TR 2004/13 - Income tax: the meaning of an asset for the purposes of Part 3-90 of the Income Tax Assessment Act 1997

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Taxation Ruling

Income tax: the meaning of an asset for the purposes of Part 3-90 of the *Income Tax Assessment Act 1997*

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Preamble

*The number, subject heading, **What this Ruling is about** (including **Class of person/arrangement** section), **Date of effect**, and **Ruling** parts of this document are a 'public ruling' for the purposes of **Part IVAAA of the Taxation Administration Act 1953** and are legally binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a 'public ruling' and how it is binding on the Commissioner.*

What this Ruling is about

1. This Ruling addresses the question of what is an asset for the purposes of the tax cost setting rules in Part 3-90 of the *Income Tax Assessment Act 1997* (ITAA 1997).

Date of effect

2. This Ruling applies to years of income commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Ruling

3. The meaning of an asset in Part 3-90 is not defined in the ITAA 1997. In contrast, the meaning of a liability is defined in subsection 705-70(1). A liability is recognised and measured in accordance with the Australian Accounting Standards Board (AASB) accounting standards and statements of accounting concepts. The inclusion of a definition of a liability and the omission of a definition of an asset is consistent with the word 'asset' being given its ordinary commercial or business meaning.

4. The meaning of the word 'asset' is found within the commercial or business context that applies where a single entity joins an existing consolidated group (Subdivision 705-A of the ITAA 1997). Assets are recognised for the purposes of the consolidation tax cost setting rules on the basis that a head company of a consolidated group is acquiring

a joining entity. All the assets of the joining entity therefore need to be identified. The total costs (both direct and indirect) of acquiring the joining entity are allocated to the underlying assets of the joining entity.

5. Accordingly, an asset for the purpose of the tax cost setting rules is anything recognised in commerce and business as having economic value to the joining entity at the joining time for which a purchaser of its membership interests would be willing to pay. The business or commercial assets of a joining entity would include the things that would be expected to be identified by a prudent vendor and purchaser as having value in the making of a sale agreement in respect of all the membership interests in an entity and its business. These assets would also come within the scope of a due diligence examination undertaken on behalf of a prudent purchaser of such an entity and business.

6. The commercial or business meaning of an asset in Part 3-90 is not limited to assets that would be recognised under accounting standards or statements of accounting concepts. Internally generated assets would not normally be disclosed in the financial statements of a joining entity prepared in accordance with generally accepted accounting principles when they do not possess a cost or other value that can be measured reliably. However, these assets would be identified under the wider criteria that apply for the consolidation tax cost setting rules.

7. There are situations where accounting principles and practice do influence the commercial or business meaning of what is an asset. A future income tax benefit (FITB) or a deferred tax asset (DTA) would be recognised as an accounting asset in the financial statements of a joining entity prepared in accordance with Accounting Standards AASB 1020: *Accounting for Income Tax (Tax-Effect Accounting)* or AASB 1020: *Income Taxes* respectively. The future economic benefit that arises from the tax consequences of a transaction or event that is recognised as a FITB or DTA would constitute a commercial or business asset for the purposes of Part 3-90 of the ITAA 1997. Examples of these types of assets would include unused tax losses, carry-forward capital losses, deductions for borrowing expenses and future deductions (for example, in respect of an allowance for doubtful debts) and foreign tax credits that are of economic value.

8. There is an alternative view that the tax consequences of transactions and events recognised in DTAs are not assets because they are not things that are recognised separately in commerce or business as having economic value. This view is not accepted. Where economic value can be identified as arising from these tax consequences, the sources of that value are assets for consolidation purposes. The legislative scheme of Division 705 is to treat the economic benefits that arise from FITBs and DTAs like other reset cost base assets. The recognition of an excluded asset in subsection 705-35(2) is on the basis that a DTA such as an entitlement to a deduction for which there is a reduction under steps 2, 5, 6 or 7 in the table to section 705-60 of the ITAA 1997 is an asset for consolidation purposes.

9. Most of the commercial or business assets comprising the economic benefits arising from the future tax consequences of transactions represented in DTAs would be excluded assets under subsection 705-35(2) because there would be reductions under steps 2, 5, 6 or 7 of the table to section 705-60 of the ITAA 1997 in respect of those assets.

10. Franking credits are not a commercial or business asset of a corporate tax entity because they are of economic value to the ultimate shareholders rather than the entity itself. However, an exception arises where franking credits are acquired or are held at the joining time to frank non-share dividends under subsection 202-40(2) of the ITAA 1997. Franking credits used in this way provide an economic benefit to an entity in the form of a lower cost of funds. To the extent that franking credits are required for this purpose their value represents a commercial and business asset of the entity.

