or under a "Purple title" arrangement, the trading stock provisions of the *Income Tax Assessment Act 1997* (the "**Act**") will apply.

In the case of an interest-free loan arrangements, if the relevant arrangement satisfies the requirements of a loan as prescribed in TR 2002/14, then the receipt and repayment of the Resident Liability are on capital account.

For all other occupancy arrangements (e.g. assignable and non-assignable leases and loan/ lease arrangements to which TR 94/24 still apply[3]), the lump sum received is on revenue account and constitutes assessable income of the operator in the year in which it is derived. Accordingly, the Resident Liability repayable by the operator to the resident upon termination of the occupancy arrangement is an allowable deduction in the year in which the operator becomes liable to make that payment.

Treatment of DMF under TR 94/24 and TR 2002/14

In the case of non-assignable lease premium arrangements, the way in which the DMF is returned is by the owner including the entire lease premium received from an incoming resident in assessable income in the year of receipt, and deducting the entire amount of a lease premium paid to an outgoing resident (less any DMF) in the year of departure (i.e. gross receipts from, and outgoings to, residents are included in assessable income/ allowable deductions, as opposed to just including the "net" DMF amount in relation to a resident).

For loan/lease and loan/licence arrangements:

- under TR 94/24, the way in which the DMF is returned is by the owner including the entire interest-free loan received from an incoming resident in assessable income in the year of receipt, and deducting the entire amount of the interest-free loan (less any DMF) repaid to an outgoing resident in the year of departure; and
- under TR 2002/14, only the DMF is included in assessable income in the year it is derived – the receipt and payment of the interest-free loans from/ to the resident is otherwise ignored.

For all other occupancy arrangements (i.e. strata/ purple title and assignable leases), the treatment of DMF is the same (i.e. it is included in the owner's assessable income when it is derived).

Treatment of cost of acquisition or development under TR 94/24 and TR 2002/14

Under TR 94/24, generally, expenditure incurred by the village operator in acquiring or developing the village is considered to be expenditure of a revenue nature. Accordingly, a deduction will be allowed for that expenditure in the year in which it is incurred.

In contrast, under TR 2002/14, the treatment of the cost of acquiring or developing a retirement village depends on the purpose of the village operator. TR 2002/14 provides that:

> *8. Where a taxpayer acquires land and develops a retirement village for the purpose of selling the entire village, the land and buildings are trading stock of the property developer and the trading stock provisions will apply.*
>
> *…*
>
> *19. Where a village operator develops or acquires a retirement village to conduct the business of granting occupancy rights to village residents, the costs of acquiring or developing the village is expenditure of a capital nature.*

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[3] Under the transitional rules in para 77 of TR 2002/14, broadly, TR 94/24 still applies where a lease/ licence that is currently on foot was entered into prior to 19 April 2000.

20. Where the costs of development or acquisition are capital in nature, a village operator is entitled to claim deductions for that capital expenditure to the extent allowed under Division 43.

Treatment of capital growth payments under TR 94/24 and TR 2002/14

As stated above, under certain occupancy arrangements, an outgoing resident may be entitled to receive a share of the difference between the initial Resident Liability paid by the outgoing resident and the amount of the Resident Liability provided by the new resident. This amount is sometimes referred to as a capital growth payment ("**CGP**").

The treatment of a capital appreciation/depreciation share amount is the same as the treatment of the receipt and repayment of the Resident Liability under the Rulings. That is, under TR 94/24, such amount is considered on revenue account.

The treatment under TR 2002/14 is the same as under TR 94/24, except in relation to loan/ lease or loan/ licence villages. In those cases, the ruling states that as the interest-free loan incoming contribution is on capital account, then any capital appreciation payment made to a departing resident is also treated as capital in nature. This view has been restated in a private ruling, which also states that the payment instead forms part of the cost base of an asset[4]. However, it should be noted that the decision of the Administrative Appeals Tribunal ("**AAT**") in *Tricare Group Pty Limited v Commissioner of Taxation*[5] contradicts this element of the ruling.

Sale of a retirement village

Under TR 94/24, upon the sale of a retirement village, the whole of the proceeds will be included in the assessable income of the operator vendor under s 8-1 of the Act. To the extent that it is necessary to make a calculation for capital gains tax (CGT) purposes, any capital gain will be reduced in accordance with s 118-20 to the extent to which the amount is otherwise assessable.

Under TR 2002/14, the sale of the village is a CGT event A1. In this regard, paragraph 57 of TR 2002/14 states that:

57. The capital proceeds from the event include the following:

- *any money received for the sale (paragraph 116-20(1)(a));*
- *the amount of any secured liabilities assumed by the new village owner (section 116-55); and*
- *the market value of any other property received, such as a right in the nature of a contractual promise by the purchaser of the village to pay amounts to outgoing residents for unused rent in advance (paragraph 116-20(1)(b)).*

…

59. The cost base for a village owner includes the money paid in respect of acquiring it, under sub-section 110-25(2). Purchasers of an existing retirement village business would include the amount of any assumed liabilities in the first element of the cost base, under section 112-35. However, where the new owner undertakes to meet contingent liabilities, such as the potential refund of any unexpired portion of rent in advance paid by existing residents to the outgoing owner, only amounts subsequently paid in satisfaction of that obligation would then form part of the cost base: see Taxation Ruling TR 93/15.

3 Issues

3.1 Deductible liabilities

As outlined in 2.2 above, there are two types of deductible liabilities relevant to retirement village operators, being:

[4] See private ruling authorisation number 88882.

[5] [2011] AATA 298

1 Resident Liabilities, representing the obligation to pay amounts to departing residents under lease premium, licence, TR 94/24 loan/ lease occupancy arrangements ("**Deductible Resident Liabilities**"); and

2 CGPs, where the AAT held that CGPs made by a retirement village operator to its departing residents were deductible under s 8-1 of the Act. However, it is also noted that the ATO has expressed a contrary view in respect of CGPs paid under occupancy arrangements covered by TR 2002/14.

