Linked assets and liabilities

There are special rules for setting the tax cost of a joining entity's assets if, immediately before it joins a consolidated group, it has a set of linked assets and liabilities that must be set-off against each other under the joining entity's accounting principles for tax cost setting. The joining entity's accounting principles for tax cost setting are the accounting standards or authoritative pronouncements of the Australian Accounting Standards Board (AASB) that the entity would use if it were to prepare its financial statements just before the joining time. → section 705-59, subsections 705-70(3), 995-1(1), *Income Tax Assessment Act 1997* (ITAA 1997)

Apart from these rules, the consolidation regime treats assets and liabilities that are required to be set-off, in accordance with accounting principles, as separate assets and liabilities. That is, in general linked assets and liabilities are not netted; their gross amounts are used. → section 705-58, ITAA 1997

Note

Retained cost base assets and excluded assets

The tax cost of *retained* cost base assets is always set by section 705-25. These rules do not affect that section. Also, if the only linked assets in a set are retained cost base assets these rules have no application. → subsection 705-59(4), ITAA 1997

Excluded assets, which are described in subsection 705-35(2), do not have a tax cost setting amount and are ignored by these rules. → subsection 705-59(6)

Linked assets & liabilities under the accounting standards

A set of linked assets and liabilities consists of at least one asset and at least one liability that the joining entity's accounting principles for tax cost setting require to be:

- set-off against each other in preparing an entity's statements of financial position, and
- presented in that statement as a net amount.

→ subsection 705-59(2)

Generally, the accounting standards require assets and liabilities to be set-off and net amounts to be recognised in the balance sheet only when there is both a legally recognised right to set-off and an intention to settle on a net basis or simultaneously → e.g. see AASB 1014, section 9 (AAS 23) and AASB 1033 section 4 (AAS 33). The standards also list circumstances in which set-off would usually be inappropriate, such as where assets and liabilities within a portfolio have the same primary risk exposure but different counterparties.

Applying the special rules

The treatment of linked assets and liabilities under these special rules depends on the number and type of assets in a set of linked assets and liabilities, and their market value in relation to the 'available amount' (see definition below).

The number of liabilities in a set is not relevant.

The rules are set out in two tables in section 705-59, one applying where there is a single reset cost base asset and the other applying to all other cases (except where the only linked assets in a set are retained cost base assets, in which case the rules have no application). Within the tables a further series of tests determine the treatment of the linked assets and liabilities. These tests and their application are set out in this section of the Reference Manual.

The available amount

The available amount is the ACA step 2 amount for the linked liabilities in a set worked out as if we ignore the special rules for linked assets and the accounting standards that apply to them. → subparagraph 705-59(3)(a)

Where in the cost setting process do the rules need to be considered?

The ACA step 2 amount is firstly worked out ignoring the special rules for linked assets and liabilities.

If the linked asset and liability rules apply to a joining entity, their application may not only set the tax costs of the affected assets, but it may also affect the ACA step 2 calculation for the entity. → subsection 705-70(1), ITAA 1997

Where the linked asset rules operate to set the tax cost of an asset, sections 705-40, 705-45 and 705-50 (adjustments for revenue-like assets, accelerated depreciation assets and over-depreciated assets respectively) still apply where relevant. → subsection 705-59(7)

Note that, effective from 1 July 2009, the over-depreciation adjustment in section 705-50 of the ITAA 1997 has been repealed so that it will no longer apply to over-depreciated assets of entities that become subsidiary members of a consolidated group on or after that date. → former subsection 705-50, ITAA 1997

What information is needed to apply the rules?

Before the rules can be applied the following amounts need to be determined:

- the market values of the linked reset cost base assets at the joining time
- the tax cost setting amounts for the linked retained cost base assets
- the available amount of the linked liabilities.

→ subsection 705-59(3) and (5)

Only one linked asset – a reset cost base asset

When the only asset in a set of linked assets and liabilities is a single reset cost base asset the following rules apply:

1. Where the linked asset's market value ≤ the total available amount of the liabilities:

- the linked reset cost base asset's tax cost setting amount is its market value, and the linked asset does not share in the allocation of the ACA, and
- the difference between the market value of the linked asset and the available amount of the linked liabilities is included at ACA step 2.

