

JOINT SUBMISSION BY

CPA Australia, the Institute of Chartered Accountants in Australia, National
Institute of Accountants, the Taxation Institute of Australia and
Taxpayers Australia

Draft Taxation Ruling TR 2010/D7

***Income tax: business related capital expenditure – section 40-880 of the
Income Tax Assessment Act 1997 core issues***

Date: 11 February 2011

The Professional Bodies welcome the opportunity to comment on Draft Taxation Ruling TR 2010/D7 (the Draft Ruling).

GENERAL COMMENTS

We welcome the issue of the Draft Ruling. The need for a comprehensive ruling on section 40-880 of the Income Tax Assessment Act 1997 (“the ITAA 1997”) is evident from the number of ATO Interpretative Decisions (34 excluding those that have been withdrawn) and private rulings (176 of which contain references to section 40-880) that have been issued on the application of this provision.

SPECIFIC COMMENTS

1. Expenditure which serves more than one purpose or object

1.1 Underlying statutory interpretation principles

At paragraph 21, the Draft Ruling states that the absence of the expression ‘to the extent that’ in subsection 40-880(2) does not prevent an apportionment of expenditure on a single thing or service which serves more than one purpose or object.

At paragraph 116, the ATO states that there is no obvious policy reason for prohibiting apportionment in the situations concerned notwithstanding that the explanatory memorandum does not clearly resolve the ambiguity. In these circumstances, the ATO concludes that, on balance, recourse to the established principles on apportionment under section 8-1 seems most likely to be what was intended.

Given that the ATO’s interpretation is not consistent with a literal reading of subsection 40-880(2), we recommend that its view be supported by reference to statutory interpretation principles. For example, in *CIC Insurance Ltd v. Bankstown Football Club* (1997) 187 CLR 384, the High Court stated (at 408):

[T]he modern approach to statutory interpretation (a) insists that the context be considered in the first instance, not merely at some later stage when ambiguity might be thought to arise, and (b) uses “context” in its widest sense to include such things as the existing state of the law and the mischief which, by legitimate means such as those just mentioned, one may discern the statute was intended to remedy... [I]f the apparently plain words of a provision are read in the light of the mischief which the statute was designed to overcome and of the objects of the legislation, they may wear a very different appearance. Further, inconvenience or improbability of result may assist the court in preferring to the literal meaning an alternative construction which, by the steps identified above, is reasonably open and more closely conforms to the legislative intent.

1.2 Fair and reasonable apportionment

We recommend that guidance be provided on how to determine what constitutes a fair and reasonable apportionment. Example 11, which is broadly based on the facts of ATO ID 2007/94 (withdrawn), states that the expenditure on professional services incurred by ResCo must be apportioned as it relates to the incorporation and listing of the overseas entity as well as the business that will continue to be conducted by ResCo. However, no guidance is provided on how a fair and reasonable apportionment is to be performed. The objects that the expenditure is designed to achieve appear to be qualitative in nature unless the apportionment can be performed by reference to the expected future profits to be derived by the overseas entity and the business carried on by ResCo over, say, the next 5 years.

1.3 Passive income

Paragraph 118(a) states that apportionment is required where a single amount is incurred for a thing or service that indifferently serves business and non-business objects. The use of the term 'objects' seems to be inconsistent with the rest of the Draft Ruling which focuses on the business and non-business 'activities'. Clarification of the difference between the two terms by way of example would be helpful. We suggest that an example of a non-business object might be the derivation of passive income. For example, if a company incurred costs in raising funds, some of which were to be used to expand its business and some of which were invested in, say, a share portfolio to be held as a passive investment. It would be useful if a similar example was included in the ruling.

2. Definition of a business

It would be useful if the Ruling also made reference to the identification of the relevant business in a consolidated context where there may be multiple businesses and activities. In fact, the Draft Ruling fails to make any reference to the application of s40-880 in a consolidated group environment. For instance, all examples deal with subsidiaries which are not part of a consolidated group.

On a related point, reference could be made in the Ruling to the recently issued Tax Determinations which dealt with the treatment of incidental costs incurred when a subsidiary member joins or leaves a consolidated group (ie TD 2010/D4, TD 2010/D5, TD 2010/D6 and TD 2010/1).

Paragraph 74 of the Draft Ruling indicates that capital expenditure relating to non-business activities does not constitute business related capital expenditure. For the avoidance of doubt, it would be helpful if an example is given that confirms common industry practice that capital raising costs of new managed funds or collective investment vehicles whose business activity is to acquire and hold investments (under a particular investment strategy, whether that be for the short, medium or long term) would be considered business related capital expenditure.

3. Taxable purpose and apportionment

3.1 Application to the business

In relation to the taxable purpose test, which is stated to apply to the business rather than the expenditure, the Draft Ruling implies that a taxpayer will always need to consider apportionment having regard to an overall business even where the expenditure is incurred directly in connection with only one particular business of the taxpayer. Where the facts would support a direct "sufficient and relevant connection" between the expenditure and a particular clearly identifiable business of the taxpayer that should suffice to meet the taxable purpose test. It would be useful if there were a simple example where the expenditure was clearly incurred in connection with a specific business operation of a taxpayer which solely generated

assessable income (in spite of there being other business activities unconnected with the relevant expenditure). This would be fairly typical in a consolidated group.

