*High-level worked example*

# Partnership – *not all* partners join consolidated group

## Description

The cost setting process for a partner joining a consolidated group depends on whether:

- at least one (but not all) of the partners in a partnership joins a particular consolidated group, or
- all partners in the partnership join the same consolidated group

  → 'Partnership – *all* partners join consolidated group', C2-2-150.

This high-level example shows how the cost setting process applies to set the tax costs of the assets of a partner, including interests in the partnership, when *not all* partners join the consolidated group.

## Commentary

Due to the characteristics of a partner's interests in the assets of a partnership, the basic case rules that apply to entry into a consolidated group are modified in the case where not all partners join the consolidated group, to achieve a comparable outcome to other entry circumstances → Subdivision 713-E, *Income Tax Assessment Act 1997* (ITAA 1997). Those modifications include:

- The tax cost setting amount is calculated for the partner's fractional interests in the partnership assets. These fractional interests are known as partnership cost setting interests (PCSI) → section 713-210, ITAA 1997. The tax costs for the underlying assets of the partnership are not reset.
- The adjustment for the partnership's over-depreciated assets is made to the allocable cost amount (ACA), *not* to the tax cost setting amount (TCSA) of the PCSI (unlike non-partnership over-depreciation cases, where the adjustment is made to the TCSA of the asset). → subsection 713-225(5), ITAA 1997
- The TCSA of a PCSI in a partnership asset that is trading stock or a depreciating asset is equal to the interest's individual share of the terminating value of the partnership asset (unlike non-partnership trading stock or depreciating assets, which are reset cost base assets). → subsection 713-225(4), ITAA 1997

## Example

### Facts

On 1 July 2002, Comedy Co acquires 100% of the shares in Laurel Co for $3,050 (the value of net assets). The assets of Laurel Co include a 50% interest in the assets of Funny Partnership. The market value of the net assets of Laurel Co and Funny Partnership at the time of acquisition are:

**Table 1: Value of net assets of Laurel Co at 1 July 2002 ($)**

| | Market value | |
|---|---|---|
| **Assets** | | |
| Cash | 50 | |
| Land | 500 | |
| Motor vehicle | 600 | |
| Interest in partnership | 1,900 | 3,050 |
| **Liabilities** | | nil |
| **Value of net assets** | | **3,050** |

**Table 2: Value of net assets of Funny Partnership at 1 July 2002 ($)**

| | Market value | |
|---|---|---|
| **Assets** | | |
| Cash | 2,100 | |
| Recording studio | 1,700 | 3,800 |
| **Liabilities** | | nil |
| **Value of net assets** | | **3,800** |

The financial position of Laurel Co and Funny Partnership at the time of acquisition is as follows:

**Table 3: Laurel Co – financial position at 30 June 2002 ($)**

| | | | |
|---|---|---|---|
| Cash | 50 | Capital | 3,050 |
| Land | 500 | | |
| Motor vehicle | 600 | | |
| Investment in Funny Partnership | 1,900 | | |
| | 3,050 | | 3,050 |

**Table 4: Funny Partnership – financial position at 30 June 2002 ($)**

| | | | | |
|---|---|---|---|---|
| Cash | | 2,100 | Laurel Co capital | 1,900 |
| Studio | cost 1900 | | Hardy Co capital | 1,900 |
| | (acc depn 200) | 1,700 | | |
| | | 3,800 | | 3,800 |

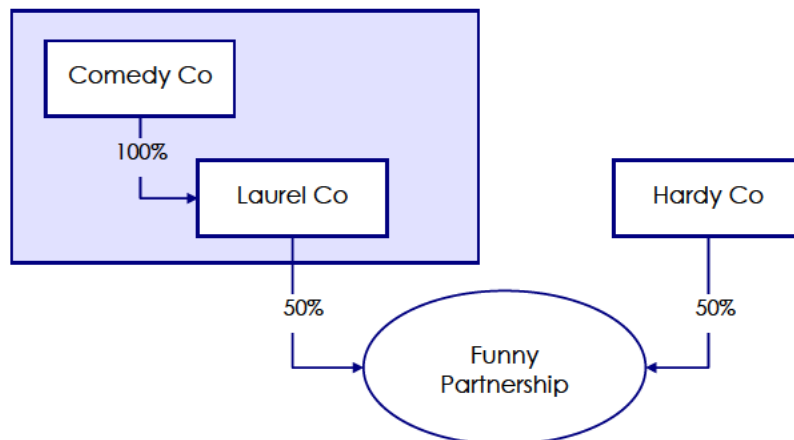
For tax purposes the land has a cost base and reduced cost base of $500 and the motor vehicle has an adjustable value of $600. Funny Partnership's recording studio has an adjustable value of $1,700.