3.1.1 Deductible Resident Liabilities

The Deductible Resident Liabilities is a type of liability that is not contemplated under any of the adjustments in Step 2 of entry ACA calculation and Step 4 of exit ACA calculation, as an amount equal to the original amount of the liability is also included in assessable income.

None of the examples in Explanatory Memoranda to the consolidation tax cost-setting rule legislation include, and the Discussion Paper does not contemplate liabilities that, although giving rise to future deductions when they are settled, also gave rise to an inclusion of an amount in assessable income when they were first recognised.

We have sought to highlight the issues by way of simplified examples. A summary of the facts is outlined below.

FACTS

1 Establishment of Sub Co
- Vendor Co incorporates wholly-owned Sub Co and subscribes capital of $50
- Sub Co borrows $150 from a bank
- Sub Co constructs a retirement village for $200

2 Sub Co prior to ownership change
- The First Resident enters into a lease premium arrangement with Sub Co, and pays a lease premium of $300
- Sub Co repays the bank loan of $150.

3 Ownership changes
- Purchaser Co purchases Sub Co for market value:

	Investment Property	$300
plus	Cash	150
less	Resident Liability	(300)
		$150

4 Post-acquisition transactions of the Purchaser Co group
- The First Resident leaves and is paid $300, then:
- Scenario A: the First Resident leaves the village and the retirement village land is sold for $400.
- Scenario B:
  - the Second Resident enters into a lease premium arrangement with Sub Co and pays lease premium of $400
  - Sub Co is sold via share sale for $120

To make the calculations easier, it is assumed that all of the above transactions occur during the one income year, so as to avoid having to compare pre-tax and post-tax amounts.

To provide a comparison, the following sets out the current tax treatment of a Vendor Co, and Purchaser Co, if the transfers of Sub Co set out in the facts above were instead performed by way of an asset sale of the underlying retirement village. This comparison is provided to show the current outcomes under asset sales, which should provide a base from which the consolidation provisions can be compared. Indeed, ideally the consolidation provisions would provide an identical outcome, so that the regime does not create a preference as between asset and entity sales.

(a) Vendor Co outcomes under current law – asset sale

After constructing the village, the entry of the First Resident and repayment of the bank loan, Vendor Co's balance sheet would be as follows:

Assets		Liabilities	
Investment Property	$300	Resident Liabilities	$300
Cash	$150	Contributed Equity	$50
		Retained Profits	$100
Total	**$450**	**Total**	**$450**

Purchaser Co purchases the retirement village for $150.

The economic position of Vendor Co as a result of the disposal is as follows:

Economic Position of Vendor Co	
Cash Inflows:	
Sale Proceeds	$150
First Resident Ingoing Payment	$300
Bank Loan Funds	$150
Cash Outflows:	
Development spend	($200)
Bank repayment	($150)
Cash "sold" to Purchaser	($150)
Total	**$100**

Under TR 2002/14, Vendor Co must include the $300 Ingoing Contribution from the First Resident as assessable income, and work out its gain on sale of the retirement village as follows:

Proceeds	
Cash	$150
Assumption of Resident Liabilities	$300
Cost Base	
Investment Property	$200
Cash	$150
Gain/ (Loss) on Sale	**$100**

The tax position of Vendor Co is therefore as follows:

Tax Position	
Income:	
Gain on Sale	$100
First Resident Payment	$300
Deductions:	
N/A	0
Total tax profit	**$400**

(b) Purchaser Co outcomes under current law – asset acquisition and sale

On acquiring the retirement village, Purchaser Co obtains a cost base equal to its capital proceeds, being $450 (i.e. the $150 of cash paid, and the $300 of Resident Liabilities assumed). This cost base is essentially allocated as to $150 to Cash, and $300 to Investment Property.

i. Scenario A

Under Scenario A, the First Resident leaves the retirement village, and Purchaser Co then sells the retirement village land for $400 in the same income year.

Purchaser Co makes a taxable gain of $100 on the sale of the Investment Property (that is $400 proceeds, less cost base of $300). The payment to the First Resident results in a deduction of $300. Accordingly, Purchaser Co realises a **tax loss of $200**.

However, the economic position of Purchaser Co is as follows:

Economic Position of Purchaser Co	
Cash Inflows:	
Land Sale Proceeds	$400
Cash	$150
Cash Outflows:	
Sub Co Acquisition Price	($150)
Payment to First Resident	($300)
Total economic profit	**$100**

So under current law, the $200 overall economic profit recognised on the transactions (being the construction of the village for $200, and its ultimate sale by Purchaser Co for $400), is split:

- economically, as to $100 to Vendor Co, and as to $100 to Purchaser Co; and
- for tax purposes, as to $400 to Vendor Co, and as to ($200) to Purchaser Co.

That is, $200 is subject to tax in the tax system, it is just that, due to the "up-front" assessment profile afforded to lease premium contracts under TR 2002/14, and the deferral of recognition for deductions for the construction of the village under that same ruling, Vendor Co is taxed on a greater amount than its economic gain, which does not correct until Purchaser Co sells the village before recognising, or otherwise does not recognise, assessable income from a new resident.

ii. Scenario B

Under Scenario B the First Resident leaves the retirement village and $300 is paid by Purchaser Co to the First Resident. Purchaser Co then enters into a lease premium arrangement with the Second Resident and receives an assessable incoming contribution of $400. At that point in time, the accounting position of the retirement village is as follows:

Assets		**Liabilities**	
Investment Property	$400	Resident Liabilities	$400
Cash	$250	Contributed Equity	$50
		Retained Profits	$200
Total	**$650**	**Total**	**$650**

Purchaser Co sells the retirement village via asset sale for $250 cash.