3.2 Known and predictable facts

For an existing or proposed business, paragraph 26 suggests that the test takes into account all known and predictable facts about the business in future years, not just in the year the expenditure is incurred or the years in which the s40-880 claim would be made. In connection with apportionment reference is made (paragraph 29) to income the business "has derived or will derive" - is there a preferred ATO position in relation to looking forward versus looking back to make this assessment? If so, the Professional Bodies consider this should be covered in the Draft Ruling.

As a related issue, the Draft Ruling would also benefit from inclusion of a discussion and an example of where a business made losses.

3.3 Reasonable time - subsection 40-880(7)

Paragraphs 103 through 106 cover the requirements of subsection 40-880(7):

103. In addition to showing that the expenditure relates to a proposed business the taxpayer is required under subsection 40-880(7) to demonstrate that it is reasonable to conclude that the business is proposed to be carried on within a reasonable time.

104. There is no hard and fast rule as to what is a reasonable time within which a proposed business needs to commence. What is reasonable will depend on the facts of each case, such as the nature of the business and lead times for the particular industry.

Example 10

105. Carolyn incurred capital expenditure to incorporate AB Company. AB Company was to carry on a consultancy business offering IT training programs. The business was to be carried on two months after incorporation.

106. As the business was to commence two months after the incorporation of AB Company it is reasonable to conclude that the business was proposed to be carried on within a reasonable time.

We are concerned that in the absence of any further Examples the two month period in Example 10 will, notwithstanding paragraph 104, become regarded by ATO staff as the 'benchmark' for determining what is a reasonable time. Accordingly, we would request the inclusion of further examples as to what time frames will be regarded by the ATO as 'reasonable'.

3.4 Taxable purpose – consideration of future plans

Paragraph 131 of the Draft Ruling indicates that a determination of the extent to which a company's business is carried on for a taxable purpose is required to be made at the time the business related expenditure is incurred.

In the Draft Ruling, at paragraph 148, it is stated that the purpose may be determined considering current activities and activities "reasonably expected" to be carried on. We consider that it would be helpful if further clarity was provided on the level of objective evidence required to establish such an expectation. For example, is an intention to provide management services in the future sufficient to demonstrate that there is a reasonable expectation of carrying on activities that will be for a taxable business purpose?

The Ruling also needs to provide clarity as to the application to taxpayers which do not necessarily derive any current year income (eg start-up ventures, loss making companies). This should not be detrimental to a determination that there is a business carried on for a

taxable purpose where there is an expectation that in future years, there will be assessable income generated.

3.5 Connection between expenditure and former or proposed business

Where a taxpayer incurs expenditure for a business that another entity used to carry on or proposes to carry on, subsection 40-880(4) only allows a deduction to the extent that the expenditure is in connection with:

- The taxpayer deriving assessable income from the business; and
- The business that was carried on or is proposed to be carried on.

Guidance has previously been sought from the ATO on the application of this provision to the following examples:

- Aco, the holding company of a non-tax consolidated group, owns 100% of the shares in Bco. Aco wishes to set up a new company to carry on a new business. Aco decides to establish Cco as a 100% subsidiary of Bco. Aco incurs pre-business expenditure in relation to establishing Cco.

Aco, as the holding company of the group, may derive assessable income in the form of dividends from Bco in future years of income. The dividends that Bco pays may consist of profits from its own activities and dividends paid by Cco. Given the use of the expression 'to the extent' in subsection 40-880(4), it appears that expenditure in relation to establishing Cco would only satisfy subsection 40-880(4) to the extent that futures dividends paid by Bco will represent dividends received by Bco from Cco. It would be helpful if the ATO could provide guidance on this example in the Draft Ruling.

- Aco wishes to establish a partnership with Bco, to be named the AB partnership. Aco incurs \$50,000 of pre-business establishment costs. Bco incurs no pre-business establishment costs.

Guidance is sought on whether the requirements of subparagraph 40-880(4)(b)(i) will be satisfied given that only one party has incurred the expenditure, and that party has a less than 100% interest in the entity.

- Gary is looking to establish a discretionary trust called the Gary C Family Trust. Gary proposes to carry on a new business using the discretionary trust structure. Gary, as well as his family members, are all beneficiaries of the discretionary trust and are expected to receive trust distributions from the trust. However, due to the discretionary nature of the trust, Gary cannot estimate the extent to which he will receive income from the trust. Gary incurs pre-business establishment costs.

Guidance is sought on whether the requirements of subparagraph 40-880(4)(b)(i) will be satisfied where a beneficiary of a discretionary trust incurs pre-business capital expenditure.

3.6 Apportionment method

Paragraph 29 and examples 12, 13, 14 and 33 of the Draft Ruling refer to an apportionment approach.

