TR 2011/6EC - Compendium

Ruling Compendium –

Taxation Ruling TR 2011/6

This is a compendium of responses to the issues raised by external parties to draft Taxation Ruling TR 2010/D7 – Income Tax: business related capital expenditure – section 40-880 of the *Income Tax Assessment Act 1997* core issues

This compendium of comments has been edited to maintain the anonymity of entities that commented on the draft ruling.

Summary of issues raised and responses

Issue No.	Issue raised	ATO Response/Action taken
1	**Expenditure which serves more than one purpose or object - underlying statutory interpretation principles to support apportionment** Paragraphs 21 and 116 deal with the ability to apportion expenditure when it indifferently serves more than one purpose or object. As the interpretation in the draft is not consistent with a literal reading of subsection 40-880(2) reference should be made to a judicial authority such as *CIC Insurance v Bankstown Football Club* (1997) 187 CLR 384 to support the plain words being read in light of the then existing state of the law and the mischief which the provision was intended to remedy.	Noted. The ATO considers that explanation at paragraphs 116 to 118 of TR 2010/D7 is sufficient.
2	**Expenditure which serves more than one purpose or object - fair and reasonable apportionment** Example 11 states that expenditure that serves more than one purpose or object must be apportioned on a fair and reasonable basis. Guidance should be provided on how a fair and reasonable apportionment is to be performed.	Agree. The following new paragraphs have been inserted as paragraphs 146 to 150: Identifying the extent to which a single amount of expenditure relates to different businesses covered by subsection 40-880(2) is a question of fact and degree. It follows that in each case the method which

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		produces a fair and reasonable apportionment will depend on the facts and circumstances unique to that case. There is no single formula or universal approach that necessarily gives a true reflex of the extent of the relationship between such expenditure and each particular business. Just as the courts have rejected a prescriptive approach to apportionment in the context of section 8-1of the ITAA 1997 and subsection 51(1) of the ITAA 1936, so too apportionment of expenditure for the purposes of applying subsection 40-880(2) involves an exercise of judgement rather than the application of a rigid approach. If the method used is properly considered and supported by the available evidence then it is apt to reflect an apportionment of the expenditure that is fair and reasonable in those particular circumstances. In some cases the available evidence may support an apportionment based on a comparison of projected revenue flows from the different businesses. For example, in *Adelaide Racing Club Inc. v Federal Commissioner of Taxation* (1964) 114 CLR 517, the High Court considered the apportionment of expenditure relative to the assessable and non-assessable income of the club in the context of subsection 51(1) of the ITAA 1936 and endorsed an approach that allowed a deduction corresponding to the formula of assessable income to total assessable income and exempt income. Owen J at page 525 observed that the process of ascertaining the figure allowable as a deduction in such cases is difficult. In that case the taxpayer had proposed alternative methods which produced varying results and although the Commissioner's method was criticised by the taxpayer, his Honour remarked that the Commissioner had 'made what he regarded as a just apportionment of the Club's expenditure….that seemed right and I am not satisfied that the

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		course he followed was wrong…' In other cases where a comparison of anticipated revenue does not seem in the circumstances to correctly reflect the importance of the expenditure relative to each of the businesses the extent to which the expenditure meets a purpose of each business may be a more suitable way to allocate the expenditure. Again, the question is one of judgement.
3	**Expenditure which serves more than one purpose or object - 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 inconsistent with the rest of the draft which focuses on the business and non-business 'activities'. Clarification of the difference between the words 'objects' and 'activities' by way of example would be helpful. 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 a share portfolio to be held as a passive investment.	Noted. This issue is addressed at issue 5 below.
4	**Definition of a business** The draft does not make any reference to the application of section 40-880 in a consolidated group environment. 1. The draft should identify the relevant business in a consolidated context where there may be multiple businesses and activities.	Noted. The following new paragraphs have been inserted as paragraphs 20 to 22: **The relevant business** Subsection 40-880(2) requires identification of the business in relation to which the relevant capital expenditure was incurred. The word 'business', as defined at subsection 995-1(1), is used throughout section 40-880. The nature and scope of a business for

