

# ***TD 2005/D54 - Income tax: consolidation: what is an excluded asset under subsection 705-35(2) of the Income Tax Assessment Act 1997 ?***



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This document has been finalised by TD 2006/57.



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## Draft Taxation Determination

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### Income tax: consolidation: what is an excluded asset under subsection 705-35(2) of the *Income Tax Assessment Act 1997*?

#### **Preamble**

*This document is a draft for industry and professional comment. As such, it represents the preliminary, though considered views of the Australian Taxation Office. This draft may not be relied on by taxpayers and practitioners as it is not a ruling for the purposes of Part IVA of the **Taxation Administration Act 1953**. It is only final Taxation Determinations that represent authoritative statements by the Australian Taxation Office.*

1. An entitlement to a future tax benefit that constitutes a commercial or business asset would be an excluded asset under subsection 705-35(2) of the *Income Tax Assessment Act 1997* (ITAA 1997) if the joined group's allocable cost amount (ACA) for a joining entity is reduced by an amount in respect of that asset under any of the steps in the table in section 705-60 of the ITAA 1997. An entitlement to a future tax benefit would not be an excluded asset merely because an event has reduced an accounting balance or income tax cost base that becomes a starting point for one of the steps in the table in section 705-60. The reduction has to occur under one of the steps. It is also necessary to demonstrate that the reduction has a discernible connection to a relevant asset before it can be concluded that the reduction has been made in respect of the asset.
2. There are two tests that have to be satisfied in order for an asset comprising an entitlement to a future tax benefit to be an excluded asset. The first test is that there is an identified connection or relationship between the asset and a reduction of the ACA. This test is embodied in the use of the words 'in respect of' in subsection 705-35(2) of the ITAA 1997. The second test is that there is a discernible connection between the reduction of ACA and the application of a step in the table in section 705-60 of the ITAA 1997. This test is embodied in the use of the word 'under' in subsection 705-35(2). The second test will not be satisfied if the reduction is not sufficiently connected to an application of any of the steps in the table in section 705-60 of the ITAA 1997. Examples of the types of adjustments that can reduce the ACA without a sufficient degree of connection to one of the steps in the table in section 705-60 include reductions made to the financial accounts which affect the amounts of accounting liabilities and undistributed profits taken into account under subsections 705-70(1) and 705-90(2) of the ITAA 1997 respectively.
3. The ACA must be reduced by an application of one of the steps in the table in section 705-60 of the ITAA 1997 rather than merely as an effect of an application of another provision in the ITAA 1997. For example, shortly after the joining time, a loss company that has become a subsidiary member of a consolidated group could enter into a

written agreement to transfer a loss under Subdivisions 170-A or 170-B of the ITAA 1997 in respect of the year of income ended just before the joining time. If this occurred the cost base and reduced cost base of shares in the subsidiary member could be reduced under either subsections 170-210(3) or 170-220(3) of the ITAA 1997. In these circumstances the reduction would be triggered by section 705-65(3) of the ITAA 1997 on the assumption that a CGT event happened to the shares in the loss company just before the joining time. Consequently the ACA would be reduced by an application of step 1 in the table in section 705-60 of the ITAA 1997. While the amount and timing of the reduction would be worked out under subsections 170-210 and 170-220 respectively, the reduction to the ACA is made under section 705-65(3) and therefore under step 1. Accordingly, if such a reduction is made, the asset associated with such a loss would be an excluded asset (refer to Draft Taxation Determination TD 2005/D50).

4. Any reduction to the ACA in respect of an entitlement to a future tax benefit even if only by one dollar will mean that the entitlement will be treated as an excluded asset. However it is important that the asset is recognised at the correct level or degree of composition and aggregation when applying this test. For example, an accounting provision can be in respect of the aggregation of many entitlements to tax benefits. Accounting policies are not necessarily determinative of the asset unit that is to be recognised for tax cost setting purposes. The level of composition of an asset has to be determined by the level at which assets are addressed by subsection 705-35(1) and the other provisions of Subdivision 705-A of the ITAA 1997. For example under section 705-70 of the ITAA 1997 it is 'each thing' (an accounting liability) that is recognised as a liability and when one such liability is reduced it is the corresponding asset that is the relevant excluded asset.