Lag times

It is common for companies in the mining sector to incur a significant amount of business related expenditure in the raising of capital. This capital ultimately ends up being spent on the development of foreign mining and exploration projects. These projects do not typically yield assessable income to those companies. This is because the capital is invested in the form of interest-free loans or equity share capital.

The same can be said of the funding of typical start-up ventures (including interest-free loans).

However, there is ordinarily a long time lag between the time at which the capital is raised and the time at which it is required to be spent. This time lag means that these companies hold cash balances or other investments on which assessable income is derived. In addition, these companies typically maintain only a minimal administrative staff and presence in Australia for overall cost efficiency.

On the basis that the other requirements of section 40-880 are met, our issue is the extent to which such a company's business is carried on for a taxable purpose in the above circumstances and the resulting apportionment calculation.

The apportionment method contemplated in the body of the Draft Ruling is that based on comparing total income to exempt and non-assessable non-exempt income (NANE) income. A time based apportionment method is also contemplated in example 14 of the Draft Ruling. Example 33, in which business related expenditure is simply denied outright, is of some concern.

Staying with Example 33, we consider that this could be extrapolated in the context of taxpayers which carry on business which generates assessable, NANE and exempt income. This is recommended as it is unclear how the need to apportion the income producing activities of the business to ascertain taxable purpose (in paragraph 25) interacts with the exclusion in s40-880(5)(j) (eg, reconciling the outcomes from Example 12 and Example 33). Indeed, the Draft Ruling would benefit from inclusion of a complete example demonstrating the application of the two conditions.

Activities of multinational groups

As noted above, the principle behind Examples 12, 13 and 14 regarding the apportionment of blackhole expenditure is unclear and requires more practical guidance. It will affect many Australian multinational groups setting up offshore and also when their operations lead to the derivation of section 23AJ NANE income.

There appear to be two main acceptable approaches of apportioning section 40-880 expenditure that is for a "taxable purpose". However, when is it appropriate to use the income approach and when is it appropriate to use the business activity approach requires clarification in the Ruling.

Other observations

- Is the "income apportionment approach" appropriate given the comments in paragraph 24 that the taxable purpose test is applied to the business rather than the expenditure? This appears to be somewhat contradictory to us.
- Has the ATO given consideration to whether an alternative asset test could be (optionally) applied for compliance reasons as *prima facie* it is easier to identify assets on a balance sheet for past/present businesses (and maybe a future business)?
- The Professional Bodies consider that the footnote in paragraph 36 to the withdrawn ATO IDs should provide better references/explanation as to why the ATO IDs are withdrawn as the current references are inadequate. We consider that the references in the footnotes should be to the relieving paragraphs in the explanation section of the Draft Ruling.

4. Exception for leases and legal and equitable rights

4.1 “Make good” clauses

We submit that the approach taken by the ATO in Example 25 of the Draft Ruling is likely to cause (at the very least) confusion for affected taxpayers (including SMEs) and their advisors:

Example 25

211. *Joe operates a business out of leased premises which he has fitted out to his specifications. At the end of the lease Joe incurs capital expenditure to restore the premises to their original condition as required under the lease agreement.*

212. *Because the expenditure is incurred to satisfy an obligation arising under the lease agreement, it is expenditure 'in relation to a lease' for the purposes of paragraph 40-880(5)(d). Joe cannot deduct the expenditure under section 40-880.*

That is, “make good” clauses to restore premises to the condition they were in at the start of a lease are a common feature of many leases, particularly those entered into by SMEs. A number of businesses will therefore, at some stage in their business cycles incur expenditure to restore premises to the condition they were in at the start of a lease - i.e. as required under the relevant lease agreement.

If, as per Example 25 of the Draft Ruling, such expenditure cannot be deducted under section 40-880 then we believe that the ATO should provide guidance as to which section(s) this expenditure can be claimed under.

In this regard, we note that:

- (i) the ATO has actually withdrawn some guidance that it had issued on this area; and
- (ii) some of the earlier (withdrawn) guidance seems to contradict the position taken in the Draft Ruling.

There is therefore, a ‘vacuum’ (so to speak) on ATO guidance as to which section(s) “make good” expenditure can be claimed under¹.

Given the large number of leases that contain “make good” clauses, we submit that it is incumbent on the ATO to provide guidance in this area as quickly as possible.

In support of our submission, set out in the Appendix are:

1. the guidance on this area that the ATO has withdrawn; and
2. our views on the provisions under which “make good” expenditure can be deducted.

4.2 Other issues

The exception for leases or other legal or equitable rights in paragraph 40-880(5)(d) is considered in ATO IDs 2007/93, 2007/111, 2009/36, 2010/30 and 2010/157, and in various private rulings. In addition to “make good” clauses, aspects of the exception that have been

¹ A similar ‘vacuum’ would seem to exist regarding the section(s) under which business relocation costs can be claimed - for example, when moving between leased premises. Whilst there is an ATO ID dealing with the costs of relocating a depreciating asset (i.e. ATO ID 2002/920) the only other ATO ID dealing with more general business relocation costs (i.e. ATO ID 2001/431) was withdrawn on 30 July 2010 as being “a straightforward application of the law [relating to section 8-1].” There is no mention of a deduction(s) being available under any other section(s) in the withdrawal notice.

covered in ATO IDs and private rulings, but which are not discussed in the Draft Ruling include those below.