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		the purposes of the section is a question of fact in each case. The reference in paragraph 40-880(2)(a) to 'your business' is a reference to the taxpayer's overall business rather than a particular undertaking or enterprise within the overall business. Similarly, where the taxpayer is the head company of a consolidated group, 'your business' refers to the overall business of the head company. In contrast, paragraphs 40-880(2)(b) and (c), which concern a former business and a proposed business, could refer to an overall business or a business activity which is an element or aspect of the taxpayer's overall business. This is also the case with the head company of a consolidated group.
	2. The draft should refer to recently issued Tax Determinations TD 2010/D4, 2010/D5, 2010/D6 and TD 2010/1 which deal with incidental costs incurred when a subsidiary member joins or leaves a consolidated group.	Agree. Draft TDs 2010/D4, 2010/D5 and 2010/D6 have now been finalised as TD 2011/8, 2011/9 and 2011/10 respectively. The following new paragraph has been inserted as paragraph 262: Tax Determinations TD 2010/1, 2011/8, 2011/9 and 2011/10 deal with incidental costs incurred when a subsidiary member joins or leaves a consolidated group.
	3. An example should be given that confirms the common industry practice that capital raising costs of new managed funds or collective investment vehicles (whose business activity is to acquire and hold investments) would be considered business related capital expenditure. (This would clarify paragraph 74 which indicates that capital expenditure relating to non-business activities does not constitute business related capital expenditure).	Noted. The principle relating to non-business activities has been clarified by the response to issue 5.

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5	The final ruling should include a discussion on whether 'business' in section 40-880 should be interpreted broadly (as per IT 2423) so as to include a broad range of activities having a commercial flavour. In this regard specific guidance should also be provided on: • The circumstances in which a holding company (or any other type of holding entity) will be taken to be carrying on a business; • The extent to which an entity whose activities are restricted to letting out a commercial property for rent will be taken to be carrying on a business; and • The extent to which collective investment vehicles, including but not limited to managed investment trusts, listed investment companies, real estate investment trusts and superannuation funds will be taken to be carrying on a business.	Agree. See issue 4 above which identifies new paragraphs to be inserted to explain the relevant business. The following new paragraph has been inserted as paragraph 97: What is passive income of an individual will not necessarily be passive income of a company *Brookton Co-Operative Society Limited v Federal Commissioner of Taxation* 81 ATC 4346 per Aickin J at 4363. Whether other entities such as partnerships, trusts or other collective investment vehicles have incurred expenditure on passive investments or in relation to a business will be determined on the individual facts of each case.
6	**Taxable purpose and apportionment - application to the business** The draft should include a simple example where the expenditure was clearly incurred in connection with a specific business operation of a taxpayer which solely generated assessable income (despite there being other business activities unconnected with the relevant expenditure). This would be fairly typical in a consolidated group.	Agree. The following new example has been inserted as paragraphs 28 to 31. *Example 1* *D Coy carries on a manufacturing business in Australia and is also the holding company of a number of overseas subsidiaries. The income it derives from manufacturing is assessable income. It also derives dividends, which are non-assessable non-exempt income under section 23AJ of the Income Tax Assessment Act 1936 (ITAA 1936), from its overseas subsidiaries. The proportion of its assessable income to total income for all foreseeable years is 50%.* *D Coy decides to cease manufacturing in Australia. Prior to terminating its manufacturing activities it incurs capital expenditure to close down those activities.* *D Coy's business for the purposes of subsection 40-880(2) is its overall business of being a holding company and a manufacturer.*

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		As the expenditure is incurred exclusively for a part of D Coy's business that was carried on for a taxable purpose, pursuant to subsection 40-880(3) it is fully deductible under subsection 40-880(2).
7	**Taxable purpose and apportionment -apportionment method** Paragraph 29 and examples 12, 13, 14 and 33 of the draft refer to an apportionment approach. ***7.1 Lag times*** Companies in the mining sector commonly 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 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. The draft should explain the extent to which such a company's business carried on for a taxable purpose and what is the resulting apportionment calculation? The apportionment method contemplated in the body of the draft is	7.1 Noted. The following new example has been inserted at paragraphs 42 and 43*:* *Example 4* *M Coy, a resident taxpayer incurs capital expenditure to raise equity to acquire a discrete off-shore enterprise from which M Coy will derive only non-assessable non-exempt income by way of dividends. However, the acquisition is delayed for two years during which M Coy invests the equity on-shore in return for assessable interest income.* *In circumstances such as these, where dividends would be a discretionary matter for the directors of the off-shore enterprise, a fair and reasonable approach to determine the extent to which the capital expenditure is deductible would be to apportion it on a temporal basis. That is, to compare the two years of the on-shore investment against the anticipated duration of M Coy's investment in the off-shore enterprise.* This comment also touches on the question of how you identify whether a set of activities comprises a discrete business or whether there is only one business – see issue 4 above.