On 1 July 2002 Funny Partnership purchased recording equipment for $700.

Division 40 of the ITAA 1997 (relating to depreciating assets) applies to the recording studio and recording equipment.

Comedy Co and its wholly-owned subsidiary Laurel Co form a consolidated group on 1 July 2003.

**Figure 1: Structure of consolidated group**




The value of the net assets and the financial position of Laurel Co and Funny Partnership at the formation time are as follows:

**Table 5: Value of net assets of Laurel Co at 1 July 2003 ($)**

| | Market value | |
|---|---|---|
| **Assets** | | |
| Cash | 115 | |
| Land | 500 | |
| Motor vehicle | 500 | |
| Investment in partnership | 2,000 | 3,115 |
| **Liabilities** | 15 | 15 |
| **Value of net assets** | | **3,100** |

### Table 6: Value of net assets of Funny Partnership at 1 July 2003 ($)

| | Market value | |
|---|---|---|
| **Assets** | | |
| Cash | 1,800 | |
| Recording studio | 1,500 | |
| Recording equipment | 700 | 4,000 |
| **Liabilities** | | nil |
| **Value of net assets** | | **4,000** |

### Table 7: Laurel Co – financial position at 30 June 2003 ($)

| | | | |
|---|---|---|---|
| Cash | 115 | | |
| Land | 500 | Deferred tax liability | 15 |
| Motor vehicle | 500 | | |
| Investment in Funny Partnership | 1,950 | Capital | 3,050 |
| | 3,065 | | 3,065 |

### Table 8: Laurel Co – profit & loss for year ended 30 June 2003 ($)

| | | | | | |
|---|---|---|---|---|---|
| 30.6.03 | Depreciation expense | 100 | 30.6.03 | Income | 100 |
| 30.6.03 | Income tax expense | 15 | 30.6.03 | Share of net profit – Funny Partnership | 50 |
| 30.6.03 | Profit cfwd | 35 | | | |
| | | 150 | | | 150 |
| | | | 30.6.03 | Profit bfwd | 35 |
| 30.6.03 | Provision for dividend | 35 | | | |
| | | 35 | | | 35 |

### Table 9: Funny Partnership – financial position at 30 June 2003 ($)

| | | | | |
|---|---|---|---|---|
| Cash | | 1,800 | Laurel Co capital | 1,900 |
| Studio | cost 1900 | | Hardy Co capital | 1,900 |
| | (acc depn 400) | 1,500 | Laurel Co ret. profit | 50 |
| Equipment | cost 700 | | Hardy Co ret. profit | 50 |
| | (acc depn 100) | 600 | | |
| | | 3,900 | | 3,900 |

Table 10: Funny Partnership – profit & loss for year ended 30 June 2003 ($)

| | | | | | |
|---|---|---|---|---|---|
| 30.6.03 | Depn expense | 300 | 30.6.03 | Income | 400 |
| 30.6.03 | Profit cfwd | 100 | | | |
| | | 400 | | | 400 |
| 30.6.03 | Profit distribution | 100 | 30.6.03 | Profit bfwd | 100 |
| | | 100 | | | 100 |

Table 11: Funny Partnership – Profit distribution for year ended 30 June 2003 ($)

| | | | | | |
|---|---|---|---|---|---|
| 30.6.03 | Laurel Co ret. profits | 50 | 30.6.03 | P&L | 100 |
| 30.6.03 | Hardy Co ret. profits | 50 | | | |
| | | 100 | | | 100 |

For tax purposes, Funny Partnership's gross income for the year ending 30 June 2003 was $400. The tax deductions claimed for the decline in value of the recording studio and the recording equipment were $200 for each. Funny Partnership's net partnership income for the year ended 30 June 2003 is nil.