→ subsection 705-70(1)

In effect, the linked liability is dedicated firstly to setting the tax cost of the asset to which the liabilities are linked. In relation to the linked liabilities, only the excess of the available amount over the asset's market value is added to the ACA at step 2 for use in increasing the tax cost of the other assets. The linked asset does not share in the allocation of the ACA and does not affect how it is allocated among the other assets of the joining entity. This limits the transfer of value to or from the linked asset.

→ paragraph 705-59(3)(b), item 1 in the table

Example 1

A consolidated group pays $6,000 for 100% of the membership interests in JCo, which therefore joins the group. At the joining time, JCo owns land with a market value of $8,000 and has a net liability of $2,000. The net liability represents a reset cost base asset with a market value of $4,000, which is required to be set-off, under the joining entity's accounting principles for tax cost setting, against a liability of $6,000. The liability's available amount is the full $6,000.

The available amount of $6,000 exceeds the market value of the linked reset cost base asset of $4,000. Therefore, the linked asset's tax cost setting amount is $4,000, its market value. When calculating the ACA step 2 amount, only the $2,000 difference between the available amount of $6,000 and the market value of the linked asset of $4,000 is included.

The ACA for JCo is $8,000 ($6,000 purchase price plus the $2,000 of the liability not used to set the linked asset's tax cost). As the linked asset already has a tax cost setting amount of $4,000, it does not share in the ACA allocation under paragraph 705-35(1)(c). The total of the ACA is allocated to the land, being the only other reset cost base asset.

2. Where the linked asset's market value > the total available amount of the liabilities:

- the linked asset's tax cost setting amount is the sum of:
  - the available amount, plus
  - the amount worked out under subsection 705-35(1) as if the asset's market value were equal to the difference between the market value of the linked asset and the available amount

and

- the linked liabilities are not taken into account at step 2 of the ACA.

The linked liability is again dedicated firstly to setting the tax cost of the asset to which it is linked. In this situation the asset has a greater market value than the liability to which it is linked. As a result, the linked asset, in addition to the dedicated available amount, will also get a proportionate share of the ACA, based on the difference between the market value of the asset and the available amount of the liability.

The proportion is worked out as follows:

$$\left(\frac{\text{market value of the linked reset cost base asset} - \text{available amount}}{(\text{market value of the linked reset cost base asset} - \text{available amount}) + \text{market values of all other reset cost base assets}} \right) \times \quad \text{ACA}$$

→ paragraph 705-59(3)(b), item 2 in the table

Example 2

RCo joins a consolidated group. In RCo's balance sheet there is a net asset of $4,000 which represents a set of linked assets and liabilities as follows:

reset cost base asset	$16,000	(market value)
liability	$12,000	(the available amount)

RCo also owns reset cost base assets land 1 and land 2:

land 1	$1,000	(market value)
land 2	$2,000	(market value)

RCo is acquired for $7,000, the net value of the linked assets and liability plus the land.

The market value of the linked reset cost base asset of $16,000 exceeds the available amount of $12,000. Therefore the ACA for RCo is calculated as $7,000, the purchase price (step 1 amount). There is no step 2 amount as the linked liability is not taken into account. The linked liability will be dedicated to setting the linked asset's tax cost setting amount.

The linked reset cost base asset is allocated a proportionate share of the ACA based on the difference between its market value and the available amount (i.e. \$16,000 – \$12,000 = \$4,000). The ACA is allocated to the linked asset as follows:

[\$4,000 ÷ (\$4,000 + \$3,000 (land 1 & 2))] × \$7,000 = \$4,000

This amount is then increased by the available amount of \$12,000 which sets the asset's tax cost at \$16,000.

