

## Treatment of special classes of assets

### Internally generated assets

Internally generated assets that are depreciating assets are treated as reset cost base assets. Special rules may apply where a joining entity brings an internally generated asset into a consolidated group and the joining entity was a continuing majority-owned entity. A joining entity is a continuing majority-owned entity if a person or persons continued to be majority beneficial owners (directly or indirectly) of it from the start of 27 June 2002 until the joining time. An internally generated asset is an asset for which more than 50% of the total expenditure incurred in constructing or creating it was of a revenue nature and was deductible to the joining entity.

A dual 'cost' is ascribed on consolidation for a depreciating, internally generated asset where:

- its terminating value is less than its tax cost setting amount, and
- for each balancing event that occurred for that asset before the continuing majority-owned entity became a subsidiary member of the group there was rollover relief under section 40-340 of the ITAA 1997.

This dual cost consists of:

- a cost that is used when working out the decline in value under Division 40 of the ITAA 1997 and which is based on the entity's terminating value for the asset, and
- a cost that is used when a balancing adjustment event occurs or if the asset leaves the group with a leaving entity, and which is based on the asset's tax cost setting amount less any decline in value that has since been calculated.

When the head company ceases to hold the internally generated asset, the head company is allowed to either claim a deduction or increase the exit ACA for the shortfall between the deductions for the asset's decline in value and the deductions that would have been worked out using the asset's actual tax cost setting amount.

→ 'Continuing majority-owned entity and internally generated assets', C2-5-810; section 701A-10, IT(TP)A 1997; Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill (No. 1), paragraphs 1.118 – 1.120 and 1.131-1.174; 'Applying the continuing majority-owned entity test to multi-tiered structures' C2-4-855

## Pre-CGT assets

### Treatment of pre-CGT assets on entry

Generally, any pre-CGT asset (that is, an asset acquired before 20 September 1985) of the joining entity at the formation or joining time will continue to be a pre-CGT asset in the consolidated group.

### Pre-CGT membership interests

The pre-CGT status of the membership interests acquired by the group before 20 September 1985 is preserved by attaching a pre-CGT factor to each asset (other than current assets) of the joining entity. This allows a proportion of the membership interests in a leaving entity to be treated as pre-CGT assets by reference to the pre-CGT factors attached to the assets that leave with it.

#### On formation

The pre-CGT status of membership interests held directly by the head company (that is, in the first subsidiary) is preserved by attaching a pre-CGT factor to the assets (other than current assets) of the first subsidiary at the formation time.

If, on formation, the first subsidiary holds membership interests in another subsidiary member (the second subsidiary), the pre-CGT factor must first be worked out for the first subsidiary's assets before any pre-CGT factor can be worked out for the second subsidiary's assets.

The market value of each membership interest owned by the first subsidiary in the second subsidiary is multiplied by the pre-CGT factor that was worked out and attached to the first subsidiary's assets. → 'Pre-CGT factor for assets where subsidiary has membership interests in another member – formation', C2-4-820

### Consolidated group joins another consolidated group

Section 705-125 of the ITAA 1997 is modified to make it clear that pre-CGT factors formerly worked out for assets of entities when they became subsidiary members of the acquired group cease to have any relevance. They are replaced with new pre-CGT factors determined under section 705-125 if the acquiring group holds any pre-CGT membership interests in the acquired group.

→ section 705-205, ITAA 1997

### Linked entities join a consolidated group

Where there has been a loss of pre-CGT status of membership interests in a linked entity, the tax cost setting amount for certain assets is reduced.

→ section 705-240, ITAA 1997

The rules for determining the pre-CGT factors for assets of the linked entities are also modified. → section 705-240, ITAA 1997

### Pre-CGT status of membership interests in a discretionary trust

When working out the pre-CGT factor to be attached to the non-current assets of a trust joining a group, any pre-CGT membership interests of the group that are discretionary interests in that trust are disregarded.

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Conversely, when a trust leaves a group any membership interests that are discretionary interests in that trust are disregarded for the purposes of determining the number of membership interests in the leaving trust to which the pre-CGT proportion is to be applied. → paragraph 711-15(1)(d), ITAA 1997

### Treatment of pre-CGT assets on exit

When a leaving entity takes with it an asset that was a pre-CGT asset immediately before the leaving time, it generally remains a pre-CGT asset after the entity leaves the group. Where, just before the leaving time, any of the assets the leaving entity takes with it had a pre-CGT factor, a proportion of the membership interests in the leaving entity held by members of the group will be treated as pre-CGT membership interests.

