

TR 2004/2 - Income tax: whether expenses incurred obtaining valuations for consolidation are deductible under section 8-1 of the Income Tax Assessment Act 1997

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Taxation Ruling

Income tax: whether expenses incurred obtaining valuations for consolidation are deductible under section 8-1 of the *Income Tax Assessment Act 1997*

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Preamble

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

What this Ruling is about

Class of person/arrangement

1. This Ruling considers whether consolidation valuation expenses incurred by an entity for the purpose of becoming a head company or a subsidiary member of a consolidated group are deductible under section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997). Representations have been made that such expenses are deductible under the second limb of section 8-1 of the ITAA 1997 where the *Corporations Act 2001* requires that the financial report of the entity comply with the accounting standards issued by the Australian Accounting Standards Board. The purpose of this Ruling is to deal with those representations.

Date of effect

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

Previous Rulings

3. Taxation Determinations TD 2003/10 and TD 2003/11 deal with the deductibility of consolidation valuation expenses under section 25-5 of the ITAA 1997 that are incurred by an entity for the purpose of becoming a head company or a subsidiary member respectively.

Ruling

4. Expenditure incurred either by a head company of a consolidatable or consolidated group or an entity that may become a subsidiary member of a consolidated group in obtaining a market valuation for consolidation is not deductible under section 8-1, either as an outgoing incurred in gaining or producing assessable income or as a loss or outgoing necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income. This expenditure can be deductible under section 25-5.¹

5. Consolidation valuation expenses are not regarded as a normal incident of managing the business of the head company or entity even where a financial report has to be prepared under the *Corporations Act 2001* that complies with the accounting standards and in particular either AASB 1020: *Accounting for Income Tax (Tax-Effect Accounting)* or AASB 1020: *Income Taxes*. These expenses are incurred in the course of working out the income tax payable by a head company of a consolidated group under the self-assessment system and as such are incurred in managing the tax affairs of the consolidated group.

Explanation

Market valuations for consolidation

6. Market valuations are initially required for consolidation:
- to determine new tax costs for the assets of joining entities that become subsidiary members of a consolidated group at the joining or formation time. Unless a choice is made under the transitional provisions to retain existing cost bases, the market values of assets need to be ascertained to enable consolidated groups to determine the new tax cost

¹ As explained in Taxation Determinations TD 2003/10 and TD 2003/11

- setting amounts for the assets of subsidiary members;
and
- to calculate the available fraction for the utilisation of transferred losses. The available fraction is used to limit the annual rate at which transferred losses may be recouped by the head company. The calculation of the available fraction is the proportion that the joining loss entity's modified market value at the initial transfer time bears to the adjusted market value of the whole consolidated group at that time.

Application of section 8-1 ITAA 1997

7. Under section 8-1 a deduction is allowed for a loss or outgoing to the extent that it is (a) incurred in gaining or producing assessable income or (b) necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income.

8. To be deductible under the first limb of section 8-1 a loss or outgoing must be relevant and incidental to the gaining or producing of assessable income (*Ronpibon Tin NL & Tongkah Compound NL v. FC of T* (1949) 78 CLR 47 at 56; 8 ATD 431 at 436).

9. In *FC of T v. Green* (1950) 81 CLR 313 at 319; 4 AITR 471 at 479, the High Court held that the expenses of engaging an accountant to keep and audit the books and records of the taxpayer were deductible because they were incurred in relation to the management of the taxpayer's income-producing enterprises:

‘His Honour found that it was reasonably necessary for the taxpayer to keep books and records and to have them audited ... The evidence supported these findings. The expenditure, a deduction of which is claimed, was incurred in relation to the management of the income producing enterprises of the taxpayer. If this is so it is immaterial that there might be a difficulty in holding that the taxpayer was carrying on in a continuous manner an identifiable business of some particular description ...’