For accounting purposes, Funny Partnership's income is also $400 and the depreciation expenses for the recording studio and the recording equipment are $200 and $100 respectively. Net accounting profit before tax is $100.

None of the assets of Laurel Co or Funny Partnership have been revalued in the accounts.

At the formation time, the land has a tax cost base and reduced cost base of $500 and the motor vehicle has an adjustable value for tax purposes of $500. The recording studio and the recording equipment have adjustable values of $1,500 and $500 respectively. The depreciation for tax and accounting purposes is as shown in Table 12.

Table 12: Funny Partnership – depreciation schedule ($)

| Studio | TAX (effective life = 9.5yrs) | | ACCOUNTING (useful life 9.5yrs) | |
|---|---|---|---|---|
| | cost 1.7.01 | 1,900 | cost 1.7.01 | 1,900 |
| | y/e 30.6.02 | –200 | y/e 30.6.02 | –200 |
| | adjustable value | 1,700 | carrying amount | 1,700 |
| | y/e 30.6.03 | –200 | y/e 30.6.03 | –200 |
| | adjustable value | 1,500 | carrying amount | 1,500 |
| Equipment | TAX (effective life = 3.5yrs) | | ACCOUNTING (useful life 7yrs) | |
| | cost 1.7.02 | 700 | cost 1.7.02 | 700 |
| | y/e 30.6.03 | –200 | y/e 30.6.03 | –100 |
| | adjustable value | 500 | carrying amount | 600 |

Note: These effective and useful lives have been selected for demonstration purposes only.

Laurel Co paid $35 out as an unfranked dividend to its shareholder, Comedy Co, on 30 June 2003. This dividend was paid out of the $50 profits Laurel Co received from Funny Partnership. Comedy Co received an intercorporate dividend rebate on the unfranked dividend.

### Setting the tax cost for the joining partner

The tax cost of the partner's assets is set by applying the general cost setting provisions of section 701-10 and Subdivision 705-A of the ITAA 1997 (including any provisions that modify Subdivision 705-A) – as modified by Subdivision 713-Eof the ITAA 1997, which contains the special cost setting rules for partners and partnerships. Although this is a formation case, for the purposes of this example the modifications to the basic case for a group formation in Subdivision 705-B of the ITAA 1997 have been disregarded.

Calculating the tax cost of partnership cost setting interests

The tax cost of Laurel Co's partnership cost setting interests is worked out as follows:

### Working out the ACA for the joining partner

The ACA for a joining partner is allocated among its assets (including those consisting of PCSIs) in accordance with the general cost setting rules, subject to modification to reflect the nature of the joining entity. It has been assumed for this example that Laurel Co is not a chosen transitional entity.

Laurel Co's ACA is worked out using the 8 step process → figure 1: Cost setting process on formation and entry in C2-1.

**Step 1 – cost of membership interests: $3,050**

For the purposes of this example it is assumed that the market value of Comedy Co's membership interests in Laurel Co is greater than its cost base for the membership interests. The step 1 amount is therefore the cost base of the interests → section 705-65, ITAA 1997.

**Step 2 – add liabilities: $15**

The temporary difference between the carrying value of Funny Partnership's recording equipment ($600) and its tax base ($500) multiplied by the tax rate (30%) results in a deferred tax liability of $30. Laurel Co, as an equal partner in Funny Partnership, therefore has a deferred tax liability of $15.

The costs that are relevant in determining the net income or loss of the partnership are the tax costs of the underlying assets of the partnership. As the tax costs (tax base) of the underlying assets of the partnership are not reset, the amount of the liability will not be different when it becomes a liability of the group and there is no adjustment under subsection 705-70(1A) of the ITAA 1997.