The economic position of Purchaser Co as a result of the disposal is as follows:

Economic Position of Vendor Co	
Cash Inflows:	
Sale Proceeds	$250
Second Resident Ingoing Payment	$400
Cash Outflows:	
First Resident payment	($300)
Cash "sold" to purchaser	($250)
Total	**$100**

Under TR 2002/14, Purchaser Co must include the $400 Ingoing Contribution from the Second Resident as assessable income, and work out its gain on sale of the retirement village as follows:

Proceeds	
Cash	$250
Assumption of Resident Liabilities	$400
Cost Base	
Investment Property	$300
Cash	$250
Gain/ (Loss) on Sale	**$100**

The tax position of Vendor Co is therefore as follows:

Tax Position	
Income:	
Gain on Sale	$100
Second Resident Payment	$400
Deductions:	
First Resident Payment	$300
Total tax profit	**$200**

So for Scenario B under current law, the $200 overall economic profit recognised on the transactions (being the construction of the village for $200, and its ultimate sale by Purchaser Co to Second Resident for $400), is split:

- economically, as to $100 to Vendor Co, and as to $100 to Purchaser Co; but
- for tax purposes, as the $200 construction expenditure "deduction" and the deduction for the payment to be made to the Second Resident are yet to be recognised in the tax system, the tax positions are $400 assessable to Vendor Co, and $200 assessable to Purchaser Co.

In essence, what the above shows is that the full amount of the liability is taken into account on the transfer of a retirement village by way of asset sale as either, an increase to consideration (from the perspective of a vendor), or an increase to the cost base of the assets (from the perspective of a purchaser). Further, the tax profile does not work unless the purchaser is entitled to claim a tax deduction for the payment to the outgoing First Resident.

Ideally, under an entity sale, the tax consolidation rules would mirror the outcomes as set out above. However, as the following sections (c) and (d) demonstrate, the outcomes under tax consolidation are different, due to the adjustments required to be made to deductible accounting liabilities.

(c) Base Case - outcomes for Vendor Co

After constructing the village, and the entry of the First Resident Sub Co's balance sheet would be as follows:

Assets		**Liabilities**	
Investment Property	$300	Resident Liabilities	$300
Cash	$150	Contributed Equity	$50
		Retained Profits	$100
Total	**$450**	**Total**	**$450**

Purchaser Co (the head company of the Purchaser Co consolidated group) purchases Sub Co for the market value of the company of $150.

Therefore, Sub Co becomes a member of the Purchaser Co consolidated group.

The economic position of Vendor Co as a result of the disposal is as follows:

Economic Position of Vendor Co	
Cash Inflows:	
Sale Proceeds	$150
Cash Outflows:	
Equity Contribution	($50)
Total	**$100**

When the Vendor Co consolidated group sells its shares in Sub Co, it works out the tax cost of the shares by performing the exit ACA calculation under Division 711, as follows:

Step 1	Investment Property	$200[6]
	Cash	$150
	Sub-Total	$350
Step 4	Resident Liabilities	$300
	Section 711-45(3)	($90)
	Section 711-45(5)	$0[7]
	Sub-Total	$210[8]
Step 5	**Total Exit ACA**	**$140**

Accordingly, Vendor Co realises a total gain of $100 on the sale, comprising of:

Capital Proceeds	$150
Less: Exit ACA cost base	$140
Total	**$10**

The tax position of Vendor Co is therefore as follows:

Tax Position	
Income:	
Gain on Sale	$10
First Resident Payment	$300
Deductions:	
N/A	0
Total taxable income	**$310**

There is a mismatch of $210 as between Vendor Co's economic profit of $100 and its taxable income of $310. There is also a mismatch as between the tax outcome for Vendor Co under tax consolidation (i.e. taxable income of $310), and that arising outside of tax consolidation where the relevant village is sold by way of asset sale – being a taxable income of $400. This difference is due to any adjustment required to be made to the original amount of the liability under ss 711-45(3) and (5) – in this case, a reduction of $90. This is contrasted with the position in (b) above, where the liability is taken into account in full (albeit as an inclusion in capital proceeds, rather than a reduction to cost base) in working out Vendor Co's tax position.

[6] The terminating value of the investment property is $200 (i.e. the construction cost of the retirement village).

[7] There are competing interpretations on the application of s 711-45(5). For the purpose of this submission, it is assumed that s 711-45(5) does not require any further adjustment to Resident Liabilities, as the liability has already given rise to a tax outcome, being the inclusion of an amount in assessable income - accordingly, s 711-45(5) does not apply.

[8] There are some in the industry who consider that Resident Liabilities should not be included in either the Step 2 entry ACA amount, nor the Step 4 exit ACA amount because of ss 705-70(2) and 711-45(2) respectively. The problems raised with this view are set out in 3.4 below.

(d) Base Case - outcomes for Purchaser Co

On acquiring Sub Co, Purchaser Co resets the tax cost setting amount of the assets by performing the entry ACA calculation under Division 705, as follows:

Step 1	Cost of membership interests	$150
Step 2	Resident Liabilities	$300
	Section 705-75	($90)
	Sub-Total	$210
Step 8	**Total Entry ACA**	**$360**

As such, the accounting value and tax cost base of Sub Co's assets and liabilities after it joins the Purchaser Co consolidated group are as follows:

	Accounting	**Tax Base**
Assets		
Investment Property	$300	$210
Cash	$150	$150
Liabilities		
Resident Liabilities	$300	
Equity		
Contributed Equity	$50	
Retained Profits	$100	

iii. Scenario A

Under Scenario A, the First Resident leaves the retirement village and Purchaser Co subsequently sells the retirement village land for $400 in the same income year.

Purchaser Co makes a taxable gain of $190 (that is $400 less $210). The payment to the First Resident results in a deduction of $300. Accordingly, Purchaser Co realises a **tax loss of $110**.

However, under an asset acquisition and sale, the tax position of Purchaser Co is a **tax loss of $200**.

As such, the current rules give rise to a mismatch of $90 between an asset acquisition and sale and an entity acquisition that is subject to the tax consolidation rules.

The mismatch is caused by the $90 reduction required by s 705-75. In an asset acquisition scenario, the Resident Liability would be included in Purchaser Co's tax cost base in full. Further, it is important to note that, outside of consolidation, and indeed, under the current tax consolidation rules, Purchaser Co would be entitled to a tax deduction for any payment made to the First Resident on their departure from the village.

iv. Scenario B

Under Scenario B, in Year 2, the First Resident leaves the retirement village and $300 is paid by Sub Co to the First Resident. Sub Co then enters into a lease premium arrangement with the Second Resident and receives an assessable incoming contribution of $400. Purchaser Co Sub Co for $250 in the same income year.