10. However the High Court went on to limit the scope of its judgment by stating:

‘...but we are not to be taken as deciding whether or not the cost of preparing taxation returns or of advising in relation to taxation liability is a deductible expenditure.’

11. Consolidation valuation expenses are not deductible under the first limb of section 8-1 because they are incurred in working out the taxable income and the income tax liability of the head company of

the consolidated group rather than as a cost incurred in gaining or producing the assessable income of the group.

12. For an outgoing to be deductible under the second limb of section 8-1 as expenditure necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income, it must have the character of a working or operating expense of the entity's business or be an essential part of the cost of its business operations. In *John Fairfax & Sons Pty Ltd v. FC of T* (1958-9) 101 CLR 30 Menzies J stated (at page 49):

‘... there must, if an outgoing is going to fall within its terms, be found (i) that it was necessarily incurred in carrying on a business; and (ii) that the carrying on of the business was for the purpose of gaining assessable income. The element that I think is necessary to emphasise here is that the outlay must have been incurred in the carrying on of a business, that is, it must be part of the cost of trading operations.’

13. Accounting fees incurred in preparing a financial report for a financial year are deductible under section 8-1 as a cost of the trading operations of a business that is being carried on for the purpose of gaining assessable income.

14. It has been suggested that consolidation valuation expenses should also be deductible under the second limb of section 8-1 as a working or operating expense of an entity that is a member of a corporate group, in circumstances where the management of the income producing activities of the group includes compliance with a statutory obligation to disclose correct income tax information in accordance with relevant AASB accounting standards.

15. Under Part 2M.3 of the *Corporations Act 2001* disclosing entities, public companies, large proprietary companies and certain small proprietary companies are required to prepare an annual financial report. The content of the financial report is specified in section 295 of the *Corporations Act 2001*. Generally, an annual financial report has to comply with the AASB accounting standards, subject to an exception for certain reports of small proprietary companies (section 296 of the *Corporations Act 2001*). However mandatory application of the accounting standards is limited to where the company or other entity is a ‘reporting entity’ (AASB 1025: *Application of the Reporting Entity Concept and Other Amendments*).

16. The accounting treatment of income tax in the financial report of a company or group of companies is the subject of Accounting Standard AASB 1020: *Accounting for Income Tax (Tax-Effect Accounting)* which issued in October 1989 and is still currently operative, and Accounting Standard AASB 1020: *Income Taxes* which issued in December 1999 and will generally become mandatory in reporting periods beginning on or after 1 January 2005, but can be

applied prior to that time where an election is made in accordance with subsection 334(5) of the *Corporations Act 2001*.

17. These accounting standards require disclosure of information on the impact of income tax ‘...which is necessary for an understanding of the financial position, performance, and financing and investing of the company or group of companies’ (Clause .03 of AASB 1020 – October 1989). They apply to an entity that is required to prepare a financial report in accordance with Part 2M.3 of the *Corporations Act 2001* and which is either a ‘reporting entity’ or which holds its financial reports out as a ‘general purpose financial report’. These expressions are defined in both versions of AASB 1020.

18. In *Cliffs International Inc v. FC of T* (1985) 85 ATC 4374 at 4395; 16 ATR 601 at 625 in the course of considering the deductibility of accounting costs and unrecovered legal costs incurred pursuing objections and tax appeals in respect of income tax assessments of earlier years, Kennedy J stated that:

‘The appellant contended that these outgoings fell within the second limb of s 51, being expenses necessarily incurred in carrying on a business for the purpose of producing assessable income, and it was argued that they fell into the same category as other incidents in business which are not immediately productive, or at all productive, of revenue, such as audit fees, fees payable to the Stock Exchange for the listing of a public company and the like. It was said in support of this contention that attention to one’s income tax affairs and the scrutiny of claims for income tax are an inevitable and ordinary incident of the carrying on of any business in the same way as other claims, and that, accordingly, they fell within s 51 as they flowed necessarily and directly from the conduct of the business and more especially so where the very financial foundation of the business was in question, as it was in the case of the royalties.’