**(No steps 3 to 7 amounts)**

**Step 8 – total: $3,065**

The group's ACA for Laurel Co of $3,065 is allocated to all of its assets, including its PCSIs in the partnership assets.

**Determining the terminating value of the PCSI**

The terminating value of each of Laurel Co's PCSIs at the joining time is its individual share of the terminating value of each of the partnership's assets → subsection 713-215(2), ITAA 1997. The terminating value of the assets is worked out as if Funny Partnership had joined the consolidated group at the joining time → subsection 713-215(3), ITAA 1997.

Funny Partnership's terminating value for the depreciable assets is equal to their adjustable value just before the joining time → subsection 705-30(3), ITAA 1997.

As the joining time is the beginning of an income year, the opening adjustable value for both depreciating partnership assets will be the adjustable value at the end of the previous income year (that is, just before joining time) → section 40-85, ITAA 1997.

The terminating values for the PCSIs are:

- for the recording studio, $750 ($1500 x 50% share)
- for the recording equipment, $250 ($500 x 50% share).

### Working out the TCSA for PCSIs in a partnership asset that is a depreciating asset

The TCSA for a partnership asset that is a depreciating asset has a special character and its calculation reflects this → Division 705, ITAA 1997. The TCSA:

- is worked out as if the PCSI relating to the asset were a retained cost base asset, and
- is equal to its terminating value (as worked out above).

→ subsection 713-225(4), ITAA 1997

### Adjustment to ACA if partnership asset is over-depreciated

Where the joining entity is a partner in a partnership, its ACA is reduced if one or more of the partnership assets are over-depreciated at the joining time → subsection 713-225(5), ITAA 1997. The reduction is worked out in relation to the joining entity's PCSIs in depreciating assets (the reduction interests) → section 713-230, ITAA 1997.

An asset is over-depreciated if it is a depreciating asset to which Division 40 of the ITAA 1997 applies and its:

- market value exceeds its adjustable value, and
- cost exceeds its adjustable value.

→ subsection 705-50(6), ITAA 1997

The over-depreciation of the asset is the *lesser* of the two excesses (or either of them if they are the same).

→ subsection 705-50(6), ITAA 1997

The adjustable value of the reduction interest is equal to the partner's individual share of the adjustable value of the underlying partnership asset to which it relates. The cost of the reduction interest is equal to the partner's individual share of the cost of the asset to which it relates → section 713-230, ITAA 1997.

Note: if Laurel Co's non-partnership assets were over-depreciated, the TCSAs of those assets would be reduced – not the ACA.

First it is necessary to determine whether any of the partnership assets are over-depreciated.

#### Worksheet 1: For PCSI in recording studio – is the asset over-depreciated?

| | Test for each depreciable asset<br>At the joining time: | Test satisfied? Yes/No | Excess amount ($) |
|---|---|---|---|
| M | Does market value ($750) exceed adjustable value ($750)? | No | 0 |
| N | Does the cost ($950) exceed adjustable value $(750)? | Yes | 200 |
| | If the answer is YES to both questions, the asset is over-depreciated by the lesser of M and N. | | 0 |

The adjustable value of the PCSI in the recording studio is equal to Laurel Co's individual share of the adjustable value of the recording studio, and the cost of the PCSI in the recording studio is equal to Laurel Co's individual share of the cost of the recording studio → section 713-230, ITAA 1997. As the market value does not exceed the adjustable value, the recording studio is not over-depreciated.

#### Worksheet 2: For PCSI in recording equipment – is the asset over-depreciated?

| | Test for each depreciable asset<br>At the joining time: | Test satisfied? Yes/No | Excess amount ($) |
|---|---|---|---|
| M | Does market value ($350) exceed adjustable value ($250)? | Yes | 100 |
| N | Does the cost ($350) exceed adjustable value ($250)? | Yes | 100 |
| | If the answer is YES to both questions, the asset is over-depreciated by the lesser of M and N. | | 100 |

As Funny Partnership's recording equipment is an asset to which Division 40 applies, and both the market value and the cost of the interest exceed its adjustable value, it is an over-depreciated asset. The amount of over-depreciation is $100 (the amount by which either the asset's market value, or the asset's cost, exceeds its adjustable value) → section 713-230, ITAA 1997.