The balance sheet of Sub Co prior to the sale is therefore as follows:

Assets		**Liabilities**	
Investment Property	$400	Resident Liabilities	$400
Cash	$250[9]	Contributed Equity	$50
		Retained Profits	$200
Total	**$650**	**Total**	**$650**

When Purchaser Co consolidated group sells its shares in Sub Co, it works out the tax cost of the shares by performing the exit ACA calculation under Division 711, as follows:

Step 1	Investment Property	$210
	Cash	$250
	Sub-Total	$460
Step 4	Resident Liabilities	$400
	Section 711-45(3)	($120)
	Section 711-45(5)	$120
	Sub-Total	$400
Step 5	**Total Exit ACA**	**$60**

Accordingly, Purchaser Co realises a total gain of $190 on the sale, comprising of:

Capital Proceeds	$250
Less: Exit ACA cost base	$60
Total	**$190**

The tax position of Purchaser Co is therefore as follows:

Tax Position	
Income:	
Second Resident Payment	$400
Gain on Sale	$190
Deductions:	
First Resident Payment	($300)
Total tax profit	**$290**

However, under an asset acquisition and sale, the tax position of Purchaser Co is **taxable income of $200**.

As such, the current rules give rise to a mismatch of $90 between an asset acquisition and sale and an entity acquisition that is subject to the tax consolidation rules.

Again, the mismatch is caused by the $90 reduction required by s 705-75. In an asset acquisition scenario, the Resident Liability would be included in Purchaser Co's tax cost base in full. Further, it is important to note that, outside of consolidation, and indeed, under the current tax consolidation rules, Purchaser Co would be entitled to a tax deduction for any payment made to the First Resident on their departure from the village.

The following sets out a summary of the tax positions of Vendor Co and Purchaser Co under current law, where the retirement village is bought and sold via asset transactions, as compared to where shares in Sub Co are bought and sold and thus, the transactions are subject to the tax cost-setting rules in tax consolidation.

[9] The cash balance of $130 is made up of the cash balance at Sub Co's joining time of $60, and the after tax cash receipt from the roll-over of residents (that is $400 less $300 less $30).

Summary of outcomes under current law[10]

	Vendor Co outcomes	Purchaser Co outcomes Scenario A (No Second Resident, then Sale)	Purchaser Co outcomes Scenario C (Second Resident, then Sale)
Tax outcomes under current legislation			
Asset sales and acquisitions	*$400*	*($200)*	*$200*
Entity sales and acquisitions	*$310*	*($110)*	*$290*
Mismatch	**($90)**	**$90**	**$90**
Comments	The mismatch is caused by the reduction required to be made to the liability by ss 711-45(3) and (5).	The mismatch is caused by the $90 reduction required by s 705-75.	The mismatch is caused by the $90 reduction required by s 705-75.

[10] It is noted that there are differing views in the industry regarding the application of the tax cost-setting rules to Resident Liabilities – the view upon which these outcomes are based are explained in more detail below (and, where differing views exist, they are also noted).

(e) Proposed Solution

None of the options raised by the BoT contemplate deductible accounting liabilities that have given rise to the inclusion of amounts in assessable income. As such, none of these options will cure the mismatch between the economic and tax outcomes as illustrated in the examples above.

The mismatches that occur outside of consolidation, as compared to those that occur within, are caused by the reduction to accounting liabilities that will give rise to future deductions under ss 711-45(3), (5) and 705-75(1). Therefore, we suggest amending ss 722-45(3), (5) and 705-75(1) such that they do not apply to the extent that an accounting liability has given rise, or will give rise, to the inclusion of an amount in the an entity's assessable income prior to the leaving/ joining time.

Some specific comments are provided on the 4 options raised in the Discussion Paper in this context:

- Options 1 and 2 would exacerbate the mismatch as between non-consolidation and consolidation outcomes, as to deny a deduction for the liability when it is settled with the First Resident would cause Purchaser Co's tax positions to be inflated by a further $400, when compared with the outside of tax consolidation scenario.

  Further, such an amendment would create a mismatch as between the purchaser of a retirement village by way of asset sale, and the head company of a consolidated group that purchases an entity that holds an equivalent retirement village.

  Finally, such an amendment would be grossly unfair in the context of Resident Liabilities that have been included in assessable income, as it would create an asymmetry – i.e. the recognition of the liability gives rise to the inclusion of an equivalent amount in assessable income, however the discharge of the liability would not give rise to an allowable deduction.

- Option 3 would also exacerbate the mismatch, by reducing Purchaser Co's available cost base in the assets of Sub Co by $300 – thus inflating Purchaser Co's tax positions by a further $300.

  As the discussion above shows, Purchaser Co requires both cost base, and a tax deduction in relation to the full amount of Resident Liabilities in order to ensure the correct tax is paid in the system in relation to a lease premium retirement village.

  Further, such an amendment would create a mismatch as between the purchaser of a retirement village by way of asset sale (where such liabilities would be included in the cost base of the assets), and the head company of a consolidated group that purchases an entity that holds an equivalent retirement village.

- Option 4 would also exacerbate the mismatch, by increasing Purchaser Co's tax position by a further $210 – being the final Step 2 amount of the Resident Liabilities.

  As the discussion above shows, Purchaser Co requires both cost base, and a tax deduction in relation to the full amount of Resident Liabilities in order to ensure the correct tax is paid in the system in relation to a lease premium retirement village.

  Further, such an amendment would create a mismatch as between the purchaser of a retirement village by way of asset sale (where no such capital gain would arise), and the head company of a consolidated group that purchases an entity that holds an equivalent retirement village.

Therefore, we would submit that, to the extent the above Options are recommended by the Board, they not apply to deductible liabilities to the extent those liabilities have given rise to, or will give rise to, the inclusion of amounts in the assessable income of the joining entity prior to the joining time.