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	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.	
	7.1.1 Example 33, in which business related expenditure is simply denied outright, is of some concern. Example 33 should be expanded to deal with a taxpayer carrying on business which generates assessable, NANE and exempt income. This would clarify how the need to apportion the income producing activities of the business to ascertain taxable purpose (in paragraph 25) interacts with the exclusion in paragraph 40-880(5)(j) (for example, reconciling the outcomes from Example 12 and Example 33). The draft should include a complete example demonstrating the application of the two conditions.	7.1.1 Refer to issue 8 below regarding example 33.
	7.2 Activities of multinational groups	
	7.2.1 The principle behind Examples 12, 13 and 14 regarding the apportionment of 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.	7.2.1 Disagree. The principles behind examples 12, 13 and 14 are explained at paragraphs 125 to 136.
	7.2.2 There appear to be two main acceptable approaches of apportioning section 40-880 expenditure that is for a ‘taxable purpose’. However, the draft needs to clarify when it is appropriate to use the income approach and when it is appropriate to use the business activity approach.	7.2.2 Paragraph 136 states that the general rule is that NANE is compared to total income. The facts of an individual case will determine whether it is appropriate to substitute another method for the general rule.

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	7.3 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. • 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 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. The references in the footnotes should be to the relieving paragraphs in the explanation section of the draft.	• Where the expenditure relates to a business the legislation requires that the taxable purpose of that business is tested. It is therefore appropriate to examine the proportion of the total income of that business which is non-assessable non-exempt income. • Noted. The basis for apportionment must be fair and reasonable. Ease of application is not a reason to depart from what is a fair and reasonable method of apportionment. • Disagree. The ATO considers the explanation is sufficient.
8	Further elaboration is required on how the taxable purpose test and paragraph 40-880(5)(j) applies where an Australian resident company incurs capital expenditure to raise funds to acquire shares in a foreign subsidiary. In this regard, it is unclear as to whether Example 33 in the draft is consistent with ATO ID 2009/91. It is not clear from Example 33 as to whether the ATO would have a different view from that expressed in ATO ID 2009/91. Example 33 does not give a clear answer on what the outcome would be if Company Y expected to derive management fee income (or any other form of income) from the acquired foreign subsidiary.	Agree. The current ATO view, regarding the expected derivation of management fees, differs to that expressed in ATO ID 2009/91. The ATO ID will be withdrawn. The example has been omitted and the following new paragraphs have been inserted as paragraphs 291 to 295: *Company Y carries on the business of investing in, funding and managing its subsidiaries as a holding company. It derives assessable income in the form of management fees and dividends from its subsidiaries. Company Y acquires all the shares in an*

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		offshore company. It incurs capital expenditure in relation to its business as a holding company on a rights issue and share placement to raise funds for the acquisition. *Company Y will derive dividend income from the acquired company which is non-assessable non-exempt income under section 23AJ of the ITAA 1936. Company Y also expects to derive management fees for the services it provides the acquired company which will be assessable income.* *To the extent that the expenditure is incurred in relation to the earning of dividend income from the acquired company paragraph 40-880(5)(j) will deny a deduction under section 40-880.* Where expenditure is incurred in relation to gaining or producing exempt income or non-assessable non-exempt income and an apportionment is required under subsection 40-880(3) or (4) (because the relevant business or aspect of the business was not carried on wholly for a taxable purpose) this does not mean that the section 40-880 deduction is reduced twice. The interaction of subsection 40-880(3) or (4) and paragraph 40-880(5)(j) results in only one reduction under these respective provisions to the amount that a taxpayer can deduct under section 40-880.
9	**Taxable purpose and apportionment - taxable purpose - consideration of future plans** 9.1 Paragraph 148 of the draft states that taxable purpose may be determined by considering activities which are currently carried on and reasonably expected to be carried on by the business. The draft should clarify the evidence required to establish activities which are reasonably expected to be carried on. For example, is an	9.1 Noted. The ATO considers paragraphs 148 and 149 of TR 2010/D7 provide sufficient clarity.