11. Assets recognised under the *Income Tax Assessment Act 1936* (ITAA 1936) and the ITAA 1997 would come within the ordinary commercial or business meaning of an asset for Part 3-90 of the ITAA 1997. Assets within these categories would include items of trading stock, revenue assets, traditional and qualifying securities, depreciating assets and CGT assets.

12. There are other assets that would be recognised under Part 3-90 because they are things of economic value in commerce and business that are not recognised under other Parts of the ITAA 1936 or the ITAA 1997. An asset within this category would be information or knowledge that can be identified within an entity as a separate commercial or business asset. Where the asset is identifiable as a separate business or commercial asset it is distinguished from the goodwill of the business. Examples of information and knowledge that may constitute commercial or business assets include secret formulae, client lists and mailing lists.

13. All commercial or business assets have a tax cost setting amount worked out under section 701-10 of the ITAA 1997. Assets that are recognised for the income tax purposes of the head company become assets of the head company while they are in the consolidated group. These include knowledge or information assets. The terminating value of all assets that become assets of the head company are included in the step 1 amount under section 711-25 of the ITAA 1997 if the assets are taken from the consolidated group by a leaving entity.

14. Any copyright in a client list or other record of a knowledge or information asset would also be an asset in its own right if, in the course of operating a business, copyrighted material was reproduced, published or sold. In these circumstances the copyright should be identified and valued separately from the information or knowledge itself.

15. All items of trading stock, revenue assets, traditional and qualifying securities, depreciating assets and CGT assets that are identified as a commercial or business asset of the joining entity at the joining time would have at least some economic value, and consequently are recognised as assets in Part 3-90 of the ITAA 1997.

Explanation

16. Subsection 705-35(1) of the ITAA 1997 provides:

> For each asset of the joining entity (a ***reset cost base asset)*** that is not a *retained cost base asset or an asset (an ***excluded asset)*** covered by subsection (2), the asset's *tax cost setting amount is worked out by:
>
> (a) first working out the joined group's *allocable cost amount for the joining entity in accordance with section 705-60; and
>
> (b) then reducing that amount by the total of the *tax cost setting amounts in accordance with section 705-25 for each retained cost base asset (but not below zero); and
>
> (c) finally, allocating the result to each of the joining entity's reset cost base assets (other than excluded assets) in proportion to their *market values.

17. The meaning of the word 'asset' is not defined in subsection 705-35(1) or elsewhere in the consolidation provisions. The Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002 states at paragraph 5.19 that:

> An asset, for the purposes of the cost setting rules, is anything of economic value which is brought into a consolidated group by an entity that becomes a subsidiary member of the group. This includes those assets which subsequently cease to be recognised as a consequence of the single entity rule whilst the asset is within the consolidated group.

18. In contrast, the word liability is defined in subsection 705-70(1) of the ITAA 1997 as being the amount of each thing that:

> ... in accordance with *accounting standards, or statements of accounting concepts made by the Australian Accounting Standards Board, is a liability of the joining entity at the joining time that can or must be recognised in the entity's statement of financial position.

19. The presence of a legislative definition of a liability and the absence of such a definition for an asset shows that the identification and recognition of an asset for tax cost setting rules is not simply to be found by reference to definitions in accounting standards and statements of accounting concepts.

20. Divisions 701 and 705 of Part 3-90 of the ITAA 1997 provide rules for setting the tax cost of the assets of entities that become members of a consolidated group subject to transitional arrangements in the *Income Tax (Transitional Provisions) Act 1997.* These rules are based on an asset-based model which aligns the cost of the assets of a joining entity with the cost to the group of acquiring membership interests in the joining entity.

21. The basic case under the asset-based model is where a single entity joins a consolidated group and the assets of the subsidiary member become assets of the head company. Subsection 701-10(3) of the ITAA 1997 provides that the object of Division 705 '...is to recognise the cost to the *head company of such assets as an amount reflecting the group's cost of acquiring the entity'.

22. Further detail is provided in the Objects clauses to Subdivision 705-A of the ITAA 1997 in section 705-10 which state:

> **705-10(2)** The object of this Subdivision is to recognise the *head company's cost of becoming the holder of the joining entity's assets as an amount reflecting the group's cost of acquiring the entity. That amount consists of the cost of the group's *membership interests in the joining entity, increased by the joining entity's liabilities and adjusted to take account of the joining entity's retained profits, distributions of profits, deductions and losses.
>
> **705-10(3)** The reason for recognising the *head company's cost in this way is to align the costs of assets with the costs of *membership interests, and to allow for the preservation of this alignment until the entity ceases to be a *subsidiary member ...