### Goodwill

On entry, goodwill owned by the joining entity is treated as one of its reset cost base assets, whether or not an amount has been recognised in its accounting statements. → Taxation Ruling TR 2005/17

When an entity leaves the group, goodwill lost to the group as a consequence is used, along with other reset cost base assets, to derive the group's cost base of membership interests in the leaving entity.

#### Note

##### Exception for demutualised general insurance company

Where a general insurance company that has demutualised joins a consolidated group and was wholly owned by the same group during the period from demutualisation to the joining time, a goodwill asset of the company just before the joining time is treated as a retained cost base asset. → section 713-705, ITAA 1997

### Legislative framework

Goodwill is one of the assets that has a tax cost allocated to it under subsection 705-35(1) of the ITAA 1997. Subsection 705-35(3) provides special rules to apply to certain synergistic goodwill when an entity joins a consolidated group. When a subsidiary member leaves a group, subsection 711-25(1) deals with the goodwill of the leaving entity generally. Subsection 711-25(2) applies to a specific type of synergistic goodwill in the leaving case.

Taxation Ruling TR 2005/17 shows in detail how these provisions apply to the treatment of goodwill when a subsidiary member joins or leaves a consolidated group (including the formation case).

#### **Synergistic goodwill existing in a business of the joined group due to its ownership or control of the joining entity**

In economic terms, not all the value of the goodwill paid for on acquisition of an entity or making up the market value of an entity may be reflected in a goodwill asset of that entity. At subsection 705-35(3) the legislation anticipates an argument that in certain circumstances some proportion of the amount paid for the joining entity may have been paid in expectation of benefits accruing to a business of the acquirer. In this view the source of such benefits is an asset

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of the joined group rather than asset of the joining entity and is not therefore addressed by subsection 705-35(1).

Where objective analysis shows that some of the goodwill acquired with the joining entity is an asset of the joined group at the joining time, subsection 705-35(3) applies. However, as subsection 705-35(3) is essentially an integrity measure, it has no role if all the goodwill underlying the value of a joining entity is identified under subsection 705-35(1) as an asset of the joining entity.

*Working out whether 705-35(3) applies to an asset*

Assets recognised for cost setting purposes under Part 3-90 of the ITAA 1997 take their ordinary meaning as commercial or business assets.

Synergistic goodwill is identifiable as an asset if it has a value at the joining time. Australian Accounting Standards Board (AASB) 1013 paragraph 5.1.3 provides a useful, though not definitive, reference point for commercial or business practice in recognising assets. It states that goodwill can be recognised as an asset if:

- it is expected that the future benefits in the unidentifiable assets will eventuate, and
- it possesses a cost or other value that can be reliably measured.

(AASB 1013 does not apply after 31 December 2004.)

→ Taxation Ruling TR 2004/13

Synergistic goodwill addressed by subsection 705-35(3) only crystallises as an asset where its value at the joining time can be determined by objective analysis. Such an analysis would typically take into account the time in the future when such benefits can be expected to emerge, the cost of achieving the benefits and the probability that the synergies will be realised taking into account the likely risks. Potential benefits that are costly to achieve, remote in time or have a low probability of occurring could be expected to have little or no value as an asset at the joining time. A commercial or business asset cannot be said to exist unless it can be demonstrated, using objective analysis, that a commercial value can be attributed to it.

The goodwill addressed by subsection 705-35(3) only crystallises as an asset of an acquirer once economic control has passed to the acquirer. While control may be achieved before an entity joins a group it is certain to exist at the joining time because of the 100% ownership rule. The test for whether an asset exists is applied at the joining time although the provisions require that the asset is valued at just after this time for cost allocation purposes. Subsection 705-35(3) is not applied in the formation case. → Taxation Ruling TR 2005/17

#### Note

For information about **market valuation** issues in relation to goodwill see → 'Market valuing goodwill' in 'Market valuation guidelines' C4-1.

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## Contracts

### Treatment of contracts as assets

These guidelines apply to partially performed or mutually unperformed contracts for the provision and acquisition of goods or services or the acquisition or disposal of assets, other than purely financial transactions.

Such contracts are capable of being treated as assets of an entity joining or leaving a consolidated group where it can be established they are separately identifiable from the other assets of the joining or leaving entity, and a market value can be reliably determined that does not attribute any of the value of the joining or leaving entity's other assets to the contract.

