Patrick Tuttle, Deputy Chairman
Australian Securitisation Forum
Suite 605
3 Spring Street
SYDNEY NSW 2000
Ph: +61 2 8343 3900
Fax: +61 2 8243 3939
Email:
ptuttle@pepperhomeloans.com.au

Stephen Howlin
Assistant Commissioner
Goods and Services Tax
Australian Taxation Office
PO Box 9990
PARRAMATTA NSW 2123

23 June 2009

Dear Stephen,

Income Tax Treatment of Proposed Tier 2 GST Settlements

We refer to your letter of 7 April 2009 which responds to our original letter dated 8 February 2008. Your letter comments on the income tax consequences that will result from the application of Division 72 of the *A New Tax System (Goods & Services Tax) Act 1999* to ASF member securitisation arrangements.

While your letter makes some progress in relation to the income tax aspects of this issue, we believe that it contains a significant logical shortcoming which needs to be addressed by your office.

We strongly urge that this concern be addressed prior to any further action by your office.

In part, this request is made due to our view that the following submission should enable your office to amend its letter of 7 April 2009, such that the income tax issue can finally be dealt with consistently across the industry. This request is made bearing in mind that your office took well over a year to respond to our letter of 8 February 2008 (ie the income tax issues here are clearly difficult).

Further, at our last meeting, it was acknowledged by your office that any non-deductible income tax outcome in this matter was clearly not an intended outcome of the legislation.

In essence, your letter puts forward two income tax outcomes for industry members who accept the ATO's settlement deed:

Example 1: In this example, the Corporate Entity has "made a supply of management services" to an associated trust with a market value of $2,000. The consideration for the supply was $1,100 (including $100 GST). The Corporate Entity included $1,000 assessable income in its 2005/06 return and paid $100 GST. The Trust claimed an input tax credit of $75 and claimed a deduction of $1,025 in calculating its Division 95 net income for that year.

The view taken by your office is that any Division 72 liability of the Corporate Entity is not an outgoing deductible under Section 8(1) of the Income Tax Assessment Act 1997, but is instead merely a component of the incoming revenue stream on the supply of the management services provided to the associated trust. As a consequence, you state:

- "The Corporate Entity is able to reduce its assessable income for the 2005/6 income year by $100"; and

- "…. in calculating the trust's Division 95 net income for the 2005-06 income year, the deduction for the loss or outgoing incurred in acquiring the supply needs to be reduced by the trust's entitlement to an additional $75 RITC".

In summary under Example 1, your office takes the view that instead of incurring an income tax deductible loss or outgoing as a consequence of the application of Division 72 of the GST Act, the Corporate Entity's assessable incoming management services revenue is reduced, and further, that the trust's deduction for an outgoing is also reduced. That is, rather than there being a deductible outgoing for the Corporate Entity, there is a reduction in its assessable "incoming", and on the trust side there is a reduction in its deductible loss or outgoing.

This logic yields an outcome (assuming no other impediment) that the net 2.5% additional GST flowing from an application of Division 72 has no adverse income tax consequence (ie it is akin to it being deductible). This of course is the key design construct in relation to income tax and GST, that where GST represents a net cost to business, it should be deductible for income tax purposes.

The position taken by your office in relation to Example 2 is different and we submit is logically inconsistent with Example 1.

Example 2: In this example, the Corporate entity makes no charge for its supply of management services. In relation to this supply no assessable income is reported by the Corporate Entity and no deduction is claimed by the Trust. As a consequence you state:

- "As the Corporate Entity has not reported any assessable income in relation to this supply, they are not able to reduce their assessable income";
- "As the Trust has not claimed any income tax deductions, in relation to this acquisition, they are not able to decrease their income tax deductions";
- "Therefore, there are no income tax amendments for the Corporate Entity or the Trust , in relation to this supply for the 2005-6 income year"; and
- "When, in a later income year, the trustee, receives the RITC refund the refund would represent non-assessable non-exempt income…."

In effect, this position would mean that the income tax position flowing from the application of Division 72 is that the net 2.5% GST would be non-deductible for income tax purposes.

The ASF can see that the logic adopted by your office in relation to Example 1 may be a practical way to proceed, whereby the consequences of Division 72 can be seen to reduce an incoming (for the Corporate Entity) and reduce an outgoing or loss (for the Trust). In that sense, the Division 72 treatments can be perceived as mere components of other flows of funds, rather than a clear outgoing or loss in the case of the Corporate Entity and a clear receivable in the case of the Trust.

