THE TAX INSTITUTE

27 May 2021

Vivek Raj
Law Division
The Treasury
Langton Crescent
Parkes ACT 2600

By email: miscamendments@treasury.gov.au

Dear Vivek,

**Treasury Laws Amendment (Measures for Consultation) Bill 2021: Miscellaneous and Technical Amendments – Exposure Draft**

The Tax Institute welcomes the opportunity to make a submission to the Treasury in relation to the Finance Leases – Exposure Draft (**Exposure Draft**) proposed under Schedule 1, Part 2, Division 8 of the *Treasury Laws Amendment (Measures for Consultation) Bill 2021: Miscellaneous and Technical Amendments*.

**Summary**

The Exposure Draft proposes amendments to section 705-56(1) of *the Income Tax Assessment Act 1997* (**ITAA 1997**) to expand the operation of the modified tax cost setting rule to all leases (not just finance leases) where the joining entity is the lessor or lessee under a lease of a depreciating asset to which Division 40 applies. The amendments seek to ensure consistency with the introduction of the Australian Accounting Standards Board 16 standard for Leases (**AASB 16**).

The Tax Institute considers that these amendments are necessary. However, the Institute considers that the amendments could be improved to bring certainty and clarity in order to prevent unintended outcomes resulting from AASB 16 (which seeks to align the treatment of operating leased assets with finance leased assets). For example, an inappropriate outcome may arise where an entity ceases to be a subsidiary member of a consolidated group and the exit allocable cost amount (**ACA**) for the leaving entity gives rise to a CGT event L5 gain due to the anomaly in accounting/tax treatment (ie the lease liability is included in Step 4 of the exit ACA calculation under section 711-20 but there is no associated asset recognised for tax purposes that has a terminating value).

The most appropriate outcome for any accounting asset (other than the actual leased asset that the taxpayer owns or holds) or accounting liability that is recognised under AASB 16 (whether or not it is a finance or operating lease) is for it to be disregarded for both entry and exit allocable cost amount (**ACA**) calculations under Division 705 and Division 711 of the ITAA 1997 respectively, regardless of the entity's joining time.

To address our main concerns in relation to the Exposure Draft, we propose the following:

- Section 705-56 should apply where the joining entity is the lessor or lessee under a lease of any asset (not just a depreciating asset to which Division 40 applies) that is classified as a lease in accordance with accounting principles for tax cost setting.

Level 37, 100 Miller Street
North Sydney NSW 2060
Tel: 02 8223 0000
Fax: 02 8223 0077
info@taxinstitute.com.au
taxinstitute.com.au
ABN 45 008 392 372

- The amendments should apply retrospectively to both joining and leaving entities with effect from the time of commencement of AASB 16, rather than be restricted to entities that joined a group from the time the amending law is introduced to Parliament. This will mean that section 711-45(2A) needs to be amended to ensure that it can apply to an entity that ceases to be a subsidiary member of a group where, at the leaving time, it is the lessee under a lease of any asset that is classified as a lease in accordance with accounting principles for tax cost setting (ie without section 705-56 applying to the lease on entry). If a retrospective amendment is not possible, the amendment to section 711-45(2A) should apply after the relevant time from when AASB 16 applies to an entity that ceases to be a subsidiary member of a group.

**Discussion**

The treatment of leases in the consolidation entry and exit tax cost setting rules has been a concern for many taxpayers since the introduction of the AASB 16. AASB 16 applies mandatorily for full year reporting periods commencing from 1 January 2019 (with the ability to adopt earlier). AASB 16 requires almost all leases (including finance and operating leases) to be brought onto the balance sheet as a right to use asset (representing the lessee's right to use the underlying leased asset) and a lease liability (representing obligations to make lease payments). Furthermore, the standard applies to all relevant leases, regardless of when the lease was entered into (ie leasing arrangements that commenced prior to the commencement of AASB 16 are also subject to the new accounting requirements).

Any amendments that bring certainty and clarity and prevent unintended outcomes resulting from AASB 16 and that seek to align the treatment of operating leased assets with finance leased assets are welcome.

The Tax Institute is of the view that the proposed amendments included in the Exposure Draft do not address these issues adequately. Our specific concerns are as follows:

- Section 705-56 should not be limited to depreciating assets to which Division 40 applies. There are many non-finance leases that are in relation to land, capital works or property which are not depreciating assets or assets to which Division 40 applies.

- The date of effect of the amendments should be aligned with the commencement of AASB 16, which has applied to all reporting entities from as early as 1 January 2019 (or earlier). There is no reason to restrict any amendment to entities joining from the time the amending law is introduced into Parliament. A start date that aligns with the changed accounting treatment will allow for much needed taxpayer certainty, equity, and consistency in treatment.

- Furthermore, as currently drafted (refer to Schedule 1, Item 75), the date of effect of the amendments to any subsidiary member leaving a group can only apply if the amended section 705-56 has applied to the leaving entity on its joining of a tax consolidated group or a multiple entry consolidated (**MEC**) group. This has a very narrow application and falls short of having application to any existing member of the group that has a non-finance lease that is subject to AASB 16, regardless of the joining time.

- While there may be some confusion around the treatment of leased assets and lease liabilities on entry of a joining entity or formation of a tax consolidated or MEC group, it is understood that these issues are less problematic from a practical perspective particularly since the introduction of the "deductible liability" exception to Step 2 of the entry ACA calculation under Division 705.

In contrast however, taxpayers have been particularly concerned with the potential outcomes that can arise on exit from a tax consolidated group because of the additional lease liabilities recognised under the application of AASB 16. For example, it would be extremely rare for a step 1 amount to exist on exit in relation to a right to use asset (ie there is no terminating value since the lessee only has contractual rights under the lease and does not own or hold the underlying leased asset), yet there remains an accounting liability in respect of the lease that would prima facie be reflected in the step 4 amount of the exit ACA calculation under Division 711.

We have seen various approaches in relation to exits from a tax consolidated group. However, taxpayers are uncertain as to whether these approaches are accepted by the Australian Taxation Office. We consider that the inclusion of an amount at step 4 of the exit calculation for a liability that relates to an asset that has arisen solely due to an accounting standard produces inequitable and uncommercial outcomes. From a policy perspective, we consider that it would be appropriate for the accounting lease liability as well as the right to use asset to not be recognised at all upon exit (or entry) where those amounts arise solely due to the application of AASB 16.

- Section 705-56 and 711-45(2A) have historically had limitations in their scope. For example, it is unclear whether the underlying depreciating asset and the "right to use asset" are the same asset and whether on exit, section 711-45(2A) has no application where a finance lease was entered into while the leaving entity was a member of the group. The Tax Institute is of the view that it would be beneficial for these issues to be addressed and for the scope of these provisions to be clarified.

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If you would like to discuss any of the matters raised above, please contact either myself or Associate Tax Counsel, Michelle Ma, on (02) 8223 0084.

Yours faithfully,

**Peter Godber**
President