3.1.2 Capital Growth Payments

As noted earlier, the tax treatment of the second type of liability for a retirement village operator, i.e. CGPs, is not clear. The AAT held in *Tricare* that CGPs made by a retirement village operator to its departing residents were deductible under s 8-1 of the Act. However, the ATO has expressed a view that CGPs made under occupancy arrangements covered by TR 2002/14 should be of a capital nature, and that *Tricare* is limited to its facts.

Based on the AAT view, no mismatch would arise for either Vendor Co or Purchaser Co under the current consolidation rules in respect of the CGPs. It is the ATO's view on the tax treatment of the CGPs that has caused the mismatch issues in the consolidation context. Again, we have sought to highlight the issues by way of simplified examples. The summaries of the facts and tax outcomes are outlined below.

FACTS

1 Establishment of Sub Co

- Vendor Co incorporates wholly-owned Sub Co and subscribes capital of $50
- Sub Co borrows $150 from a bank
- Sub Co constructs a retirement village for the cost of $200

2 Sub Co prior to ownership change

- The First Resident enters into a TR 2002/14 interest-free loan arrangement with Sub Co, and pays incoming contribution of $300
- Sub Co repays the bank loan of $150
- The market value of the Investment Property increases to $400
- Residents are entitled to a share of 50% of the capital growth in the value of the Investment Property

3 Ownership changes

- Purchaser Co purchases Sub Co for market value:

	Investment Property	$400
plus	Cash	150
less	Resident Liability	(350)
		$200

4 Post-acquisition transactions of the Purchaser Co group

- The First Resident leaves and is repaid $300, then:
- Scenario A: the First Resident leaves the village and the retirement village land is sold for $400.
- Scenario B:
  - the Second Resident enters into an interest-free loan arrangement with Sub Co and pays incoming contribution of $400
  - The retirement village is sold via asset sale for $120
- Scenario C:
  - the Second Resident enters into an interest-free loan arrangement with Sub Co and pays incoming contribution of $400
  - Sub Co is sold via share sale for $120

Outcomes under current law

	Vendor Co outcomes		Purchaser Co outcomes					
			Scenario A (sale of land)		Scenario B (sale of village)		Scenario C (sale of Sub Co)	
Economic position	**$150**		**$0**		**$120**		**($80)**	
Tax outcomes under current legislation	**AAT view**	**ATO view**	**AAT view**	**ATO view**	**AAT view**	**ATO view**	**AAT view**	**ATO view**
Tax cost base	*$50*	*$0*	*$350*	*$450*	*$350*	*$450*	*$150*	*$250*
Proceeds from sale	*$200*		*$400*		*$520*		*$120*	
Gain on sale	*$150*	*$200*	*$50*	*($50)*	*$170*	*$70*	*($3)0*	*($130)*
Deductions for CGP/ Loss from Sub Co	*N/A*	*N/A*	*($50)*	*$0*	*($50)*	*$0*	*($50)*	*$0*
Tax position	**$150**	**$200**	**$0**	**($50)**	**$120**	**$70**	**($80)**	**($130)**
Mismatch between tax and economic positions	**$0**	**$50**	**$0**	**($50)**	**$0**	**($50)**	**$0**	**($50)**
Comments		The mismatch is caused by the fact that the CGP liability neither gives rise to an asset nor is a deductible liability, and thus cannot be dealt with under the current tax cost-setting rules.		The mismatch is caused by the fact that the CGP liability neither gives rise to an asset nor is a deductible liability, and thus cannot be dealt with under the current tax cost-setting rules.		The mismatch is caused by the fact that the CGP liability neither gives rise to an asset nor is a deductible liability, and thus cannot be dealt with under the current tax cost-setting rules.		The mismatch is caused by the fact that the CGP liability neither gives rise to an asset nor is a deductible liability, and thus cannot be dealt with under the current tax cost-setting rules.

(a) Base Case - outcomes for Vendor Co

Sub Co is a subsidiary of Vendor Co and a member of the Vendor Co consolidated group. Sub Co was incorporated within the Vendor Co consolidated group and has issued share capital of $50. Sub Co has a bank loan of $150, and has constructed a retirement village for the cost of $200.

In Year 1, Sub Co enters into a TR 2002/14 interest-free loan arrangement with the First Resident, and the First Resident pays incoming contribution of $300. Sub Co repaid the bank loan in full. There is no other income or expenses for Year 1. As the incoming contribution is treated on capital account pursuant to TR 2002/14, the amount will not be included in the assessable income.

The market value of the Investment Property has subsequently increased to $400. Under the interest-free loan occupancy arrangement, residents are entitled to a share of 50% of the capital growth in the value of the Investment Property.

The balance sheet of Sub Co at the end of Year 1 is as follows:

Assets		**Liabilities**	
Investment Property	$400	Resident Liabilities	$350
Cash	$150	Contributed Equity	$50
		Retained Profits	$150
Total	**$550**	**Total**	**$550**

Vendor Co subsequently sells all the shares it holds in Sub Co to Purchaser Co (the head company of the Purchaser Co consolidated group) in Year 2 for the market value of the company of $200.

Therefore, Sub Co becomes a member of the Purchaser Co consolidated group.

The economic position of Vendor Co as a result of the disposal is as follows:

Economic Position of Vendor Co	
Cash Inflows:	
Sale Proceeds	$200
Cash Outflows:	
Equity Contribution	($50)
Total	**$150**

When the Vendor Co consolidated group sells its shares in Sub Co, it works out the tax cost of the shares by performing the exit ACA calculation under Division 711. However, the different views on the treatment of the CGPs as expressed by the AAT and the ATO would result in different tax outcomes, as follows:

		AAT view	ATO view
Step 1	Investment Property	$200[11]	$200
	Cash	$150	$150
	Sub-Total	$350	$350
Step 4	Resident Liabilities	$350	$350
	Section 711-45(3)	($15)[12]	0
	Section 711-45(5)	($45)	0
	Sub-Total	$300	$350
Step 5	**Total Exit ACA**	**$50**	**$0**

Accordingly, the gain that will be realised by Vendor Co on the sale would be as follows:

	AAT view	ATO view
Proceeds on sale	$200	$200
Cost base	$50	$0
Total	**$150**	**$200**

The tax position of Vendor Co would therefore be as follows:

Tax Position	AAT view	ATO view
Income:		
Gain on Sale	$150	$200
Deductions:		
N/A	0	0
Total	**$150**	**$200**

Accordingly, a mismatch of $50 (between Vendor Co's economic profit of $150 and its taxable profit of $200) would arise under the ATO's view. The mismatch is caused by the fact that the CGP liability neither gives rise to an asset nor is a deductible liability, and thus cannot be dealt with under the current tax cost-setting rules.