23. Paragraph 5.18 of the Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No 1) 2002 confirms that:

> A joined group's cost of acquiring a joining entity is treated as the head company's cost of acquiring the assets of the joining entity.

24. A joined group's allocable cost amount ('ACA') that is calculated in respect of a head company acquiring a joining entity is treated as being the cost of the assets of the joining entity. This applies not only for the basic case in Subdivision 705-A, but also for Subdivisions 705-B, 705-C and 705-D of the ITAA 1997 all of which are modifications of the basic case.

25. The ACA is allocated to the business and commercial assets of a joining entity. These assets would be things of economic value to an entity for which a purchaser of its shares or other membership interests would be willing to pay. The business or commercial assets of the entity would be those that would be identified as having value in the course of making an agreement for the sale of shares and the business of an entity between a vendor and a purchaser. These assets would also come within the scope of a due diligence examination undertaken on behalf of a prudent purchaser of such an entity. The purchaser of the shares or membership interests in an entity would usually require warranties from the vendor to be included in the sale agreement in respect of the state and existence of the

commercial and business assets of the entity that comprise the underlying value of the membership interests that are being acquired.

26. The extent and degree to which the assets of the entity should be separately identified or treated as composite items would depend on the nature of the asset and the business being carried on by the entity and the circumstances of the particular case. Depreciating assets would be identified in accordance with Subdivision 40-B of the ITAA 1997. CGT assets would be identified consistently with the interpretive positions contained in Taxation Ruling TR 95/35: Income tax: capital gains: treatment of compensation receipts, Taxation Determination TD 93/86: Income tax: capital gains: are the totality of rights under a contract considered to be the one asset, or is each right considered to be a separate asset for CGT purposes? and *The Orica Case: ATO position paper, NTLG Minutes of 6 December 2001* at: http://www.ato.gov.au/taxprofessionals/.

27. The financial statements of a joining entity would not usually record assets such as goodwill, mining information, patents, licences, and copyrights which have been generated internally. These assets are not recognised for financial reporting purposes when they do not have a cost or other value that can be measured reliably. However these assets would be recognised by a purchaser and vendor as having some value and would be reflected in the sale price of the membership interests and business of the entity. They would also be within the scope of a due diligence examination carried out on behalf of a prudent purchaser. They are consequently commercial or business assets.

28. The Macquarie Dictionary (revised 3rd ed.) defines assets in the following terms:

> **1.** *Commerce* resources available to a business or an individual for future economic benefits or service potential, and consisting of such items as real property, machinery, inventory, cash and securities, etc **(tangible assets)**, and of patents, trademarks and goodwill **(intangible assets)**. **2.** property or effects (opposed to liabilities). **3.** *Accounting* the detailed listing of property owned by a firm and money owing to it. **4.** *Law* **a.** property in the hands of an executor or administrator sufficient to pay the debts or legacies of the testator or intestate. **b.** any property available for paying debts, etc.

29. In *Commissioner of Taxes (SA) v. Executor Trustee and Agency Co. of South Australia Ltd (Carden's case)* (1938) 63 CLR 108, at pp 152-3, Dixon J stated that:

> The courts have always regarded the ascertainment of income as governed by the principles recognized or followed in business and commerce, unless the legislature has itself made some specific provision affecting a particular matter or question. Familiar but striking examples of this necessary reliance upon commercial principles and general business understanding may be found in the case law dealing with expenditure laid out for the purpose of trade, with outgoings on account of capital, with capital profits, and with the question whether items should be taken into consideration for any

> given accounting period rather than for that which follows or perhaps for that which preceded.

30. The reasoning of Dixon J equally applies to the identification of the assets that are to be subject to the tax cost setting rules. Inherent in this approach is that business and commercial conventions in classifying assets are also observed so that, for example, each asset that is ordinarily recognised as a discrete asset is separately identified. Goodwill is recognised as a residual asset.

31. The use of the expression 'each asset of the joining entity' in subsection 705-35(1) of the ITAA 1997 and the explanation in the explanatory memorandum that an asset is 'anything of economic value' show that an asset for cost setting purposes is anything of economic value to the joining entity. That the asset must be of economic value to the joining entity within the terms of subsection 705-35(1) of the ITAA 1997 is reinforced by subsection 705-35(3) of the ITAA 1997. That subsection recognises that a source of goodwill that makes up part of the value of the membership interests of the joining entity, but is not of economic value to the joining entity itself, is not within the meaning of asset in subsection 705-35(1) of the ITAA 1997. In this case the goodwill asset is deemed to be an asset of the joining entity (that then becomes an asset of the head company).