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	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? 9.2 In addition, the draft should clarify how the taxable purpose test applies to taxpayers who are not deriving income such as start-up ventures and loss-making companies. The absence of current year income should not mean that there is not a taxable purpose if there is an expectation that, in future years, assessable income will be generated.	9.2 Noted. The ATO considers that no further explanation is required.
10	**Taxable purpose and apportionment - known and predictable facts** 10.1 For an existing or proposed business, paragraph 26 of the draft states that the taxable purpose 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 section 40-880 claim would be made. In contrast paragraph 29 indicates that apportioning the expenditure on the basis of taxable purpose is determined by comparing the 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, this should be covered in the draft. 10.2 The draft should include, under the heading of taxable purpose, some discussion and an example of the test applying where a business made losses.	10.1 Disagree. The meaning is clear when paragraphs 26, 27 and 28 of TR 2010/D7 are read together. The requirement to look backwards is directed only to a former business and does not apply in the context of an existing business. 10.2 Disagree. The test compares total income (assessable income plus exempt income plus non-assessable non-exempt income) to non-assessable non-exempt income and exempt income. Whether deductions exceed assessable income to produce a tax loss is not relevant.

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<tr><td>11</td><td>Reasonable time - subsection 40-880(7)

Further examples of what timeframes will be regarded as ‘reasonable’ should be included apart from example 10.

There is concern that notwithstanding paragraph 104, in the absence of further examples the two month period will be interpreted by ATO staff as the benchmark for determining a ‘reasonable time’.</td><td>Agree.

The following example has been included as paragraphs 128 and 129:

Cameron incurs legal expenses relating to a feedlot and abattoir business that he proposes to carry on. He plans to commence business as soon as the necessary government agency approvals are obtained. Generally the approvals take two years.

It is reasonable to conclude that the business was proposed to be carried on within a reasonable time because the lead time to commence business in that particular industry is generally two years and Cameron planned to commence the business as soon as the approvals are obtained.</td></tr>
<tr><td>12</td><td>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.

In a submission by the Institute of Chartered Accountants in Australia dated 12 May 2006 to the ATO guidance was sought on the application of this provision to the following examples:

12.1
• Aco, the holding company of a non-tax consolidated group, owns 100% of the shares in Bco. Aco wishes to set up a new</td><td>12.1 Agree.
The following new paragraphs have been inserted as paragraphs 186 and 187:</td></tr>
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	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 future 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.	Assessable income from the business includes not only direct distributions but also assessable income derived indirectly from the business. For example, if a dividend paid by another company ultimately represents dividends paid to it by the business then the assessable income is from that business because it can be traced to it. However, it should be noted that whether the expenditure is deductible depends on the other requirements of section 40-880 being satisfied. For example, a deduction will be denied by paragraph 40-880(5)(f) if the purpose or expected effect of the expenditure is to increase or preserve the value of a CGT asset so that the expenditure is included in the fourth element of the asset's cost base (paragraph 110-15(5)(a)).
	12.2 • 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.	12.2 Noted. The following new example bas been inserted as paragraphs 32 and 33. *A Coy and B Coy decide to establish a retail business to be carried on in partnership. A Coy (but not B Coy) incurs capital expenditure in relation to the proposed business. When the expenditure is incurred it is proposed that, for the foreseeable future, the business will be carried on wholly for a taxable purpose.* *No apportionment of A Coy's expenditure is required under subsection 40-880(3) as the business is proposed to be carried on wholly for a taxable purpose.*
	12.3 • Gary is looking to establish a discretionary trust called the Gary C Family Trust. Gary proposes to carry on a new	12.3 Noted.