(b) Base Case - outcomes for Purchaser Co

Further, the ATO's view on the treatment of CGPs will also result in a mismatch of commercial and tax outcomes for Purchaser Co. The below examples illustrate the problems under the three different scenarios.

On acquiring Sub Co, Purchaser Co resets the tax cost setting amount of the assets by performing the entry ACA calculation under Division 705, as follows:

[11] The terminating value of the investment property is $200 (i.e. the construction cost of the retirement village).

[12] The tax effect of the $50 CGP.

		AAT view	ATO view
Step 1	Cost of membership interests	$200	$200
Step 2	Resident Liabilities	$350	$350
	Section 705-75	($15)	0
	Section 705-80	($35)	0
	Sub-Total	$300	$350
Step 8	**Total Entry ACA**	**$500**	**$550**

As such, the accounting value and tax cost base of Sub Co's assets and liabilities after it joined the Purchaser Co consolidated group are as follows:

	Accounting	**Tax Base (AAT view)**	**Tax Base (ATO view)**
Assets			
Investment Property	$400	$350	$400
Cash	$150	$150	$150
Liabilities			
Resident Liabilities	$350		
Equity			
Contributed Equity	$50		
Retained Profits	$150		

i. Scenario A

Under Scenario A, the First Resident leaves the retirement village in Year 2, and Purchaser Co subsequently sells the retirement village land for $400 in the same income year.

Accordingly, the outcome of the sale of land to Purchase Co would be as follows:

	AAT view	**ATO view**
Proceeds		
Cash	$400	$400
Cost Base		
Investment Property	$350	$450[13]
Gain/ (Loss) on Sale	**$50**	**($50)**

As such, the tax position of Purchaser Co would be as follows:

[13] The cost base of the Investment Property is made up of $400 worked out under the entry ACA calculation, and the CGP of $50 (which is treated as being on capital account and as such would be included in the cost base of the retirement village).

	AAT view	ATO view
Income:		
Gain on Sale of Land	$50	($50)
Deductions:		
CGP to First Resident	($50)	0
Total tax profit/ (loss)	**$0**	**($50)**

However, the economic position of Purchaser Co is as follows:

Economic Position of Purchaser Co	
Cash Inflows:	
Land Sale Proceeds	$400
Cash	$150
Cash Outflows:	
Sub Co Acquisition Price	($200)
Payment to First Resident including CGP	($350)
Total economic profit	**$0**

Again, the ATO treatment of CGP would give rise to a mismatch of $50 between commercial and tax outcomes. The mismatch is caused by the double recognition of the CGP in the cost base, first being included in Step 2 of the entry ACA calculation, and then being included again in the cost base of the retirement village land upon sale (refer PBR 88882).

ii. Scenario B

Under Scenario B, in Year 2, the First Resident leaves the retirement village and $350 (that is the repayment of the loan of $300 and the CGP of $50) is paid by Sub Co to the First Resident. Sub Co then enters into a new TR 2002/14 interest-free loan arrangement with the Second Resident and receives non-assessable incoming contribution of $400. There is no other income or expenses for Year 2.

Purchaser Co subsequently sells the retirement village via an asset sale for $120 in the same income year.

The balance sheet of Sub Co prior to the sale is therefore as follows:

Assets		**Liabilities**	
Investment Property	$400	Resident Liabilities	$400
Cash	$200[14]	Contributed Equity	$50
		Retained Profits	$150
Total	**$600**	**Total**	**$600**

The outcome of the sale of the retirement village assets to Purchase Co would be as follows:

	AAT view	ATO view
Proceeds		
Cash	$120	$120
Assumption of Resident Liabilities	$400	$400
Cost Base		
Investment Property	$350	$450
Gain/ (Loss) on Sale	**$170**	**$70**

[14] The cash balance of $200 is made up of the cash balance at Sub Co's joining time of $150, and the after CGP cash receipt from the roll-over of residents (that is $400 less $300 less $50).

Accordingly, the tax position of Purchaser Co under this scenario would be:

	AAT view	ATO view
Income:		
Gain on Sale of Retirement Village	$170	$70
Deductions:		
CGP to First Resident	($50)	0
Total tax profit/ (loss)	**$120**	**$70**

However, the economic position of Purchaser Co as a result of the transactions is as follows:

Economic Position of Purchaser Co	
Cash Inflows:	
Retirement Village Sale Proceeds	$120
Cash at Joining Time	$150
Second Resident Incoming Contribution	$400
Cash Outflows:	
Sub Co Acquisition Price	($200)
Payment to First Resident	($350)
Total economic profit	**$120**

As such, under Scenario B, the treatment of CGPs under the ATO view would again cause a mismatch between commercial and tax outcomes of $50, due to the dual recognition of the CGP in the cost base as outlined under Scenario A above.

iii. Scenario C

Under Scenario C, all of the facts are the same as those under Scenario B other than that Purchaser Co subsequently sells Sub Co via a share sale (as opposed to selling the retirement village via an asset sale) for $120 in Year 2.

The balance sheet of Sub Co prior to the sale is the same as that under Scenario B.