## Explanation

5. An asset in Part 3-90 of the ITAA 1997 is anything recognised in commerce or business as having economic value to the joining entity at the joining time for which the purchaser of its membership interests would be willing to pay. Paragraph 7 of Taxation Ruling TR 2005/13 Income tax: the meaning of an asset for the purposes of Part 3-90 of the *Income Tax Assessment Act 1997* states that:

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.

(FITB and DTA refer to 'future income tax benefits' and 'deferred tax assets' respectively.)

6. Lonergan, 2003 provides examples at page 617 of hidden assets that would be recognised by a valuer including: '... unrecognised future income tax benefits ...'.

7. Entitlements to future income tax benefits that are commercial or business assets will often be excluded assets under subsection 705-35(2) of the ITAA 1997. The Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002 states that:

5.32 An asset of the joining entity being a right to future tax deductions for a loss would be an excluded asset where an amount was subtracted for the loss in steps 5 or 6 in working out the allocable cost amount. Also, an asset being a right to a certain future tax deduction would be an excluded asset where an amount was subtracted for that deduction in step 2 or 7 in working out the allocable cost amount.

8. In order to come within subsection 705-35(2) of the ITAA 1997 the joined group's ACA for a joining entity has to be reduced by an amount 'in respect of the asset'. The expression 'in respect of' has been judicially considered in a number of cases and has been found to have a broad meaning. In *State Government Insurance office (Qld) v. Rees* 144 CLR 549; 26 ALR 341, Mason J cited, with approval (at 561) Mann CJ in *Trustees Executors & Agency Co. Ltd v. Reilly* [1941] VLR 110 at 111:

The words 'in respect of' are difficult of definition but they have the widest possible meaning of any expression intended to convey some connexion or relation between the two subject-matters to which the words refer.

9. In *Technical Products Pty Ltd v. State Government Insurance Office Qld* (1989) 167 CLR 45, 63 ALJR 392; 85 ALR 173 the High Court considered the meaning of the expression 'in respect of such motor vehicle' in section 3(1) of the *Motor Vehicles Insurance Act 1936* (Qld). The Court found that the words have a broad meaning that is not susceptible to precise definition but there must be some 'discernible and rational link between the basis of legal liability and the particular motor vehicle' (per Brennan, Deane and Gaudron JJ at 47). In an earlier case involving the same company, *Workers' Compensation Board of Queensland v. Technical Products Pty Ltd* (1988) 165 CLR 642; 62 ALJR 561; 81 ALR 260 at 267, Deane, Dawson and Toohey JJ (at 653-654) remarked that 'the phrase gathers meaning from the context in which it appears and it is that context which will determine the matters to which it extends'.

10. For a reduction to the ACA to be 'in respect of' a relevant asset (and therefore an excluded asset) there must be a discernible connection between the reduction and a commercial or business asset.

11. Notwithstanding the existence of an entitlement to a future tax benefit that is a commercial or business asset and the presence of a sufficient connection between that asset and the reduction made to the ACA, in order for the asset to be an excluded asset it would have to be established that the reduction to the ACA has been made 'under' one of the steps in section 705-60 of the ITAA 1997.

12. The question of whether an asset was disposed of 'under a contract' was considered in *Elmslie v. Federal Commissioner of Taxation* 93 ATC 4964; 118 ALR 357; 26 ATR 611; (1993) 46 FCR 576 (*Elmslie's case*). Wilcox J found that the word 'under' 'usually imports a direct connection between the relevant act and the instrument' (at ATC 4976). The case was decided on the basis that where there was more than one contract the relevant contract was the one that was the immediate means by which the asset was acquired. The decision followed cases where the words 'under an enactment' had previously been considered: *Australian National University v. Burns* (1982) 43 ALR 25; 5 ALD 67; 64 FLR 166, *Chittick v. Ackland* (1984) 53 ALR 143 at 153; 6 ALD 255; 1 FCR 254, *Australian Film Commission v. Mabey* (1985) 59 ALR 25; 6 FCR 107; 11 IR 79 and where the words 'under a lease' had been considered: *Chan v. Cresdon Pty Ltd* (1989) 168 CLR 242; 89 ALR 522; 64 ALJR 110.