In the case of Example 2, however, no such factual uncertainty arises upon the application of Division 72. There is a clear net outgoing or loss to the Corporate Entity. We strongly submit this is the logical flaw inherent in your letter of 7 April 2009. That is, while Example 1 proceeds on the basis that Division 72 does not result in an identifiable outgoing or loss, the same is clearly not true of Example 2.

We have already set out in prior correspondence the basis upon which a net Division 72 outgoing or loss is incurred in the ordinary course of business and is not otherwise denied a deduction. It has been conceded by your office that the Tier 2 arrangements significantly preceded GST. As a consequence, there can be no question that if a Division 72 net outgoing of 2.5% occurs (in the absence of cross charging to an associated trust) that it must arise in the ordinary course of business.

As a consequence, we can see no reason why in your letter of 7 April 2009, in the Example 2 scenario, a deduction for the net 2.5% should not arise. The position taken in relation to Example 1 has the advantage (absent some other impediment) of getting to the right income tax outcome in a purposive sense and does not require alteration.

An alteration along the above lines, only in respect of Example 2, has the advantages of:

- Providing an income tax outcome that is consistent across the industry; and
- Providing an income tax outcome that is consistent with the design intent in relation to the interaction of GST and income tax (ie that the net cost of GST to business should be deductible for income tax purposes).

For completeness, we have also included at **Appendix 1** to this letter further comments in relation to the deductibility of a Settlement Payment made by a Manager that has been paid nil or inadequate consideration (in terms of the ATO view) in respect of management services provided to a securitisation vehicle.

We look forward to discussing the above with you at your earliest convenience.

Please note that other matters mentioned in our email to you dated Monday, 15 June 2009 will be addressed in separate correspondence later this week.

Yours sincerely,

Patrick Tuttle
Deputy Chairman
Australian Securitisation Forum, Inc.

cc Attachment

APPENDIX 1 - DEDUCTIBILITY OF SETTLEMENT PAYMENTS

We have set out in prior correspondence the basis upon which a settlement payment (“**Settlement Payment**”) made by a securitisation manager (“**Manager**”) in respect of a Division 72 adjustment would be deductible for tax purposes. We do not intend to repeat that analysis here.

The purpose of this Appendix is to provide further comments in relation to the deductibility of a Settlement Payment made by a Manager that has been paid nil or inadequate consideration (in terms of the ATO view) in respect of management services provided to a securitisation vehicle (“**SPV**”). We understand (through informal discussions) that there are a substantial number of ASF members who are in this category.

We consider that it is necessary to make further comments in this regard, because, based on your letter dated 7 April 2009 and from our meetings with you, it is not clear to us why a Settlement Payment would not be deductible.

Is the Settlement Payment a loss or outgoing?

In “Example 1” of your letter, the Tax Office takes the view that:

- instead of a deduction in respect of a Settlement Payment, the Manager’s assessable income (in respect of management services) is reduced; and

- the SPV’s deduction for management services is also reduced.

From a practical perspective, Example 1 results in the Manager having a tax liability following the Settlement Payment which would be similar to the tax liability that the Manager would have if it were entitled to claim a deduction in respect of the Settlement Payment.

In “Example 2”, the Settlement Payment is clearly an outgoing or loss of the Manager. While Example 1 proceeds on the basis that Division 72 does not result in an outgoing or loss for the Manager, the same is not true of Example 2.

The Settlement Payment made by a Manager in Example 2 would have an effect in gaining or producing income of the Manager, and it reduces income or capital of the Manager. Therefore, the Settlement Payment would be a “loss or outgoing” for the purposes of section 8-1 of the *Income Tax Assessment Act 1997*: see *Amalgamated Zinc (de Bavay's) Ltd v FCT* (1935) 54 CLR 29.

The next requirement of section 8-1 is that the Settlement Payment is incurred either in gaining or producing assessable income or in carrying on a business for the purpose of gaining or producing assessable income. Most (if not all) Managers will satisfy this criterion.

As part of the business of the Manager, services are provided to third parties, and GST is charged on the provision of those services. The obligation to make payments of GST to the ATO is therefore part of a Manager’s business activities. Absent any specific provision prohibiting a deduction for the payment of GST, a Settlement Payment would be treated as being incurred as part of the Manager’s ordinary business activities.

From a policy perspective, if the Manager is entitled to claim a deduction under section 8-1 in relation to the Settlement Payment, this:

- would give an income tax outcome that is consistent across the industry for Managers that are required to make Settlement Payments;
- would not unfairly penalise Managers which are required to make Settlement Payments, where the Manager will not receive the benefit of any additional RITC entitlement (for example, because they have sold their interest in the SPV to which the RITC will be paid, or the SPV is insolvent).