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	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.	The following new paragraph has been inserted as paragraph 191: A beneficiary of a discretionary trust has no entitlement to derive assessable income from the business of the trust and therefore cannot satisfy subparagraph 40-880(4)((b)(i).
13	**Exception for leases and legal and equitable rights - “Make good” clauses** The approach taken in Example 25 of the draft is likely to cause (at the very least) confusion for affected taxpayers (including Small and Medium Enterprises (SME)) and their advisors: ‘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 as required under the relevant lease agreement. If, as per Example 25 of the draft, such expenditure cannot be deducted under section 40-880 then guidance should be provided as to which section(s) this expenditure can be claimed under.	Noted. The approach taken in Example 25 of TR 2010/D7 clearly states that the expenditure is excluded from deduction under section 40-880. It is acknowledged that this view differs to the view expressed in ATOID 2003/788 which was withdrawn on 9 June 2006. The expression ‘in relation to’ is used throughout section 40-880 and it should be interpreted consistently (particularly where the context of the provision does not suggest that the expression should be interpreted otherwise). The meaning of ‘in relation to’ is explained at paragraphs 55 to 57 of TR 2010/D7. The Commissioner does not consider it appropriate for a ruling about the scope and operation of section 40-880 to explore the alternative tax treatments which may arise in individual cases -particularly when expenditure incurred to satisfy a ‘make good’ clause does not have a universal treatment under the tax law. In other words, the circumstances of each case will determine whether the expenditure (or any part thereof) is allowable or taken into account under another provision of the income tax legislation.

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	In this regard, it is noted 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. There is therefore, a 'vacuum' on ATO guidance as to which section(s) 'make good' expenditure can be claimed under. Given the large number of leases that contain 'make good' clauses, it is incumbent on the ATO to provide guidance in this area as quickly as possible. *The appendix to the submission, sets out:* *1. the guidance on this area that the ATO has withdrawn; and* *2. views on the provisions under which "make good" expenditure can be deducted.*	
14	The interpretation of paragraph 40-880(5)(d) that leads to the conclusion in example 25 of the draft is incorrect. The example deals with expenditure incurred under a condition of a lease agreement to restore premises to its original condition. Taxpayers have been relying on the view expressed in ATO ID 2003/788 (Withdrawn) that this expenditure is not excluded even though the expenditure was required under a condition of the lease agreement. The ATO is applying too narrow a view when interpreting the	Disagree. The expression 'in relation to' is used throughout section 40-880 and it should be interpreted consistently (particularly where the context of the provision does not suggest that the expression should be interpreted otherwise). The meaning of 'in relation to' is explained at paragraphs 55 to 57 of TR 2010/D7.

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	expression 'in relation to'. To align with the intent of section 40-880 'in relation to' should be interpreted to apply directly to expenditure on the lease itself (such as legal fees in preparing the lease, etc.), not the underlying asset.	
15	**Exception for leases and legal and equitable rights - 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 covered in ATO IDs and private rulings, but which are not discussed in the draft include: *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.*	

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	Paragraph 33 of the draft, 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]**	
	15.1 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 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.	15.1 Disagree. Paragraph 40-880(5)(d) is expressed in broad terms. It is wide enough to capture most expenditure on leases and rights that is already captured by paragraphs 40-880(5)(a) and (f). However since those more specific paragraphs will already deny a deduction under section 40-880 there is no need to resort to paragraph 40-880(5)(d). Paragraph 33 merely expresses the principle that because most expenditure relating to leases and rights is already captured by the more specific exceptions the additional operation of paragraph 40-880(5)(d) is limited in practice.
	15.2 Accordingly, the draft should generally clarify the application of paragraph 40-880(5)(d) to rights of, or against a taxpayer. At the very least, the draft should deal with the ATO's views on section 40-880 and earnouts.	15.2 Noted. The Government's proposed capital gains tax look-through treatment for earnout arrangements was announced in the 2010-11 Federal Budget. The Ruling will therefore not deal with earnout arrangements.
	Scope of the exception	
	15.3 The draft attempts to provide guidance on the ambit of the exception. At paragraph 33, the draft 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.	15.3 Noted. The ATO considers that the principle is clearly stated at paragraph 207 of TR 2010/D7. In other words, a share is not a right similar to a lease. A share is not a right which allows a taxpayer to exploit an asset with which the right is associated.
	All of the examples in the draft 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	The ATO considers that additional examples are not necessary as the