13. *Elmslie's case* was cited by Hill J in *Federal Commissioner of Taxation v. Energy Resources of Australia* (1994) 126 ALR 161; 94 ATC 4923; 29 ATR 553; 54 FCR 25. His Honour noted that the determination of the relevant contract must be decided in the circumstances of the case and the context in which the expression 'under the contract' appears (at 204). On this point Gummow J concluded that a gain made 'under' an eligible contract was made in exercise of a right or discharge of an obligation conferred or imposed by the contract (at 187). The case was decided on other grounds on appeal to the High Court. However it was relevant to the decision of the High Court that no foreign exchange transaction that attracted the provisions of Division 3B of the *Income Tax Assessment Act 1936* was contemplated in any of the contracts entered into by the taxpayer such that it

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could be said there was a currency conversion 'under a contract' (*Federal Commissioner of Taxation v. Energy Resources of Australia Limited* (1996) 185 CLR 66 at 81; 33 ATR 52; 70 ALJR 629; 137 ALR 18; 96 ATC 4536). Having considered the meaning of 'under a contract' in *Federal Commissioner of Taxation v. Sara Lee Household & Body Care (Australia) Pty Ltd* (2000) 201 CLR 520; 74 ALJR 1094; 172 ALR 346; 2000 ATC 4378; 44 ATR 370; [2000] HCA 35 the High Court decided it is the contract which is the source of the obligation for a disposal that is relevant where two or more contracts affect the rights and obligations of the parties.

14. In deciding whether a reduction to the ACA is made under one of the steps of section 705-60 of the ITAA 1997 it is only reductions that are actually made by the provisions governing the eight steps followed in working out the ACA referred to in section 705-60 that are relevant. As a consequence, other sources of reductions in the amounts referred to at any of the steps at section 705-60, indirect reductions, are not considered to be reductions to the ACA made under any of those steps. Such indirect reductions could come about, for example, because a particular transaction causes an adjustment to accounting balances referred to at one or more of the steps, or other provisions of the ITAA 1997 cause adjustments to the step 1 amount.

15. An asset is not an excluded asset if the reduction at one of the steps in respect of that asset is reversed by some other provision determining an amount worked out under the steps. Specifically, subsection 705-75(1) of the ITAA 1997 makes reductions to the step 2 liability amount that is added to the allocable cost amount under section 705-70 of the ITAA 1997 which can be reversed by section 705-80 of the ITAA 1997. These provisions are read together in working out an amount by which the ACA is reduced. The effect is that where section 705-80 fully reverses a reduction made at section 705-75(1) no reduction has been made to any of the steps of section 705-60 of the ITAA 1997.

16. Reductions made under the steps because of the existence of liabilities are made in respect of the related assets. The related asset is one that corresponds to the liability in accordance with Australian Accounting Standards Board (AASB) accounting standards provided it falls within the meaning of asset in Part 3-90 of the ITAA 1997. The note to subsection 705-35(2) of the ITAA 1997 makes it clear that reductions made at step 2 in respect of future expected deductions are in respect of an asset that is an excluded asset.

17. The level at which assets are separately identified or are treated as composite items for the purpose of applying section 705-35(2) of the ITAA 1997 is the same as required by subsection 705-35(1) of the ITAA 1997 and the provisions referred to in the table at section 705-60 and related provisions of the ITAA 1997. For example, in providing for the amount added to the ACA at step 2 for liabilities, section 705-70(1) of the ITAA 1997 specifies that the amount is to be worked out by adding up the amounts of 'each thing (an accounting liability)'. Where reductions are made to one of these liabilities in any of the provisions referred to at section 706-60 and related provisions of the ITAA 1997, it is the corresponding asset that is the excluded asset.

18. When an accounting entry is made for a future tax benefit, the associated commercial or business asset must be recognised on a consistent basis. This will usually mean that the asset is recognised at the level of the income year for which the accounting entry was worked out and its specific type. For example, in applying section 705-75 of the ITAA 1997 to a future tax deduction for an employee benefit, the character of the benefit determines its value and identity. Separate assets are identified in accordance with the year in which the accounting entry was made and whether it is for annual leave, long service leave or some other benefit.

19. The effect of an asset being an excluded asset is that no amount of the ACA worked out in accordance with the table at section 705-60 of the ITAA 1997 is allocated to it under paragraph 705-35(1)(c) of the ITAA 1997.

20. Where an asset of a joining entity within the meaning of asset in Part 3-90 of the ITAA 1997 consists of a future income tax benefit and is not an excluded asset it will be a reset cost base asset within the meaning of that term at subsection 705-35(1) of the ITAA 1997.