Right or obligation

Although the provision refers to expenditure in relation to a legal or equitable right, the exception appears to cover both rights and obligations of a taxpayer (that is obligations of a taxpayer are rights held by another party). For example, in Private Ruling 93599, which is about payments made by a taxpayer in discharge of obligations under an earn out arrangement, the ATO states:

The broad categories together with the examples indicate that relevant rights are proprietary rights either of, or against the grantor of the right.

The earnout rights created under the arrangement which is the subject of this ruling are proprietary rights against the taxpayer and are therefore rights of the type considered by the Review of Business Taxation.

Paragraph 33 of the Draft Ruling, however, states:

*[Paragraph 40-880(5)(d)] applies to expenditure incurred on or after 1 July 2005 that has a sufficient and relevant connection to a lease or right **held by an entity other than the taxpayer.** [emphasis added]*

This statement suggests that paragraph 40-880(5)(d) cannot apply, for example, to expenditure incurred by a taxpayer to, say, acquire or defend rights that it holds, which is inconsistent with the discussion in Private Ruling 93599. Furthermore, the Draft Ruling states, also at paragraph 33, that the existence of paragraphs 40-880(5)(a) and 40-880(5)(f) mean that paragraph 40-880(5)(d) has limited practical application. Both of those exceptions are likely to apply to rights that a taxpayer holds or acquires.

Accordingly, we recommend that the Draft Ruling should generally clarify the application of paragraph 40-880(5)(d) to rights of, or against a taxpayer. At the very least, the Draft Ruling should deal with the ATO's views on section 40-880 and earnouts.

Scope of the exception

The Draft Ruling attempts to provide guidance on the ambit of the exception. At paragraph 33, the Draft Ruling states that the rights in question are not all legal rights, only those similar to leases which give the taxpayer a right to exploit the asset with which the right is associated. All of the examples in the Draft Ruling of where the exception applies relate to rights associated with land although paragraphs 33 and 207 clearly state that the exception is not limited to such rights. We recommend that further discussion and examples should be included in the Draft Ruling on how the exception applies to rights to exploit assets other than land (e.g. leases over chattels or licences over intellectual property).

We also note that ATO IDs 2007/93 and 2007/111 take the view that rights over shares are not the sorts of rights that fall within paragraph 40-880(5)(d). The first ATO ID concerned demerger costs paid by the taxpayer, an Australian resident company, in demerging the international business it carried on. The second ATO ID was about costs incurred by the taxpayer, a public company, in facilitating a merger. These examples should also be incorporated in the ruling, especially if the ATO IDs are going to be withdrawn, to provide additional guidance on the scope of the exception.

5. CGT exception – consolidated groups

In regard to the CGT exception in s40-880(5)(f), the Professional Bodies suggest that there be some reference to the ATO's position in the context of capital expenditure incurred by a

consolidated group. In this respect, we would recommend that the exclusion not be read so broadly to apply to the extent that any relevant s40-880 claim for a non-CGT capital asset might subsequently feature in the recreated tax cost of a membership interest of an entity that exits a consolidated group. Such a broad interpretation would mean that s40-880 would seem contrary to policy which clearly recognises that s40-880 deductions can be inherited deductions for allocable cost entry and exit calculations.

6. Acquisition of goodwill

The Draft Ruling briefly addresses at paragraphs 285 to 288 the issue of expenditure which preserves but does not enhance the value of goodwill and falls within subsection 40-880(6). However, it would be useful if the ATO could provide more than one example of when expenditure will be taken to preserve or enhance the value of goodwill. For example, will the acquisition of goodwill in the following situation preserve any existing goodwill or enhance the value of such goodwill?

Aco carries on the business of manufacturing widgets. Aco acquires the business assets of Bco which also carries on the manufacturing of widgets. Aco acquires the goodwill of Bco for \$1 million. The two businesses complement each other and are not separate and distinct.

This example was previously raised with the ATO in a submission by the Institute of Chartered Accountants in Australia dated 12 May 2006. In this example, paragraph 40-880(5)(f) would apply because the expenditure of \$1 million would be included in the cost base of the goodwill. On the basis that the goodwill represents a legal right to conduct business in a certain manner, the expenditure would also relate to a legal or equitable right as required by the provision. It is then necessary to consider if the expenditure only preserves and does not enhance the value of goodwill, and if the value of the right is solely attributable to the effect it has on goodwill. Although our preliminary view is that the expenditure would not merely preserve the value of goodwill, the ATO's views on this example are sought.

7. Exception for expenditure that forms part of cost of land

Paragraph 31 of the Draft Ruling relates to expenditure which forms part of the cost of the land (subsection 40-880(5)(c)). It is not clear from this paragraph how building demolition costs will be treated. In the event that demolition costs are not included in the cost base of land, clarification is required as to whether such costs form part of the cost of the land for the purpose of subsection 40-880(5)(c).