When Purchaser Co consolidated group sells its shares in Sub Co, it works out the tax cost of the shares by performing the exit ACA calculation under Division 711, as follows:

		AAT view	ATO view
Step 1	Investment Property	$350	$450
	Cash	$200	$200
	Sub-Total	$550	$650
Step 4	Resident Liabilities	$400	$400
	Section 711-45(3)	0	0
	Section 711-45(5)	0	0
	Sub-Total	$400	$400
Step 5	**Total Exit ACA**	**$150**	**$250**

Accordingly, the outcome of the sale of Sub Co to Purchase Co would be as follows:

	AAT view	ATO view
Proceeds		
Cash	$120	$120
Cost Base		
Investment Property	$150	$250
Gain/ (Loss) on Sale	**($30)**	**($130)**

As such, the tax position of Purchaser Co would be as follows:

	AAT view	ATO view
Income:		
Gain/ (Loss) on Sale of Sub Co	($30)	($130)
Deductions:		
Loss from Sub Co	($50)	0
Total tax profit/ (loss)	**($80)**	**($130)**

The economic position of Purchaser Co as a result of the sale is as follows:

Economic Position of Purchaser Co	
Cash Inflows:	
Sub Co Sale Proceeds	$120
Cash Outflows:	
Sub Co Acquisition Price	($200)
Total economic profit	**($80)**

Accordingly, there will be a mismatch of $50 between Purchaser Co's economic loss of $80 and its tax loss of $130 under the ATO view for the same reason outlined above.

(c) *Tricare* decision should prevail

As illustrated above, no problems arise, and thus, no solutions are required, in respect of the current consolidation rules if the CGPs are treated as deductible on revenue account under the AAT view.

However, should the ATO persist with its view, and/ or that view be affirmed by the Courts, then the mismatches set out in (a) and (b) above would still arise. Therefore, we suggest amending s 711-45(5) to read as follows, so as to guard against this potential outcome:

> *If, for income tax purposes, an accounting liability, or a change in the amount of an accounting liability, (other than one owed to a *member of the old group) ~~is taken into account~~ gives rise to, or would but for subsection 8-1(2)(a) give rise to, a *deduction at a later time than is the case in accordance with the leaving entity's *accounting principles for tax cost setting, the amount to be added for the accounting liability is equal to the payment that would be necessary to discharge the liability just before the leaving time without an amount being included in the assessable income of, or (on the basis that subsection 8-1(2)(a) is ignored) allowable as a deduction to, the *head company.*

Under the ATO view, the CGPs would be deductible but for the fact that they are capital in nature, and thus fall foul of the negative limb in s 8-1(2)(a). The above amendment would ensure that subsection 711-45(5) applied to CGPs, even if they were to be considered capital outgoings. Such an amendment would then ensure CGPs were treated in the same way as if they were revenue outgoings under the consolidation tax cost-setting rules, thus ensuring the outcomes arising under the "AAT view" above, would apply regardless of whether CGPs were ultimately seen to be on revenue or capital account.

(d) Board of Taxation Options

We have sought to address the implications of the BoT's proposed options on Vendor Co and Purchaser Co should any of these options be implemented.

In the Discussion Paper, BoT proposes four options, namely:

- Option 1: Deem deductible liabilities to be assumed by the head company, at their accounting value, at the time the entity joins a consolidated group.

  As a result, the amount included at step 2 would not be altered. Subsequently, amounts deducted, or included in assessable income, in respect of the liability will have regard to the deemed receipt.

- Option 2: Deny the deduction for deductible liabilities (equal to the step 2 amount) after the entity has joined the consolidated group.

  As a result, the head company would not have to track the deductible liabilities after the joining time.

- Option 3: Disregard deductible liabilities at step 2 of the entry tax cost amount.
- Option 4: Deem the acquiring consolidated group to have realised a capital gain at the joining time equal to the final step 2 amount for deductible liabilities.

  As a result, the head company would not have to track deductible liabilities.

The following tables separately outline the outcomes for Vendor Co and for Purchaser Co under different scenarios. As shown in the tables below, on the basis that the CGPs are considered deductible liabilities in accordance with the view expressed by the AAT (or, even if they are outgoings of a capital nature, are nonetheless treated as if they were deductible outgoings for tax cost-setting purposes, in line with the proposed legislative amendment set out above), obtaining an overall tax outcome that equates to the overall economic outcome can be achieved under all four proposed options for Vendor Co, and can also be achieved under all four proposed options for Purchaser Co, provided that the s 705-80 adjustment is removed from Step 2 of the entry ACA calculation under Options 1 & 2.

As such, we agree with the BoT's proposal to remove the s 705-80 adjustment in full acquisition cases in response to Question 4.2 of the Discussion Paper.

Outcomes for Vendor Co

	BoT Option 1	BoT Option 2	BoT Option 3	BoT Option 4
Sub Co Exit ACA				
Step 1				
Investment Property	$200	$200	$200	$200
Cash	$150	$150	$150	$150
Sub-Total	$350	$350	$350	$350
Step 4				
Resident Liabilities	$350	$350	$350	$350
Section 711-45(3)	($15)	($15)	($15)	($15)
Section 711-45(5)[15]	($35)	($35)	($35)	($35)
Sub-Total	$300	$300	$300	$300
Tax Exit ACA	$50	$50	$50	$50
Proceeds from sale of Sub Co	$185	$200	$200	$200
Tax Cost Base	$50	$50	$50	$50
Gain on Sale	$135	$150	$150	$150
Deductions	$0	$0	$0	$0
Tax Position	**$135**	**$150**	**$150**	**$150**
Sale Proceeds	$185	$200	$200	$200
Contributed Equity	($50)	($50)	($50)	($50)
Economic Position	**$135**	**$150**	**$150**	**$150**
Mismatch between tax and economic positions	**$0**	**$0**	**$0**	**$0**

[15] Under the legislative amendment proposed above, should CGPs be considered outgoings of a capital nature, there would be no s 711-45(3) adjustment, rather the s 711-45(5) adjustment would become a reduction of $50.