Land 1 & 2 then have their tax cost setting amounts calculated based on an ACA of \$7,000. The ACA is distributed to the land as follows:

land 1: [\$1,000 ÷ (\$4,000 + \$3,000 (land 1 & 2))] × \$7,000 = \$1,000

land 2: [\$2,000 ÷ (\$4,000 + \$3,000 (land 1 & 2))] × \$7,000 = \$2,000

More than one linked asset

1. Where all linked assets are reset cost base assets and their total market **values are ≤ the total available amount of the liabilities:**

- each linked reset cost base asset's tax cost setting amount is its market value, and the linked assets do not share in the allocation of the ACA, and
- the difference between the market value and the available amount is included at ACA step 2.

This is the same treatment as applies to a single reset cost base asset with a market value equal to or less than the liability to which it is linked. The linked assets do not share in the allocation of the ACA and do not affect how the ACA is distributed among the other assets of the joining entity.

→ paragraph 705-59(5)(b), item 1 in the table

2. Where all linked assets are reset cost base assets, and their total market values are > the total available amount of the liabilities:

- each linked asset's tax cost setting amount is equal to:
  - a proportionate share of the available amount (based on the assets' market values), plus
  - a proportionate share of the ACA based on an amount equal to its market value reduced by its share of the available amount;

and

- the liabilities are not taken into account at ACA step 2.

Again this is similar to the case of single reset cost base asset above. The amounts are now apportioned among the various assets based on their market values.

→ paragraph 705-59(5)(b), item 2 in the table

Example 3

Consider again RCo joining a consolidated group, but in this case it has two linked reset cost base assets and a liability.

In RCo's balance sheet there is a net asset of $4,000, which represents a set of linked assets and liabilities as follows:

reset cost base asset 1	$10,000	(market value)
reset cost base asset 2	$6,000	(market value)
liability	$12,000	(the available amount)

RCo also owns reset cost base assets land 1 and land 2:

land 1	$1,000	(market value)
land 2	$2,000	(market value)

RCo is acquired for $7,000, the net value of the linked assets and liability plus the land.

As in the previous example, the market value of the linked reset cost base assets of $16,000 exceeds the available amount of $12,000. The ACA for RCo is the $7,000 purchase price (step 1 only applies). The linked liability is not taken into account. The liability is dedicated to the tax cost setting amount of the linked reset cost base assets.

As the linked assets are worth more than the liabilities, the assets will split the available amount of $12,000 between them in proportion to their market values.

reset cost base asset 1: [$10,000 ÷ ($10,000 + $6,000)] × $12,000 = $7,500

reset cost base asset 2: [$6,000 ÷ ($10,000 + $6,000)] × $12,000 = $4,500

Reset cost base asset 1 will also get a share of the ACA based on its $10,000 market value less its $7,500 share of the available amount (i.e. $2,500). Reset cost base asset 2 will use an amount of $1,500 (i.e. $6,000 – $4,500) in working out its share of the ACA.

reset cost base asset 1:
[$2,500 ÷ ($2,500 + $1,500 + $3,000 (land 1 & 2))] × $7,000 = $2,500

reset cost base asset 2:
[$1,500 ÷ ($2,500 + $1,500 + $3,000 (land 1 & 2))] × $7,000 = $1,500

Each of the linked assets will have a tax cost equal to its share of the available amount plus its share of the ACA.

reset cost base asset 1 tax cost setting amount: $7,500 + $2,500 = $10,000

reset cost base asset 2 tax cost setting amount: $4,500 + $1,500 = $6,000

Land 1 & 2 then have their tax cost setting amount calculated based on an ACA of $7,000. The ACA is distributed as follows:

> land 1:
> [$1,000 ÷ ($2,500 (linked asset 1) + $1,500 (linked asset 2) + $3,000 (land 1 & 2))]× $7,000 = $1,000
>
> land 2:
> [$2,000 ÷ ($2,500 (linked asset 1) + $1,500 (linked asset 2) + $3,000 (land 1 & 2))] × $7,000 = $2,000

3. Where the linked assets include reset and retained cost base assets **and the retained cost base assets' total tax cost setting amounts are ≥** the total available amount of the liabilities:

The linked asset and liability rules do not effect the treatment of the linked assets or linked liabilities in the ACA process. All of the linked liabilities should be dedicated to the retained cost base assets and the normal rules for allocating the ACA will achieve this. The step 2 amount will include the available amount for the linked liabilities and the retained assets will be deducted from the ACA prior to allocation.