*Reduction amount*

The amount of the reduction is worked out in accordance with section 705-50 of the ITAA 1997. The cost setting rules are applied without reducing the ACA for the over-depreciated partnership assets and ignoring the operation of subsection 713-225(4) (PCSIs in depreciating assets of the partnership are treated as reset cost base assets) → section 713-230, ITAA 1997. The sum of all of the

over-depreciation adjustments that would otherwise have been deducted from the TCSAs of the PCSIs in over-depreciated assets is subtracted from the ACA to arrive at the final ACA.

TCSAs for partnership cost setting interests are worked out as if the PCSI were an asset of the same kind as the underlying partnership asset → section 713-225, ITAA 1997. The PCSI in the partnership's cash has a TCSA equal to the amount of Australian currency concerned, $900 → section 705-25, ITAA 1997.

Laurel Co's cash is a retained cost base asset with a TCSA equal to the amount of Australian currency concerned, $115 → section 713-25, ITAA 1997.

The TCSAs of the two retained cost base assets ($900 + $115) are subtracted from the ACA ($3,065), leaving $2,050 → section 705-35, ITAA 1997.

The remainder of the ACA ($2,050) is then apportioned among Laurel Co's remaining assets other than excluded assets in proportion to their market values.

**Table 13: Initial apportionment of ACA to Laurel Co's reset cost base assets**

| Asset | Terminating value (TV) ($) | Market value (MV) ($) | ACA apportioned ($) | Assets held on revenue account – excess over greater of TV or MV | TCSA ($) |
|---|---|---|---|---|---|
| PCSI - Recording studio | 750 | 750 | 732 | 0 | 732 |
| PCSI - Recording equipment | 250 | 350 | 342 | 0 | 342 |
| Land | 500 | 500 | 488 | | 488 |
| Motor vehicle | 500 | 500 | 488 | 0 | 488 |
| **Total** | | **2,100** | **2,050** | **0** | **2,050** |

The TCSA of a depreciating asset must not exceed the greater of the asset's market value (MV) and the joining entity's terminating value (TV) for that asset → section 705-40, ITAA 1997.

The terminating value for the motor vehicle, a depreciating asset, is equal to its adjustable value just before the joining time ($500) → section 705-40, ITAA 1997. As the TCSA of the motor vehicle ($488) does not exceed the greater of the MV ($500) and the TV ($500), there is no adjustment to the TCSA.

The PCSI in the recording studio and the PCSI in the recording equipment are treated as being depreciating assets → subsection 713-225(2), ITAA 1997. As the TCSA of the PCSI in the recording studio ($732) does not exceed the greater of its MV ($750) and its TV ($750 as worked out above), no adjustment is required under section 705-40 of the ITAA 1997. The greater of the MV ($350) and the TV ($250 as worked out above) of the PCSI in the recording equipment exceeds the TCSA ($342), so there is no adjustment under section 705-40 of the ITAA 1997.

The reduction amount is the least of the over-depreciation amount (calculated above), the excess of the TCSA over its terminating value, and the tax deferral amount (worksheet 3).