In recognising assets for cost setting purposes a key principle is that *all* the assets underlying the value of the joining entity need to be recognised. There must be a clear commercial or business practice for recognising a particular type of contract as an asset. Commercial or business practice should also guide the level of composition at which an asset is recognised; i.e., the extent to which different components are treated as part of a single asset.

There is evidence from commercial and business practice that contracts are treated as assets in some circumstances and that a market value can be determined.

In recognising assets it must also be shown that the economic benefit of a contract is separately identifiable from that of other assets. A market value must also be able to be determined in accordance with a recognised valuation methodology → 'Valuation approaches', p. 9. The accounting methods for assigning a value to beneficial or onerous contracts as defined in accounting standards *do not* provide such a methodology → 'The accounting approach to contracts', p. 7. As with other intangible assets, the valuation methodology must be able to ensure that economic benefits of the contract are segregated from the benefits flowing from other assets employed in the business, goodwill in particular.

Caution needs to be exercised in valuing contracts as they tend to be unique between two parties in the context of their individual cost and asset structures. It can therefore be difficult to establish a reliable contract value with evidence of trades in the same or similar instruments or find a suitable market indicator such as a market-based expected rate of return.

### **The basis of recognising assets for cost setting**

The basis of recognising assets for tax cost setting purposes is contained in the provisions of section 701-10 and Subdivision 705-A of the ITAA 1997. Assets subject to the cost setting provisions are referred to simply at subsection 705-35(1) as each asset of the joining entity. This is expanded on at paragraph 5.19 of the Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002:

*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*

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*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.*

The meaning of asset in this context has been interpreted in TR 2004/13, paragraph 5 of which states in part:

*... an asset for the purposes of the tax cost setting rules is anything recognised in commerce or 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 the entity and its business.*

The preliminary test, therefore, for determining whether a contract is an asset for cost setting purposes is whether it would be regarded as an asset in ordinary commercial or business usage.

### **The conceptual framework behind asset recognition**

In interpreting the meaning of ‘asset’ in subsections 700-10(2) and 705-35(1), TR 2004/13 notes that the perspective to apply in identifying assets coming into a consolidated group in a joining entity is that of a prudent vendor and buyer identifying what the assets are. More specifically, subsection 701-10(2) provides that the section applies to each asset that would be an asset of the entity at the time it becomes a subsidiary member assuming the single entity rule does not apply. That it applies to each asset and not just assets that exist for the purposes of the head company core purposes is clear from section 701-58, which addresses intra-group assets that are not recognised as assets of the head company except in some circumstances as they leave the group.

For cost setting purposes when an entity joins a group, an asset is anything of economic value that is brought into the consolidated group by the joining entity. The context for determining whether contracts are such assets is provided by the object of section 701-10 and Division 705, which is to recognise the cost to the head company of such assets as an amount reflecting the group’s cost of acquiring the entity → 701-10(3).

For the purposes of working out an allocable cost amount (ACA) to be distributed across the assets of a joining entity, the group’s cost of acquiring an entity (equity = total assets less debt) is represented as membership interests (step 1) + liabilities (step 2) = total assets → section 705-60. While step 1 adjusts the amount of the actual payment for membership interests for the purposes of the ACA calculation, the basic accounting principle of equity = total assets – liabilities is retained. Conceptually the acquirer has chosen the assets identified under section 701-10, and the value of those assets is reflected in the amount paid for the membership interests together with the liabilities assumed on acquiring ownership.

In the acquisition of an entity, the total value of its identified assets cannot exceed the acquisition cost and assumed liabilities. This means that, where an asset such as a contract for the disposal of another asset is said to exist, the

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acquirer needs to identify which assets contain the value reflected in the entity value for which it paid. Given that entities are ordinarily acquired as going concerns, it can be assumed that contracts will be fulfilled unless there is evidence to the contrary. Importantly, it needs to be established that the contract is a separate asset to any underlying assets being traded under the contract.

### The accounting approach to contracts

The accounting standards define assets as future economic benefits controlled by an entity as a result of past transactions or other past events → Statement of Accounting Concepts (SAC) 4, paragraph 14<sup>1</sup>. Control of an asset is defined as the capacity of the entity to benefit from the asset in the pursuit of the entity's objectives and to deny or regulate the access of others to that benefit. By comparison, the reference to assets in the Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002 is to 'anything of economic value'.