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	that further discussion and examples should be included in the draft on how the exception applies to rights to exploit assets other than land (leases over chattels or licences over intellectual property). 15.4 It is also noted 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.	principle is clearly stated. 15.4 The ATO considers that additional examples are not necessary as the principle is clearly stated.
16	**CGT exception - consolidated groups** There should be some reference to how the CGT exception in paragraph 40-880(5)(f) applies in the context of capital expenditure incurred by a consolidated group. The exclusion should not be read so broadly to apply to the extent that any relevant section 40-880 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 be contrary to policy which clearly recognises that section 40-880 deductions can be inherited deductions for allocable cost entry and exit calculations.	Disagree. The interaction of section 40-880 with subsection 701-55(6) was the subject of a review by the Board of Taxation (*Review into the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules*). The Board completed its review and provided its report to the Assistant Treasurer on 31 May 2011. The ATO will give further consideration to the issue after the Government releases its response to the report.
17	**Acquisition of goodwill** The draft briefly addresses at paragraphs 285 to 288 the issue of	Disagree. Example 37 is merely included to illustrate the principle.

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<tr><td></td><td>expenditure which preserves but does not enhance the value of goodwill and falls within subsection 40-880(6).

However, more than one example should be given 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.</td><td>A further example would not clarify the principle. Whether expenditure preserves or enhances goodwill is a question of fact.</td></tr>
<tr><td>18</td><td>Exception for expenditure that forms part of cost of land</td><td>Agree.</td></tr>
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<tr><td></td><td>Paragraph 31 of the draft 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).</td><td>The relevant paragraph has been amended to state that the cost of land means the cost of acquiring the ‘freehold title to’ land.

The principles expressed in the ruling are sufficient to allow taxpayers to determine whether building demolition costs are allowable under section 40-880. Inserting a specific example about demolition costs is likely to confuse rather than clarify the operation of the provision. The treatment of demolition costs under section 40-880 depends on whether the expenditure is allowable under another provision of the Act, for example whether it is a project pool amount under section 40-840.</td></tr>
<tr><td>19</td><td>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, 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</td><td>The example deals with a restraint of trade agreement entered into by a partner who continues to carry on the business as a sole trader. It clearly states that the expenditure is incurred to preserve the value of the goodwill of the taxpayer’s business. By implication the expenditure does not enhance the value of the goodwill. The example does not purport to explain how all restraint of trade agreements are treated.

Whether the capital expenditure is for legal fees or consideration for entering into the agreement does not affect the outcome.

Paragraph 287 paraphrases the following paragraphs from the Explanatory Memorandum to Tax Laws Amendment (2006 Measures No. 1) Bill 2006:

2.70 Expenditure is deductible where it is incurred in relation to a lease or other legal or equitable right, and the value of the expenditure to the taxpayer arises solely from the effect that the right has in preserving, but not enhancing, the value of goodwill. For example, capital expenditure may be incurred in relation to a right that is both unlimited in duration, and which merely prevents goodwill from being damaged. Such a right has no distinct value in itself. Its value lies in the effect its existence has upon the value of the goodwill. Such expenditure represents in substance a blackhole expense even though it is in</td></tr>
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	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 (paragraphs 286 and 287). 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 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 <u>has no value of itself</u> 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.* It is unclear what the ATO means by the reference to a right (such as a restraint of trade agreement or a restrictive covenant) having 'no	relation to an asset. [Schedule 2, item 30, subsection 40-880(6)] 2.71 Where a taxpayer incurs an expense in relation to a right and that right enhances the value of the goodwill, or has an inherent value in itself then it would not be appropriate to allow a deduction as a business related cost as the expenditure does not represent a loss to the taxpayer.

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	value of itself'and request the ATO to expand upon/explain exactly what the ATO has in mind by using this phrase. In this regard, it is noted 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*	

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	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*	

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	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*	

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<tr><td></td><td><blockquote>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.</blockquote>
Example 37 in the draft 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 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, a discussion on the interaction between section 40-880, section 110-25 and section 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. </td><td></td></tr>
<tr><td>20</td><td> Withdrawal of ATO IDs
At paragraph 36, the draft 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. The ruling states that the remaining ATO IDs will be withdrawn once the draft is finalised, as they will then be redundant.
Although the principles discussed in most of the ATO IDs have now </td><td> Noted.
Although not all the ATO IDs have been included as examples the ATO considers that the principles have been clearly explained and that, examples are therefore not necessary for all of the ATO IDs. </td></tr>
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	been covered in the draft, 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. 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.	
21	**Application date** The draft, with the exception of paragraphs 20 to 22 and paragraph 31, should apply retrospectively from 1 July 2005, the commencement date of the current section 40-880. This is because the ruling sets out	Agree.