8. Restraint of trade agreements

Under the heading 'Expenditure which preserves (but does not enhance) the value of goodwill' in the Explanation section of the draft Ruling, an Example is included that involves a restraint of trade agreement:

Example 37

288. Felicity and Rick carry on a business in partnership. Rick decides to leave the partnership to run his own business. To preserve the value of the goodwill of her business, Felicity incurs capital expenditure to secure Rick's agreement not to operate a similar business in the same town. Subsection 40-880(6) applies to prevent the application of paragraph 40-880(5)(f) which would otherwise deny a deduction for the expenditure.

The Example however, does not set out whether the capital expenditure that Felicity incurs is:
(a) legal fees to draw up the restraint of trade agreement; and/or

- (b) the amount actually paid to Rick in return for his agreement not to operate a similar business.

Nor does the Example go on to explain how the facts meet the requirements set out in the paragraphs preceding this Example (i.e. paragraphs 286 and 287). We submit that without this additional information the Example is not only incomplete but may lead to confusion, for both advisors and ATO staff, as to exactly how a restraint of trade agreement should be treated under section 40-880.

In paragraph 286, the Draft Ruling states that subsection 40-880(6):

... provides that the exceptions in paragraphs 40-880(5)(d) and 40-880(5)(f) do not apply to expenditure the taxpayer incurs to preserve (but not enhance) the value of goodwill if the expenditure incurred is in relation to a legal or equitable right and the value to the taxpayer of the right is solely attributable to the effect that the right has on goodwill.

This paragraph therefore, essentially just paraphrases this subsection.

Paragraph 287 however, then goes on to say (emphasis added) that in the view of the ATO subsection 40-880(6):

... ensures that expenditure in relation to a right which has no value of itself and does not increase the value of goodwill from what it was before the expenditure took effect is not excluded from deduction under section 40-880.

We are unsure as to what the ATO means by the reference to a right (such as a restraint of trade agreement or a restrictive covenant) having "no value of itself" and would request the ATO to expand upon/explain exactly what the ATO has in mind by using this phrase.

In this regard, we note that in Taxation Ruling TR 1999/16 Income tax: capital gains: goodwill of a business the ATO states that if:

... on a sale of a business a restrictive covenant is entered into, the restrictive covenant is a CGT asset created and vested in the purchaser separate in its own right from the goodwill acquired by the purchaser.

33. A restrictive covenant given by a vendor of a business or by an employee of the vendor is inextricably linked to the value of any goodwill disposed of. If a vendor and purchaser dealing at arm's length in a sale of a business (and its associated goodwill) do not allocate a specific part of the sale proceeds in the contract of sale to the covenant, for Part 3-1 purposes we will treat the giving of the covenant as being ancillary to the disposal of the goodwill of the business and no part of the proceeds will be attributed to the grant of the restrictive covenant.

34. If a vendor and purchaser allocate separate parts of the sale proceeds in the contract of sale to the granting of the restrictive covenant and to the disposal of the goodwill, we will accept the proceeds so allocated provided the parties dealt with each other at arm's length in reaching their agreement.

35. If the parties have dealt with each other at arm's length the first element of the purchaser's cost base of the restrictive covenant is the amount allocated to the restrictive covenant in the contract of sale of the business. If the parties do not allocate any specific part of the sale proceeds in the contract of sale to the restrictive covenant, no amount is included in the purchaser's cost base of the covenant. ...

What is the relationship between a restrictive covenant and goodwill?

102. *A restrictive covenant on the sale of a business is a CGT asset separate from the goodwill of the business. The restrictive covenant constitutes a 'CGT asset' as defined in section 108-5. It is either a proprietary right (paragraph 108-5(1)(a)) or a legal or equitable, non-proprietary right (paragraph 108-5(1)(b)) that is created by the vendor or employee of the vendor in the purchaser. If one entity creates a contractual or other legal or equitable right in another entity CGT event D1 in subsection 104-35(1) happens and the first entity makes a capital gain if the capital proceeds from creating the right are more than the incidental costs incurred that relate to the event. It is beyond the scope of this Ruling to consider whether any amount received by an employee for a restrictive covenant is also income according to ordinary concepts.*

103. *In the House of Lords decision in Trego v. Hunt [1896] AC 7, a restrictive covenant was viewed as being something distinct from goodwill in the sale of a business.*

104. *The function and goal of a restrictive covenant is to protect the goodwill; it prevents the vendor from destroying the value of the goodwill of the business transferred.*

105. *The value of goodwill and the granting of a restrictive covenant on the sale of a business are inextricably linked. The absence of a covenant may be reflected in a lower price being paid for goodwill. The presence of a restrictive covenant tends to indicate the parties really do transfer some goodwill, though this is by no means conclusive. As the High Court majority justices said in the Murry case, the lack of competition from an enforceable restrictive covenant may enhance the goodwill of a business: 98 ATC at 4591; 39 ATR at 138.*

106. *If a vendor and a purchaser of a business, dealing at arm's length and having given proper thought to the appropriate value of a restrictive covenant, do not separately allocate any part of the capital proceeds to a restrictive covenant, we will treat the granting of the covenant as being ancillary to the disposal of the goodwill of the business. We will accept that no part of the capital proceeds is attributable to the restrictive covenant.*