### **Example**

21. *A joining entity has a provision for long service leave of \$1,000 made in a particular year which will be deductible for tax purposes when the amount is paid to an employee. A deferred tax asset to the value of \$300 is recognised in respect of that liability under accounting standard AASB 1020: Accounting for Income Tax (Tax-Effect Accounting). The entitlement to a future tax benefit is an excluded asset because the amount of the allocable cost amount added at step 2 is reduced by an amount in respect of that asset by Section 705-75(1) of the ITAA 1997. However, if section 705-80 of the ITAA 1997 fully reverses the adjustment made under subsection 705-75(1), the entitlement to a future tax benefit is not an excluded asset and would be a reset cost base asset.*

### **Date of effect**

22. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination will 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 Determination (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

### **Your comments**

23. We invite you to comment on this draft Taxation Determination. Please forward your comments to the contact officer by the due date. (Note: The Tax Office prepares a compendium of comments for the consideration of the relevant Rulings Panel. The Tax Office may use a sanitised version (names and identifying information removed) of the compendium in providing its responses to persons providing comments. Please advise if you do not want your comments included in a sanitised compendium.)

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## Commissioner of Taxation

14 December 2005

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### *Previous draft:*

Not previously issued as a draft

### *Related Rulings/Determinations:*

TR 92/20; TR 2005/13; TD 2005/D50

### *Subject references:*

- consolidation
- consolidation - assets
- consolidation - forming

### *Legislative references:*

- TAA 1953 Pt IVA
- ITAA 1936 Div 3B
- ITAA 1997 Subdiv 170-A
- ITAA 1997 Subdiv 170-B
- ITAA 1997 170-210
- ITAA 1997 170-210(3)
- ITAA 1997 170-220
- ITAA 1997 170-220(3)
- ITAA 1997 Pt 3-90
- ITAA 1997 Subdiv 705-A
- ITAA 1997 705-35(1)
- ITAA 1997 705-35(2)
- ITAA 1997 705-35(1)(c)
- ITAA 1997 705-60
- ITAA 1997 705-65(3)
- ITAA 1997 705-70
- ITAA 1997 705-70(1)
- ITAA 1997 705-75
- ITAA 1997 705-75(1)
- ITAA 1997 705-80
- ITAA 1997 705-90(2)
- Motor Vehicles Insurance Act 1936 (Qld) 3(1)

### *Case references:*

- Australian National University v. Burns (1982) 43 ALR 25; 5 ALD 67; 64 FLR 166
- Chittick v. Ackland (1984) 53 ALR 143 at 153; 6 ALD 255; 1 FCR 254

- Australian Film Commission v. Mabey (1985) 59 ALR 25; 6 FCR 107; 11 IR 79
- Chan v. Cresdon Pty Ltd (1989) 168 CLR 242; 89 ALR 522; 64 ALJR 110
- Elmslie v. Federal Commissioner of Taxation 93 ATC 4964; 118 ALR 357; 26 ATR 611; (1993) 46 FCR 576
- Federal Commissioner of Taxation v. Energy Resources of Australia Ltd Australia (1994) 126 ALR 161; 94 ATC 4923; 29 ATR 553; 54 FCR 25
- Federal Commissioner of Taxation v. Energy Resources of Australia Limited (1996) 185 CLR 66; 33 ATR 52; 70 ALJR 629; 137 ALR 18; 96 ATC 4536
- Federal Commissioner of Taxation v. Sara Lee Household & Body Care (Australia) Pty Ltd (2000) 201 CLR 520; 74 ALJR 1094; 172 ALR 346; 2000 ATC 4378; 44 ATR 370; [2000] HCA 35
- State Government Insurance office (Qld.) v. Rees 144 CLR 549; 26 ALR 341
- Technical Products Pty Ltd v. State Government Insurance Office Qld (1989) 167 CLR 45; 63 ALJR 392; 85 ALR 173
- Trustees Executors & Agency Co. Ltd v. Reilly [1941] VLR 110
- Workers' Compensation Board of Queensland v. Technical Products Pty Ltd (1988) 165 CLR 642; 62 ALJR 561; 81 ALR 260

### *Other references:*

- AASB 1020: Accounting for Income Tax (Tax-Effect Accounting)
- Lonergan, W 2003, The Valuation of Businesses, Shares and Other Equity (4th ed.), Allen and Unwin
- Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002

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### ATO references

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