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	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.	
22	**Capital expenditure on landscaping leased land** The draft has resulted in the withdrawal of ATO ID 2009/37. Paragraph 36 footnote 1 states that this is on the basis of paragraph 31 of the draft which states that paragraph 40-880(5)(d) 'excludes from deductibility expenditure incurred to acquire land in relatively uncommon situation where the cost of acquiring land does not form part of the cost base or reduced cost base of the land'. The draft should clarify whether 'land' includes all real property interests or only freehold **-** particularly since ATO ID 2009/37 is now withdrawn.	Agree. The relevant paragraph has been amended to state that the cost of land means the cost of acquiring the 'freehold title to' land.
23	The draft ruling, TR 2010/D7, overturns established practice and indeed the ATO's previous views, to put forward an interpretation of the section that could not have been originally contemplated. Most deduction sections in the ITAA 1997 and ITAA 1936 require a purpose of producing assessable income. Section 8-1 also allows a deduction incurred in carrying on a business for the purpose of gaining or producing assessable income. In enacting section 40-880, the purpose of Parliament was to provide a deduction for so-called 'blackhole' expenditure that would not otherwise meet the test for a deduction under these other provisions. Because the expenditure lacks a direct nexus with the production of assessable income, section 40-880 requires the expenditure have a nexus with a 'business'. That 'business' must be carried on for a taxable purpose. It is unfortunate that the draftsman did not link this language to the	Noted. The following new paragraphs have been inserted at paragraphs 20 to 22 to explain the relevant business: Subsection 40-880(2) requires identification of the business in relation to which the relevant capital expenditure was incurred. The word 'business', as defined at subsection 995-1(1), is used throughout section 40-880. The nature and scope of a business for the purposes of the section is a question of fact in each case. The reference in paragraph 40-880(2)(a) to 'your business' is a reference to the taxpayer's overall business rather than a particular undertaking or enterprise within the overall business. Similarly, where the taxpayer is the head company of a consolidated group, 'your business' refers to the overall business of the head company.

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	well established understanding of the second limb of section 8-1, an amount incurred in carrying on a business for the purpose of gaining or producing assessable income. However, the ATO thinks the section 8-1 test is actually more narrow! The ATO has chosen in the ruling to define the business in these circumstances as including non-assessable non-exempt income such as section 23AJ dividends, or businesses carried on in foreign branches and subject to section 23AH. Thus, the ATO believes an apportionment is required across these types of NANE income items to effectively disallow deductions - refer paragraphs 23 to 30 and various examples. This approach is wrong as it incorrectly includes in the 'business' items that are expressly excluded in paragraph 40-880(5)(j). That is, expenditure that is incurred in relation to gaining or producing exempt income or NANE income is excluded by paragraph 40-880(5)(j). Thus, under the ATO view, expenditure that was not for that purpose (does not fall into paragraph 40-880(5)(j)) could nevertheless be apportioned to that purpose because the NANE items are included in the ATO's definition of 'business'. This desire to include exempt income and NANE income in the business then leads the ATO to numerous difficulties in arriving at a sensible apportionment methodology. Presumably, the 'business activities' that relate to foreign subsidiaries are covered by management fees; clearly any dividend income is not generated by the Australian management but by the employees of the foreign company. The ATO in its Blackhole Risk Review activities is using this draft ruling to review the costs of various capital raisings. Where the capital raised is used to fund an offshore business, clearly no deduction arises. Where the funds are used solely in the Australian business, to	In contrast, paragraphs 40-880(2)(b) and (c), which concern a former business and a proposed business, could refer to an overall business or a business activity which is an element or aspect of the taxpayer's overall business. This is also the case with the head company of a consolidated group. The discussion relating to the extent to which the taxpayer's business is carried on for a taxable purpose has also been amended. Paragraphs 26 to 39 now read as follows: Subsections 40-880(3) and (4) both contain a 'taxable purpose test' which applies to the expenditure identified in subsection 40-880(2) by reference to the extent to which it relates to carrying on the business for a taxable purpose. In other words, *the* expenditure identified in subsection 40-880(2) is deductible only to the extent that it relates to so much of the business that is, was or will be, carried on for a taxable purpose. If the expenditure relates to the whole of the business but part of the business is carried on to derive exempt income or non-assessable non-exempt income then to that extent the expenditure will not be deductible. If the expenditure relates solely to that part of the business carried on to derive assessable income however, the whole of the expenditure will be deductible. On the other hand, if the business is carried on to derive exempt income or non-assessable non-exempt income only then none of the expenditure is deductible under subsection 40-880(2). *<u>Example 1</u>* *D Coy carries on a manufacturing business in Australia and is also the holding company of a number of overseas subsidiaries. The income it derives from manufacturing is assessable income. It also derives dividends, which are non-assessable non-exempt income under section 23AJ of the Income Tax Assessment Act 1936 (ITAA 1936), from its overseas subsidiaries. The proportion of its assessable income to total income for all foreseeable years*