→ paragraph 705-59(5)(b), item 3 in the table

4. Where the linked assets include reset and retained cost base assets and the retained cost base assets' total tax cost setting amounts are < the total available amount of the liabilities:

- the linked retained cost base assets are disregarded for the purposes of paragraph 705-35(1)(b) (reduces the ACA by the tax cost setting amount of retained cost base assets), and
- the linked reset cost base assets and liabilities are then treated as if the set included only reset cost base assets. Tests 1 or 2 above, as appropriate, are used to determine the result for these assets and liabilities. The available amount used in tests 1 or 2 is reduced by the total of the tax cost setting amounts of the retained cost base assets.

The same rules apply as if there were only reset cost base assets. The linked retained cost base assets are not deducted from the ACA – i.e. subsection 705-35(1)(b) disregards these assets. However, they are deducted from the available amount.

→ paragraph 705-59(5)(b), item 4 in the table

Example 4

Consider again RCo joining a consolidated group with linked assets and liabilities that include a retained and a reset cost base asset.

RCo's balance sheet shows a net asset of $4,000, representing a set of linked assets and liabilities as follows:

one retained cost base asset	$10,000	(tax cost setting amount)
one reset cost base asset	$6,000	(market value)
liability	$12,000	(the available amount)

RCo also owns reset cost base assets land 1 and land 2:

land 1	$1,000	(market value)
land 2	$2,000	(market value)

RCo is acquired for $7,000, the net value of the linked assets and liability plus the land.

As the linked assets and liabilities include a retained and a reset cost base asset, and the retained cost base asset's tax cost setting amount of $10,000 is less than the available amount of $12,000, subsection 705-59(5), table item 4 applies (test 4 above).

In respect of the reset cost base asset, item 4 refers to 'item 1 or 2, as appropriate, of this table on the basis that: (a) the available amount is reduced by the retained cost base total …'. Therefore the reset cost base asset's market value of $6,000 is compared to the available amount of $12,000 less the $10,000 retained cost base asset (i.e. $2,000). The market value of $6,000 is greater than $2,000 so item 2 of the table applies.

The reset cost base asset's market value of $6,000 exceeds the $2,000 available amount by $4,000. An amount of $4,000 is used to allocate the ACA as follows:

The ACA for RCo is the $7,000 purchase price. Note that under items 2 & 4 the ACA does not include an amount for the linked liabilities.

The $12,000 liability has been dedicated to the retained cost base asset and the reset cost base asset. The linked retained cost base asset's tax cost setting amount is not deducted from the ACA because part of the linked liability has already been dedicated to the retained cost base asset and that liability has not been added to the ACA at step 2.

The linked reset cost base asset's market value share of the ACA is:

$4,000 ÷ ($4,000 + $3,000 (land 1 & 2)) ×$7,000 = $4,000

The reset cost base asset's tax cost setting amount is calculated by adding the available amount to a portion of the ACA calculated above. There is only one reset cost base asset so the $2,000 available amount is all apportioned to that asset. The reset cost base asset's tax cost setting amount is:

$4,000 + $2,000 = $6,000

Land 1 & 2 then have their tax cost setting amount calculated based on an ACA of $7,000. The ACA is distributed as follows:

land 1: [$1,000 ÷ ($4,000 + $3,000 (land 1 & 2))] × $7,000 = $1,000

land 2: [$2,000 ÷ ($4,000 + $3,000 (land 1 & 2))] × $7,000 = $2,000

Example 5

MCo joins a consolidated group. MCo's balance sheet shows a net liability of $5,000 representing a set of linked assets and liabilities as follows:

one retained cost base asset	$3,000	(tax cost setting amount)
one reset cost base asset	$8,000	(market value)
liability	$16,000	(the available amount)

MCo also owns a reset cost base asset:

land	$10,000	(market value)

MCo is acquired for $5,000, the net value of the linked assets and liability plus the land.