The standards (which are designed to provide for the broad information needs of the users of general purpose financial reports → SAC 2) provide for assets to be recognised where:

*(a) it is probable that the future economic benefits embodied in the asset will eventuate and*

*(b) the asset possesses a cost or other value that can be measured reliably.*

→ SAC 4, paragraph 38

The bringing together of separate entities or businesses into one reporting entity is addressed by AASB 3, paragraph 4. The result of nearly all business combinations is that one entity, the acquirer, obtains control of one or more businesses from an acquiree. For present purposes, business combinations include parent-subsidiary relationships in which the acquirer is the parent and the acquiree the subsidiary of the acquirer → AASB 3, paragraph 6.

All business combinations are to be accounted for by applying the purchase method → AASB 3, paragraph 14. This views a business combination from the perspective of the combining entity that is identified as the acquirer. The acquirer purchases the net assets and recognises the assets acquired and liabilities and contingent liabilities assumed, including those not previously recognised by the acquiree. The cost of the business combination is the aggregate of the fair values (at date of exchange) of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer in exchange for control of the acquiree. The conceptual basis of treating business combinations in accounting is similar to steps 1 and 2 in section 705-60 of the ITAA 1997. Under both regimes, failure to recognise an asset that is contributing to the value of an entity can distort the value assigned to other assets. Similarly a stream of economic benefits cannot be counted more than once.

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<sup>1</sup> While SACs 3 and 4 have been replaced by the Accounting Framework from 1 January 2005, the principles referred to here are substantially carried on in the Framework.

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The acquirer shall recognise separately the acquiree's identifiable assets and liabilities at the acquisition date → AASB 3, paragraph 37. Intangible assets must be identifiable and their fair value capable of being measured reliably. Fair value is defined as 'the amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in an arm's length transaction'

→ AASB 3, Appendix A, p 37.

### **Intangible assets**

A non-monetary asset without physical substance must be identifiable to meet the definition of an intangible asset → AASB 3, paragraph 46. This means that the intangible asset must be separable (capable of being separated from the entity and sold or transferred either individually or together with a related contract, asset or liability) or arises from contractual or other legal rights, regardless of whether those rights are transferable → AASB 138. Customer contracts, purchase and sale orders, lease agreements and servicing contracts can be recognised as intangible assets (and therefore separately to goodwill) provided they can be separately identified and their fair values measured reliably.

However, it might not be possible to measure reliably the fair value of an intangible asset if either the asset is not separable or is separable but 'there is no history or evidence of exchange transactions of the same or similar assets, and otherwise estimating fair value would be dependent on immeasurable variables' → AASB 138, paragraph 38. In some cases agreed proxies can be substituted for exchange values determined from the market when applying AASB 3 to business combinations. For example, it specifies that the fair value of receivables, beneficial contracts and other identifiable assets shall use present values of the amounts to be received, determined at appropriate current interest rates less allowances for uncollectibility and collection costs

→ AASB 3, paragraph 16(c).

In referring to the fair value of receivables, beneficial contracts and other identifiable assets, AASB 3 paragraph B16(c) does not define a beneficial contract but treats it as a counterpart to onerous contracts as defined in AASB 137. (The latter applies to all entities in accounting for provisions, contingent liabilities and contingent assets except those resulting from executory contracts, except where the contract is onerous → AASB 137, paragraph 1). An onerous contract is '...a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it' → AASB 137, paragraph 68. Some industries, including insurance and construction, have specific treatments that may lead to an asset and a liability being recognised.

It is considered that executory contracts cannot be included as beneficial contracts because the latter only apply to contracts under which an amount has been earned or partially earned but is not yet recoverable. This state would not exist for a mere executory contract. It is important to note also that income that is merely prospective (fully unearned) is not included in the value of the beneficial contract. In essence, the recognition of beneficial contracts as assets



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provides a way of bringing forward the recognition of income and associated future expenses when accrual of that income is virtually certain.

In summary, a value worked out under a prescribed methodology can be included in accounts in respect of contracts under the limited notions of beneficial or onerous contracts. It seems that service contracts and customer contracts can also be recognised provided their value can be measured reliably by reference to trades in similar instruments or other means.

Because of the nature of the framework for asset cost setting, whereby the cost of the entity is transferred to all the assets that underlie its value at the joining time, or a tax value is transferred from all the assets of a leaving entity to membership interests at the leaving time, it is accepted that it is not necessary to show that each type of asset recognised is capable of being traded in the market. This is analogous to the accounting treatment of assets in business combinations. However, a recognised market valuation methodology must be applied.