107. *We take this approach because:*

- (a) the intended purpose of a restrictive covenant in a sale of business contract is to facilitate the transfer of the goodwill of the business and to protect the goodwill disposed of by the vendor of the business;*
- (b) the parties may be well justified in agreeing that the covenant has no value independent of the business to which it relates because, for example, the vendor may have no intention of competing and, in any event, because the vendor is not permitted at law to derogate from their grant; and*
- (c) we believe, that it reflects business reality.*

108. *If in their contract of sale, however, a vendor and purchaser dealing at arm's length and having given proper thought to the appropriate value of a restrictive covenant, do allocate separate parts of the capital proceeds to the covenant and to the goodwill, we will accept that attribution. The amount they allocate to the goodwill qualifies for the concession in section 118-250.*

We believe that Example 37 in the draft Ruling should be cross referenced to the above discussion in Taxation Ruling TR 1999/16.

In addition, if the statement that a right "has no value of itself" in paragraph 287 of the draft Ruling is merely a reference to the fact that (as in Taxation Ruling TR 1999/16) no separate amount is allocated to a restraint of trade/restrictive covenant by the parties, then we would request the ATO to specifically state this in paragraph 287.

Finally, whilst it is not crucial for the purposes of the draft Ruling, we note that a discussion on the interaction between sections 40-880, 110-25 and 110-55 for the cost bases/reduced cost bases of the goodwill and the restraint of trade agreement could be the subject of further ATO guidance in the future.

9. Withdrawal of ATO IDs

At paragraph 36, the Draft Ruling indicates that ATO views on most of the matters covered by the ruling are already stated in a number of ATO IDs. Three of those ATO IDs have been withdrawn on the basis that they are inconsistent with the Draft Ruling. The ruling states that the remaining ATO IDs will be withdrawn once the Draft Ruling is finalised, as they will then be redundant.

Although the principles discussed in most of the ATO IDs have now been covered in the Draft Ruling, we note that many of the ATO IDs would continue to be useful in that they illustrate the application of section 40-880 in a number of different scenarios, some of which have not been covered by examples in the Draft Ruling. Some examples are:

- ATO IDs 2007/91 and 2007/92 address capital expenditure incurred under a demerger and whether that expenditure is in relation to an existing business or a business that used to be carried on
- ATO ID 2007/93 addresses capital expenditure incurred under a demerger and whether it falls within the exception for leases or other legal or equitable rights in paragraph 40-880(5)(d)
- ATO ID 2010/69 sets out the view that the exception in paragraph 40-880(5)(f) for expenditure that could be taken into account in working out a capital gain or loss can still apply even if the taxpayer is out of time to amend a net capital gain to take into account such expenditure. A similar issue has been highlighted at paragraph 179 but in relation to paragraph 40-880(5)(b)
- ATO ID 2009/102 states that legal and accounting fees incurred by the head company of a consolidated group and included in the cost base or reduced cost base of shares in a joining entity, falls within the exception in paragraph 40-880(5)(f)

Prior to withdrawing the ATO IDs, we recommend that the ATO review the ATO IDs on section 40-880 to confirm that there are no further factual scenarios that should form the basis for examples in the Draft Ruling.

10. Application date

We recommend that the Draft Ruling, with the exception of paragraphs 20 to 22 and 31, should apply retrospectively from 1 July 2005, the commencement date of the current section 40-880. This is because the ruling sets out the ATO views on a number of aspects of the application of section 40-880 which are currently contained in ATO IDs that have been issued since 1 July 2005. However, since paragraphs 20 to 22 and 31 change views expressed in those ATO IDs, they should only apply prospectively from 8 December 2010.

APPENDIX

Exception for leases and legal and equitable rights - “Make good” clauses

Withdrawn ATO Guidance material

ATO ID 2003/787 Income Tax - Capital allowances: business related costs - restoration of leased premises

This ATO ID states that capital expenditure incurred in restoring leased premises to the condition that they were in at the beginning of the lease is “deductible under paragraph 40-880(1)(g) of the ITAA 1997 provided the other requirements of section 40-880 of the ITAA 1997 are satisfied.”

The withdrawal notice for this ATO ID states that it is “withdrawn as former section 40-880 of the *Income Tax Assessment Act 1997* has been repealed. New section 40-880 provides deductions for a greater range of business related costs where the expenditure is incurred after 30 June 2005.” (Emphasis added)

Here are the ‘Facts’ and ‘Reasons for Decision’ in the ATO ID:

Facts

A partnership operated a shop out of leased premises. Expenditure was incurred to fit out the shop. The fit out involved the tiling of the floor and walls.

At the end of the lease period, the taxpayer incurred further expenditure to demolish the fit out, including the removal of the tiling. This was done to return the premises to their original state as required under the lease agreement. The termination of the lease was an integral element of the cessation of the business and occurred contemporaneously with the cessation.