As the linked assets and liabilities include a retained and a reset cost base asset, and the retained cost base asset's tax cost setting amount of $3,000 is less than the available amount of $16,000, subsection 705-59(5), table item 4 applies.

The ACA is not reduced by the linked retained cost base asset of $3,000 under paragraph 705-35(1)(b). The remaining linked reset cost base assets and liability are therefore treated as a reset cost base asset of $8,000 and a linked liability with an available amount of $13,000 (i.e. $16,000 – $3,000). They are then dealt with under item 1 in the same table.

The reset cost base asset's tax cost setting amount is $8,000, its market value. It does not share in the ACA.

The difference between the available amount (as adjusted under paragraph 705-59(5)(b), table item 4) of $13,000 and the market value of the reset cost base asset of $8,000 (i.e. $5,000) is included at ACA step 2. The ACA to be allocated to the land is therefore the purchase price of $5,000 plus the $5,000 now included at ACA step 2.

CGT event L3

Broadly, under CGT event L3 a capital gain occurs where the total of the tax cost setting amounts of the retained cost base assets exceeds the ACA. Subparagraph 104-510(1)(b)(ii) only considers retained cost base assets that 'are taken into account under paragraph 705-35(1)(b)' (reduces the ACA available for reset cost base assets by the tax cost setting amounts of retained cost base assets).

If the tax cost setting amounts of the retained cost base assets in the set of linked assets is less than the available amount, those retained cost base assets are not taken into account in 705-35(1)(b) – as in item 4 above. This means that they are not included in working out the sum of tax cost setting amounts for the retained cost base assets in paragraph 104-510(1)(b), because of subparagraph 104-510(1)(b)(ii).

In example 4, the $10,000 tax cost setting amount of the retained cost base asset exceeded the $7,000 ACA by $3,000. The tax cost of the linked retained cost base asset was fully funded by the linked liability and that part of the linked liability was not included in the ACA. The retained cost base asset was not deducted from the ACA prior to allocation. CGT event L3 does not count that linked retained cost base asset in working out any capital gain when RCo joins the group. As there are no other retained cost base assets in this example, there will be no capital gain.

Note

A modification has been made to the treatment of doubtful debts for cost setting purposes that allows for the reduction of any CGT event L3 capital gain in respect of doubtful debts as retained cost base assets with a corresponding reduction to the tax cost setting amount of the head company's outstanding debts. These modifications apply from 10 February 2010, unless a written choice to apply the changes from 1 July 2002 is made within the prescribed time by the head company of the group. → section 705-27, ITAA 1997

References

New Business Tax System (Consolidation) Act (No. 1) 2002 (No. 68 of 2002)

Taxation Laws Amendment Act (No. 6) 2003 (No. 67 of 2003), Schedule 3

Tax Laws Amendment (2010 Measures No. 1) Act 2010 (No. 56 of 2010), Schedule 5, parts 6, 8 and 13

Explanatory Memorandum to the Taxation Laws Amendment Bill (No.6) 2003, paragraphs 3.4 and 3.9 to 3.48

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No.1) Bill 2010, Chapter 5

Revision history

Section C2-1-310 first published 8 June 2004.

Further revisions are described below.

Date	Amendment	Reason
26.6.07	Note on proposed changes to the treatment of doubtful debts for cost setting purposes, and proposed changes to clarify both the valuation of liabilities and the accounting principles to be used, p. 10.	Reflect announcement on 8 May 2007 by Assistant Treasurer in media release no. 50.
6.5.11	Removal of note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used. Reference to 'accounting standards for tax cost setting' and definition of that term included on p. 1, and consequential minor changes. Minor changes to reflect the repeal of section 705-50, effective 1 July 2009. Removal of note on proposed changes and insertion of a new note to reflect the changes to the treatment of doubtful debts for tax cost setting purposes, p. 10.	Legislative amendments.