## Valuation approaches

While very little has been published in Australia on determining a market value for contracts, detailed treatments have been published elsewhere. In addressing the issue of valuing contracts, US authors Reilly and Schweihs (1999) refer to contract intangibles as generally representing ‘...value *attributable* to that broad category of rights accruing to an individual or business entity as a result of a written, legally enforceable contractual arrangement’.

They set out key elements of a contract that lend it value:

*While common logic dictates that two parties generally would not enter into a contractual agreement unless it was viewed as economically advantageous by both parties, a change in general industrial or economic conditions subsequent to the original consummation of a contract may exert a positive or negative impact on the current value of an existing contract, based on the contract terms initially established.*

Three valuation methods are recommended: the cost approach, the market approach and the income approach → pp. 313-14. The cost approach is in essence replacement cost. Its primary defect is that costs change in the market so that today’s contract may cost more or less to replace in the future. The market approach is essentially value in exchange. Its deficiencies stem from the lack of active markets in most forms of contracts and the difficulty of establishing exactly what is being exchanged in transactions. Under the income approach the future cost savings expected to be realised over the remaining term of a supplier contract can be discounted to its present worth (net present value) at a discount rate equal to the (market) required rate of return of the investment generating the savings. Under this approach, comparative data needs to be obtained for similar businesses or transactions to determine the market rate of return. Because of the complexity of contracts and the scarcity of data it is not possible to be definitive on suitable methods.

Net present value methods can also be used to show any positive value in a contract over and above the amount it was expected to earn when entered into. For example, if it was determined at the initiation of a contract that it would

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yield 10% per annum (being the necessary rate of return on the assets employed as determined by the market), a net present value analysis of the project's net cash flow using the present market discount rate will reveal any improvement in the value of the contract above its presumed nil starting value. However some contracts can be favourable or unfavourable to a given party from the beginning, possibly reflecting advantages in bargaining power.

Key issues that should be taken into account in valuing contracts include:

- the number and different types of contracts maintained by an entity
- an entity's history regarding renewal and the premature termination of contracts
- the average service life of contracts by category
- an entity's history regarding breach of contract claims and related litigation
- break clauses and penalties for breach, and
- the terms of the contract generally.

In summary the factors that can contribute to the value of a contract include the cost of establishing the contract, any work carried out under the contract and movements in the market conditions that may make the contract favourable in the hands of one or more of the parties. Where income methods are employed to value a contract it is the net income that is used rather than gross future receipts. Basing a valuation on gross receipts where expenses will be incurred in earning that income will invariably attribute value to a contract that is more properly attributed to another asset.

## References **Legislation**

*Income Tax Assessment Act 1997*, section 40-340

*Income Tax Assessment Act 1997*, section 705-35, as inserted by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

*Income Tax Assessment Act 1997*, subsection 705-35(1), as amended by *Taxation Laws Amendment Act (No. 6) 2003* (No. 67 of 2003), Schedule 3

*Income Tax Assessment Act 1997*, section 705-125, as inserted by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

*Income Tax Assessment Act 1997*, sections 705-205; as inserted by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 4

*Income Tax Assessment Act 1997*, sections 705-240; as inserted by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 4

*Income Tax Assessment Act 1997*, sections 711-15; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 5

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*Income Tax Assessment Act 1997*, section 711-25, as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Explanatory Memorandum to the New Business Tax System (Consolidation and other Measures) Bill (No. 1) 2002, paragraphs 1.118 – 1.120 and 1.131 – 1.174

### **Tax rulings**

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

TR 2005/17 – Income tax: goodwill: identification and tax cost setting for the purposes of Part 3-90 of the *Income Tax Assessment Act 1997*

### **Other**

Australian Accounting Standards Board:

- Statement of Accounting Concepts (SAC) 4
- AASB 3 Business Combinations
- AASB 137 Provisions, Contingent Liabilities and Contingent Assets
- AASB 138 Intangible Assets

Robert F. Reilly and Robert P. Schweihs, *Valuing intangible assets*, McGraw Hill, 1999

### **Revision history**

Section C2-1-070 first published as separate section 26 June 2007.

Further revisions are described below.

Date	Amendment	Reason
28.02.08	New section on Contracts, p. 5.	For clarification.

### **Proposed changes to consolidation**

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- <http://assistant.treasurer.gov.au> (Assistant Treasurer's press releases)
- [www.treasury.gov.au](http://www.treasury.gov.au) (Treasury papers on refinements to the consolidation regime).