Reasons for Decision

Paragraph 40-880(1)(g) of the ITAA 1997 allows a deduction for amounts of capital expenditure incurred that are costs to stop carrying on your business, to the extent that the business was carried on for a taxable purpose.

The Explanatory Memorandum accompanying Taxation Law Amendment Act (No. 5) 2002 (TLAA No. 5) refers to site rectification costs and costs associated with the removal of tenant’s fixtures incurred upon the cessation of business as examples of costs that may come within paragraph 40-880(1)(g) of the ITAA 1997.

The termination of the lease was an integral element in the cessation of the business and occurred contemporaneously with its cessation. Therefore the capital expenditure incurred to restore the premises to their original condition, as required by the lease, will be a cost to stop carrying on a business.

A deduction will be available for this expenditure where the other requirements of section 40-880 of the ITAA 1997 are also met. The deduction is claimed over 5 years, with 20 percent of the expenditure deductible in the year it is incurred and in each of the next 4 income years under (subsection 40-880(2) of the ITAA 1997).

Here is the full text of the Explanatory Memorandum reference above (emphasis added):

Paragraph 40-880(1)(g) - costs to stop carrying on your business

3.60 Item 46 amends paragraph 40-880(1)(g) to clarify that costs incurred by a taxpayer to stop carrying on their business, as opposed to any business, come under the provision.

3.61 In addition, item 47 inserts an example immediately after the paragraph to clarify its operation. The example deals with a situation in which a taxpayer incurs capital expenditure in the form of legal costs for terminating the services of employees when it stops carrying on its business. That expenditure is covered by this paragraph.

3.62 Examples of other categories of expenditure that may come within the paragraph are ... the costs associated with the removal of tenants fixtures if those costs are not already recognised in the income tax law. For example, if such costs did not form part of the cost of a depreciating asset or did not reduce the termination value of a depreciating asset where a balancing adjustment event occurs for the asset they may be deductible under this paragraph.

ATO ID 2003/788 Income Tax - Capital allowances: business related costs - exclusion of costs of restoration of leased premises

This ATO ID is related to ATO ID 2003/787 and deals with the former subsection 40-880(3)(d) - which, as the draft Ruling correctly notes, is now replicated in the form of subsection 40-880(5)(d).

The withdrawal notice for this ATO ID states that it is “withdrawn as former section 40-880 of the *Income Tax Assessment Act 1997* has been repealed. New section 40-880 provides deductions for a greater range of business related costs where the expenditure is incurred after 30 June 2005.” (Emphasis added)

According to ATO ID 2003/788 subsection “40-880(3)(d) of the ITAA 1997 does not deny a deduction for expenditure incurred in the restoration of leased premises as it is not capital expenditure that is incurred in relation to a lease to which the exclusion applies.”

The facts in this ATO ID are as per ATO ID 2003/787 above. Here are the ‘Reasons for Decision’ (emphasis added) in ATO ID 2003/788:

Reasons for Decision

Broadly, paragraph 40-880(1)(g) of the ITAA 1997 allows a deduction for an amount of capital expenditure you incur that is a cost to stop carrying on your business, to the extent it was conducted for a taxable purpose. The expenditure incurred in the restoration of the premises would be deductible under this paragraph (see ATO ID 2003/787).

However paragraph 40-880(3)(d) of the ITAA 1997 does not allow a taxpayer to deduct anything under section 40-880 of the ITAA 1997 for an amount of capital expenditure that has been incurred to the extent that it is in relation to a lease or other legal or equitable right.

The Explanatory Memorandum to Taxation Law Amendment Act (No. 5) 2002 explains that the Government is reviewing the treatment of expenditure incurred in relation to leases or other legal or equitable rights. A deduction for that type of expenditure is not available under section 40-880 of the ITAA 1997 as the appropriate income tax treatment will be determined in that review. Expenditure representing

lease surrender payments incurred in closing down your business is given as an example of expenditure incurred in relation to a lease which is excluded by the paragraph.

The capital expenditure excluded by paragraph 40-880(3)(d) of the ITAA 1997 does not extend to capital expenditure incurred for the restoration of leased premises even though the premises are leased and the work was required under a condition of a lease agreement.

Provided all other conditions in subsection 40-880(3) of the ITAA 1997 are met, a deduction is allowed under paragraph 40-880(1)(g) of the ITAA 1997 for expenditure incurred in restoring leased premises to the condition they were in at the beginning of a lease.

In short, ATO ID 2003/788 reaches the opposite conclusion to Example 25 in the Draft Ruling. That is:

- the Draft Ruling states that expenditure incurred to satisfy an obligation arising under a lease agreement is expenditure “in relation to a lease”; whereas
- ATO ID 2003/788 states that work required under a condition of a lease agreement is “not capital expenditure that is incurred in relation to a lease”.

Whilst the ATO may not feel that it is under any compulsion to reconcile (or even to attempt to reconcile) the position taken in a withdrawn ATO ID with a subsequent Tax Ruling, as ‘make good’ clauses are a common feature of many leases that SMEs enter into, it is incumbent on the ATO to provide guidance as to which section(s) expenditure that is incurred under a ‘make good’ clause can be claimed under.