32. Assets are recognised at the joining time for tax cost setting purposes as if the single entity rule was not in effect at that time to cause the assets of the joining entity to become the assets of the head company. This is made clear by subsection 701-10(2) which provides:

> *Assets to which section applies*
>
> This section applies in relation to each asset that would be an asset of the entity at the time it becomes a *subsidiary member of the group, assuming that subsection 701-1(1) (the single entity rule) did not apply.
>
> [Subsection 701-10(2) of the ITAA 1997 was amended by *Tax Laws Amendment (2004 Measures No. 2) Act 2004* which received Royal Assent on 25 June 2004.]

33. Assets that are recognised for the income tax purposes of the head company become assets of the head company while they are in the consolidated group. Such assets include trading stock, revenue assets, traditional and qualifying securities, depreciating assets, CGT assets and knowledge and information assets. The mechanism provided in the legislation is that things of economic value that would be recognised in commerce and business as assets of the joining entity have their tax cost set under section 701-10. The income tax effect of setting the costs of assets is set out in section 701-55 of the ITAA 1997.

34. Some things of economic value that would be recognised as assets in commerce and business are not recognised for income tax purposes outside of Part 3-90 of the ITAA 1997. They nevertheless have their tax cost set under section 701-10. They become assets of the head company under section 701-1 of the ITAA 1997 if income tax consequences arise when they are dealt with by the group. The tax cost set for such assets can be taken into account as the terminating value for step 1 under section 711-25 of the ITAA 1997 if that asset leaves the consolidated group in a leaving entity.

35. For example, knowledge and information can be an asset of the joining entity in circumstances where it has been recognised as a commercial or business asset separate from the goodwill of the business. This would occur in circumstances where it is capable of being sold or otherwise commercially exploited such as by a sale of a client list. Such assets could also include secret formulae, unique business methods or manufacturing processes. The ACA allocated to these assets would be recognised as their terminating values for the purposes of section 711-25 of the ITAA 1997.

36. All items of trading stock, revenue assets, traditional and qualifying securities, depreciating assets and CGT assets that are identified as a commercial or business asset of the joining entity at the joining time would have at least some economic value, and consequently are recognised as assets in Part 3-90 of the ITAA 1997. The right to receive services under a pre-paid services contract would constitute a commercial or business asset. Such assets become assets of the head company under the single entity rule.

37. Where a reference is made to a consolidated group in this ruling it includes a MEC (multiple entry consolidated) group.

Detailed contents list

38. Below is a detailed contents list for this Taxation Ruling:

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Commissioner of Taxation
29 September 2004

Previous draft:

TR 2004/D9

Related Rulings/Determinations:

TR 92/1; TR 92/20; TR 95/35; TR 97/16; TD 93/86

Subject references:

- asset
- consolidation
- consolidated Group
- joining entity

Legislative references:

- ITAA 1936
- ITAA 1997 Subdiv 40-B
- ITAA 1997 202-40(2)
- ITAA 1997 Pt 3-90
- ITAA 1997 Div 701
- ITAA 1997 701-1(1)
- ITAA 1997 701-1(2)
- ITAA 1997 701-10
- ITAA 1997 701-10(2)
- ITAA 1997 701-10(3)
- ITAA 1977 701-55
- ITAA 1997 Div 705
- ITAA 1997 Subdiv 705-A
- ITAA 1997 705-10
- ITAA 1997 705-10(2)
- ITAA 1997 705-10(3)
- ITAA 1997 705-25
- ITAA 1997 705-35(1)
- ITAA 1997 705-35(2)
- ITAA 1997 705-35(3)
- ITAA 1997 705-60
- ITAA 1997 705-70(1)
- ITAA 1997 Subdiv 705-B
- ITAA 1997 Subdiv 705-C
- ITAA 1997 Subdiv 705-D
- ITAA 1997 711-25
- IT(TP)A 1997
- TAA 1953 Pt IVAAA
- Tax Laws Amendment (2004 Measures No. 2) Act 2004

Case references:

- Commissioner of Taxes (SA) v. Executor Trustee and Agency Co. of South Australia Ltd (1938) 63 CLR 108

Other references:

- AASB 1020: Accounting for Income Tax (Tax-Effect Accounting)
- AASB 1020: Income Taxes
- Macquarie Dictionary Revised 3rd Edition
- Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002
- The Orica Case: ATO position paper, NTLG Minutes of 6 December 2001, http://www.ato.gov.au/taxprofessionals/

ATO references
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