**Worksheet 3: For recording equipment – over-depreciation reduction of ACA**

| | Test for each over-depreciated asset | $ | $ amount |
|---|---|---|---|
| | <u>Over-depreciation amount</u> | | |
| (a) | Over-depreciation amount from previous calculation | | 100 |
| | <u>Tax cost setting amount exceeds terminating value</u> | | |
| (b) | Excess of the tax cost setting amount ($342) over its value ($250) | | 92 |
| | <u>Tax deferral amount</u> | | |
| (c) | *Start with* the amount of unfranked dividends paid by the joining entity before the joining time that were subject to section 46 or section 46A rebate | 35 | |
| (d) | The amount of the profits paid as dividends in (c) above (the *qualifying profits amount*) that were not subject to tax because of the over-depreciation of the asset, *but* count only to the extent they were not counted in ACA step 4 and to the extent the deductions for over-depreciation did not form part of a loss that reduced the ACA under step 5, were not counted in ACA step 4 (but the depreciation did not generate a tax loss to be subtracted from the entry ACA at step 5) | 35 | |
| (e) | The extent to which the dividend in (c) – adjusted to amount in (d) – was *not* further distributed (directly or indirectly) to a taxpayer who was *not* entitled to such a rebate. This is the *tax deferral amount* | 35 | |
| | <u>Transitional rule on formation</u> | | |
| (f) | *Add* – The tax deferral amount is increased to include any unfrankable undistributed profits accrued to head company and included in ACA step 3 (under transitional rules) to the extent that those profits were not subject to tax because of deductions for depreciation representing over-depreciation, and the deductions did not form part of a loss that reduced the ACA under step 5 (subsection 701-30(3), *Income Tax (Transitional Provisions) Act 1997*. | 0 | |
| (g) | **Is there a tax deferral amount?** How much? | Yes | 35 |
| | **Reduction of the ACA is the lesser of (a), (b) and (g).** | | 35 |

The final ACA available for all of Laurel Co's assets (including its interest in the partnership assets) is:

$3,065 – $35 = $3,030

### ACA allocation

The final ACA is allocated to Laurel Co's assets (including PCSIs).

The PCSI in the partnership's cash has a TCSA equal to the amount of Australian currency concerned, $900 → section 705-25, ITAA 1997.

Laurel Co's cash will also be a retained cost base asset with a TCSA equal to the amount of Australian currency concerned, $115. → section 713-25, ITAA 1997

The PCSIs in the recording studio and in the recording equipment are also retained cost base assets. Each will have a TCSA equal to its terminating value (worked out above) → section 713-225, ITAA 1997. The PCSIs in the recording studio and in the recording equipment will have TCSAs of $750 and $250 respectively.

The amounts of the retained cost base assets ($900 + $115 + $750 + $250 = $2,015) are subtracted from the ACA ($3,030) leaving $1,015 → section 705-35, ITAA 1997.

The remainder of the ACA ($1,015) is then apportioned among Laurel Co's remaining assets other than excluded assets in proportion to their market values.

**Table 14: Allocation of ACA to Laurel Co's assets ($)**

| Asset | Terminating value (TV) | Market value (MV) | ACA apportioned | Assets held on revenue account – excess over greater of TV or MV | TCSA |
|---|---|---|---|---|---|
| Land | 500 | 500 | 507.50 | | 515 |
| Motor vehicles | 500 | 500 | 507.50 | 7.50 | 500 |
| **Total** | | **1,000** | **1,015.00** | **7.50** | **1,015** |

The TCSA for a depreciating asset is limited to the greater of the asset's market value and the joining entity's terminating value for the asset → section 705-40, ITAA 1997. The TCSA for the motor vehicle, a depreciating asset, is therefore limited to $500. The amount of the reduction ($7.50) is reallocated to the land, which is the only remaining reset cost base asset, to give it a TCSA of $515.

## Background information

**Table 15: Laurel Co – income tax expense for year ended 30 June 2003 ($)**

| | | |
|---|---|---|
| **Funny Partnership net income** | | |
| Assessable income | | 400 |
| *Less*: allowable deductions | | |
| Depreciation – studio | 200 | |
| Depreciation – equipment | 200 | 400 |
| Net partnership income | | nil |
| **Laurel Co taxable income** | | |
| Assessable income | 100 | |
| Less: allowable deductions | | |
| Depreciation – motor vehicle | 100 | |
| Taxable income | | nil |

Note: Deferred tax liability 2002-03

The temporary difference between the carrying value of Funny Partnership's recording equipment ($600) and its tax base ($500) multiplied by the tax rate (30%) results in a deferred tax liability of $30. Laurel Co, as an equal partner in Funny Partnership therefore has a deferred tax liability of $15.

## References

*Income Tax Assessment Act 1997*, Subdivision 713-E; as inserted by *Taxation Law Amendment Act (No. 6) 2003* (No. 67 of 2003

### Revision history

Section C2-2-155 first published 14 July 2004.

### 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** (Treasury papers on refinements to the consolidation regime).