ATO ID 2003/789 Income Tax - CGT: fourth element of cost base or reduced cost base - expenditure by lessee to restore premises at end of lease

This ATO ID looks at whether expenditure incurred by a lessee on the expiry of a lease to restore leased business premises to the condition that they were in at the start of the lease can be included in the fourth element of the cost base or reduced cost base of the lease under subsections 110-25(5) and 110-55(2) - i.e. as those subsections existed prior to the legislative amendments made to them with effect from 1 July 2005.

The conclusion reached in this ATO ID is ‘No’. This is because the fourth element of the cost base and reduced cost base of a CGT asset pre the legislative changes required capital expenditure to be:

1. incurred to increase the asset's value; and
2. reflected in the state or nature of the asset at the time of the CGT event.

Given that the expenditure incurred by the lessee at the end of the lease to restore the premises to the condition that they were in at the start of the lease was incurred to satisfy an obligation under the lease, it was not incurred to increase the value of the lease.

ATO ID 2003/843 Income Tax - Deductions: repairs - restoration of leased premises

This ATO ID considers whether a taxpayer is entitled to claim a deduction, under section 25-10, for the costs of removing fixtures and fittings from leased premises where the lease requires them to return the premises to their original condition at the end of the lease.

The conclusion reached in this ATO ID is 'No'.

Whilst we do not agree with the actual decision stated in the ATO ID - i.e. that the "cost of removing fixtures and fittings is not considered to constitute a repair of the premises", we nevertheless agree that a deduction may not be available under section 25-10 (refer below).

What section(s) should 'make good' payments be deductible under?

Section 25-10

Given that expenditure incurred under a 'make good' clause is designed to restore an asset that continues to exist (i.e. the leased premises) to the condition that it was in at the start of the lease, such expenditure would seem to be a repair to that asset and prima facie capable of being deducted under section 25-10.

As subsection 25-10(3) however, prevent taxpayers from claiming a deduction for capital expenditure under section 25-10 it is likely that a deduction under this section will be denied for a number of taxpayers - i.e. as ATO ID 2003/843 (Withdrawn) points out the "removal of capital work (or the unimproving of the property) and any work associated with this which is required to leave the property in an undamaged condition, would [prima facie] be seen to be capital in nature".

Section 25-15

Whilst this section will not allow a deduction for any expenditure that a taxpayer actually incurs pursuant to/under a 'make good' clause, as it does not contain an exclusion for capital expenditure it would seem that a payment that a taxpayer makes for a breach of a 'make good' clause could potentially be claimed under this section.

That is, whereas the capital expenditure exclusion in subsection 25-10(3) will probably prevent a taxpayer from claiming a deduction for the expenditure incurred in fulfilling the taxpayer's obligations under a lease agreement, in the absence of a corresponding exclusion in section 25-15 a deduction would appear to be available for a payment "for failing to comply with a lease obligation to make repairs to premises".

Section 25-110

Based on PBR 95075 it would seem that the ATO interprets the words "to terminate a lease or a licence" in subsection 25-110(1) as requiring "a direct link between the incurrance of the deductible expenditure and the termination of the lease or licence. In other words, deductible expenditure is [only] that which has been incurred for the purposes of causing or inducing the termination of the lease or licence and has the consequence of having done so."

As expenditure under a 'make good' clause will be incurred pursuant to the relevant lease agreement, and not to terminate that agreement, a deduction will not be available for this expenditure under section 25-110.

Section 40-190

To the extent that the expenditure incurred under a 'make good' clause involves either:

- (i) a balancing adjustment event for a depreciating asset; or
- (ii) the relocation of a depreciating asset,

then that expenditure should fall within section 40-190 (and thus, form part of the second element of the cost of the relevant asset).

As the destruction, scrapping and/or sale of depreciating assets in order to meet the obligations imposed under a 'make good' clause will all involve balancing adjustment events, provided expenditure can be 'reasonably attributed' to these events it will form part of the cost of the relevant assets.

Sections 43-40 and 43-250

Whilst this section will not actually allow the expenditure incurred under a 'make good' clause to be deducted, as ATO ID 2003/786 acknowledges a lessee can claim a deduction (i.e. a balancing deduction calculated under section 43-250) if the conditions in section 43-40 are met for an amount of undeducted construction expenditure for capital works which are demolished at the end of a lease - i.e. in order to restore the premises to the condition they were in at the beginning of the lease.

Sections 110-25 and 110-55

Due to legislative changes to subsections 110-25(5) and 110-55(2) in 2006, the fourth element of capital expenditure that can be included in the cost base/reduced cost base of an asset now includes expenditure (emphasis added):

... the purpose or the expected effect of which is to increase or preserve the asset's value

Whilst (as the now withdrawn ATO ID 2003/789 correctly points out) expenditure under a 'make good' clause will not be incurred to increase the value of a lease, it would seem to be arguable that the expenditure has preserved the value of the lease in the hands of the lessee - i.e. by incurring the expenditure the lessee will avoid being in breach of the lease and thus, will preserve its rights under the lease/not have to pay compensation to the lessor.