Outcomes for Purchaser Co

Scenario A	BoT Option 1	BoT Option 2	BoT Option 3	BoT Option 4
Sub Co Entry ACA				
Step 1				
Cost of membership interests	$185	$200	$200	$200
Step 2				
Resident Liabilities	$350	$350	$350	$350
Section 705-75	$0	$0	$0	($15)
Section 705-80	($50)	($50)	$0	($35)
Disregard deductible CGP	N/A	N/A	($50)	N/A
Sub-Total	$300	$300	$300	$300
Tax Entry ACA	$485	$500	$500	$500
Tax Cost Base	$485	$500	$500	$500
Investment Property	$335	$350	$350	$350
Cash	$150	$150	$150	$150
Proceeds from sale of land	$400	$400	$400	$400
Cost Base of Land	$335	$350	$350	$350
Gain on sale of land	$65	$50	$50	$50
Deemed CGT Gain	N/A	N/A	N/A	$0
Deduction for payment to First Resident	$0	$0	($50)	($50)
Tax position	**$65**	**$50**	**$0**	**$0**
Sale Proceeds	$400	$400	$400	$400
Cash at joining time	$150	$150	$150	$150
Sub Co Acquisition Price	($185)	($200)	($200)	($200)
Payment to First Resident	($350)	($350)	($350)	($350)
Economic position	**$15**	**$0**	**$0**	**$0**
Mismatch between tax and economic positions	**($50)**	**($50)**	**$0**	**$0**
Comments	The mismatch arises due to the retention of s 705-80 adjustment as discussed in Chapter 4 of the Discussion Paper.	The mismatch arises due to the retention of s 705-80 adjustment as discussed in Chapter 4 of the Discussion Paper.		

Scenario B	BoT Option 1	BoT Option 2	BoT Option 3	BoT Option 4
Sub Co Entry ACA				
Step 1				
Cost of membership interests	$185	$200	$200	$200
Step 2				
Resident Liabilities	$350	$350	$350	$350
Section 705-75	$0	$0	$0	($15)
Section 705-80	($50)	($50)	$0	($35)
Disregard deductible CGP	N/A	N/A	($50)	N/A
Sub-Total	$300	$300	$300	$300
Tax Entry ACA	$485	$500	$500	$500
Tax Cost Base	$485	$500	$500	$500
Investment Property	$335	$350	$350	$350
Cash	$150	$150	$150	$150
Proceeds from Sale of Retirement Village				
Cash	$120	$120	$120	$120
Assumption of Resident Liability	$400	$400	$400	$400
Cost Base of Retirement Village	$335	$350	$350	$350
Gain on Sale	$185	$170	$170	$170
Deemed CGT Gain	N/A	N/A	N/A	$0
Deduction for Payment to First Resident	$0	$0	($50)	($50)
Tax position	**$185**	**$170**	**$120**	**$120**
Sale Proceeds	$120	$120	$120	$120
Cash at joining time	$150	$150	$150	$150
Second Resident Incoming Contribution	$400	$400	$400	$400
Sub Co Acquisition Price	($185)	($200)	($200)	($200)
Payment to First Resident	($350)	($350)	($350)	($350)
Economic position	**$135**	**$120**	**$120**	**$120**
Mismatch between tax and economic positions	**($50)**	**($50)**	**$0**	**$0**
Comments	The mismatch arises due to the retention of s 705-80 adjustment as discussed in Chapter 4 of the Discussion Paper.	The mismatch arises due to the retention of s 705-80 adjustment as discussed in Chapter 4 of the Discussion Paper.		

Scenario C	BoT Option 1	BoT Option 2	BoT Option 3	BoT Option 4
Sub Co Entry ACA				
Step 1				
Cost of membership interests	$185	$200	$200	$200
Step 2				
Resident Liabilities	$350	$350	$350	$350
Section 705-75	$0	$0	$0	($15)
Section 705-80	($50)	($50)	$0	($35)
Disregard deductible CGP	N/A	N/A	($50)	N/A
Sub-Total	$300	$300	$300	$300
Tax Entry ACA	$485	$500	$500	$500
Tax Cost Base	$485	$500	$500	$500
Investment Property	$335	$350	$350	$350
Cash	$150	$150	$150	$150
Exit ACA on Sale of Sub Co				
Step 1				
Investment Property	$335	$350	$350	$350
Cash	$200	$200	$200	$200
Sub-Total	$535	$550	$550	$550
Step 4				
Resident Loan Liabilities	$400	$400	$400	$400
Section 711-45(3)	$0	$0	$0	$0
Section 711-45(5)	$0	$0	$0	$0
Sub-Total	$400	$400	$400	$400
Total Exit ACA	$135	$150	$150	$150
Sale Proceeds	$120	$120	$120	$120
Cost Base of Shares	$135	$150	$150	$150
Gain on Sale	($15)	($30)	($30)	($30)
Deemed Capital Gain	N/A	N/A	N/A	$0
Deduction for Loss from Sub Co	$0	$0	($50)	($50)
Tax position	**($15)**	**($30)**	**($80)**	**($80)**
Sale Proceeds	$120	$120	$120	$120
Sub Co Acquisition Price	($185)	($200)	($200)	($200)
Economic position	**($65)**	**($80)**	**($80)**	**($80)**
Mismatch between tax and economic positions	**($50)**	**($50)**	**$0**	**$0**
Comments	The mismatch arises due to the retention of s 705-80 adjustment as discussed in Chapter 4 of the Discussion Paper.	The mismatch arises due to the retention of s 705-80 adjustment as discussed in Chapter 4 of the Discussion Paper.		

3.2 Deferred Tax Liabilities

The above examples have all been prepared without considering the treatment of deferred tax liabilities ("**DTLs**") for simplicity purposes. DTLs, particularly in a retirement village context, will even further complicate the ACA process.

Moreover, given that a number of villages are operated by not-for-profit entities and a number of for-profit operators are in tax loss positions, it is often the case that deferred tax balances are not carried in respect of retirement villages. Therefore, it is not uncommon for an entity to enter a tax consolidated group without any deferred tax balances in that entity's statement of financial position. This is a further reason in support of the exclusion of deferred tax balances from the tax cost-setting process.

3.3 Section 705-80 and 705-70(1A)

Other issues and adjustments identified and proposed by the BoT in Chapters 4 and 5 of the Discussion Paper have been discussed to some extent in 2.1 above.