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	repay debt where the interest expense is deductible under section 8-1, the ATO is arguing that an apportionment is required. This very wide interpretation of the 'business' appears to defeat the purpose of section 40-880 and result in inconsistent outcomes. In addition, it causes significant difficulties in defining how such an apportionment can be made and provides no certainty for taxpayers. It cannot be the case that a taxpayer cannot work out the exact amount of the deduction at the time of incurrence but rather must calculate a forecast or rolling average at year end to make the determination - if indeed this methodology can be said to be right. We submit that the ATO should urgently re-consider its position on this issue.	*is 50%.* *D Coy decides to cease manufacturing in Australia. Prior to terminating its manufacturing activities it incurs capital expenditure to close down those activities.* *D Coy's business for the purposes of subsection 40-880(2) is its overall business of being a holding company and a manufacturer.* *As the expenditure is incurred exclusively for a part of D Coy's business that was carried on for a taxable purpose, pursuant to subsection 40880(3) it is fully deductible under subsection 40-880(2).* *Example 2* *A Coy and B Coy decide to establish a retail business to be carried on in partnership. A Coy (but not B Coy) incurs capital expenditure in relation to the proposed business. When the expenditure is incurred it is proposed that, for the foreseeable future, the business will be carried on wholly for a taxable purpose.* *No apportionment of A Coy's expenditure is required under subsection 40-880(3) as the business is proposed to be carried on wholly for a taxable purpose.* Neither the legislation nor the extrinsic material sets out a particular methodology to determine the extent to which a business is carried on for a taxable purpose or not. In the absence of a prescribed method however, the Commissioner will accept an apportionment made on a fair and reasonable basis. As a general rule, the extent to which a business is, was or is proposed to be, carried on for a taxable purpose is determined by comparing the amount of any exempt income and non-assessable non-exempt income the business has derived or will derive with total income (that is, assessable income plus exempt income plus non-assessable non-exempt income). This percentage is then applied to the amount of expenditure to reduce the deduction.

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		Example 3 *J Coy is a holding company and manufacturer which incurs capital expenditure to remove a disruptive board member. The expenditure relates indifferently to all its business activities.* *J Coy's relevant business for the purposes of applying the taxable purpose test in subsection 40-880(3) is its overall business.* *For the foreseeable future 50% of its income will be assessable income derived from a business activity in Australia. The other 50% of its income will be non-assessable non-exempt income.* *As the expenditure relates to the whole of the business indifferently, pursuant to subsection 40-880(3) only 50% of the expenditure will be deductible under subsection 40-880(2).* In addition, the following new paragraphs have been inserted at paragraphs 51 and 52 to explain the interaction of subsection 40-880(3) or (4) and paragraph 40-880(5)(j): Where expenditure is incurred in relation to gaining or producing exempt income or non-assessable non-exempt income and an apportionment is required under subsection 40-880(3) or (4) (because the relevant business or aspect of the business was not carried on wholly for a taxable purpose) this does not mean that the section 40-880 deduction is reduced twice. The interaction of subsection 40-880(3) or (4) and paragraph 40-880(5)(j) results in only one reduction (under these respective provisions) to the amount that a taxpayer can deduct under section 40-880.