19. In rejecting this contention His Honour (at ATC 4395; ATR 625) said that the answer depended upon ‘...whether the principles laid down by the decision of the House of Lords in *Smith’s Potato Estates Ltd v. Bolland* (1948) AC 508 are applicable to the *Income Tax Assessment Act*.’ In this regard, His Honour (at ATC 4397; ATR 628) was of the view that ‘[t]he differences between the United Kingdom and the Australian legislation do not require a different answer.’

20. *Smith’s Potato Estates Ltd v. Bolland* [1948] AC 508; [1948] 2 All ER 367 also concerned the deductibility of legal expenses as well as accountancy expenses incurred in contesting an income tax assessment. However in the course of his judgment Lord Porter

(at pages 520-521) also considered the principles that would apply in determining the deductibility of expenses incurred in preparing the annual accounts:

‘... it is maintained that as the law obliges him to pay income tax, his expenses of calculating the balance of profits and gains for income tax purposes are incurred wholly and exclusively for the purpose of his trade, more particularly where the taxpayer is a company which by law is compelled to publish its accounts. In support of this argument it is urged that even the amount available to be put aside as reserve or for distribution in dividends cannot be ascertained until it is known what sum must be provided for excess profits and income tax purposes...

If there were no obligation to ascertain and pay either of these taxes, there would be no necessity for making up accounts on income tax principles – it would suffice to make up the ordinary commercial accounts. The computation of accounts for tax purposes is therefore not directly associated with the carrying on of a business. It is an obligation imposed upon the company for another and extraneous purpose i.e. for the purpose of ascertaining the tax to be paid out of profits. It is not, at any rate directly undertaken for trade purposes but to satisfy the revenue authorities. It is true as a matter of convenience the cost of making up accounts for the inland revenue is allowed by the authorities as a deduction from profits, as is the cost of making up the strictly business accounts of the trade, but this is not a matter of principle but of expediency. The two duties overlap and in practice are almost indivisible. Moreover it is of advantage to the Revenue to have the figures required for their purposes carefully and accurately made up. Strictly, however, I think the expenses should be divided and any additional cost of making up revenue accounts should be disallowed in determining the allowable deductions for income tax purposes, but the advantage of allowing both to be deducted as a practical measure outweighs the disadvantages, though the result may not be strictly logical.’

21. The High Court in *FC of T v. Green* did not expressly refer to the decision of the House of Lords in *Smith’s Potato Estates* case but did distinguish expenses of keeping books and records which would include the preparation of financial statements from expenses relating to the preparation of a tax return without commenting on the situation where there is an overlap.

22. R.W. Parsons in *Income Taxation in Australia* (Law Book Co 1985) commented at paragraph 6.292:

‘The express provision in s. 69 of the Assessment Act, in allowing a deduction of certain expenses in preparing an

income tax return, proceeds on an assumption that such expenses would not otherwise be deductible. There must of course be problems in making the separation, referred to by Lord Porter in *Smith's Potato Crisps (1929) Ltd*, between the expenses of recording income and the expenses of preparing a return, but where that distinction can be drawn expenses of preparing a return which are not within s. 69 will not be deductible.'

23. Section 25-5 which superseded section 69 of the ITAA 1936 allows a deduction for expenditure incurred by an entity for managing its tax affairs such as the costs incurred in preparing an income tax return or in working out its liability for income tax under the self-assessment system.

24. Consolidation valuation expenses are not incurred for the purpose of preparing the financial report of a corporate group although the valuations may subsequently be used in the preparation of such a report. They are incurred in the course of resetting the tax cost of assets and determining the rates at which transferred losses can be recouped in order to be able to work out the income tax payable by a head company of a consolidated group under the self-assessment system. The use of these income tax records (including the supporting valuations) in the preparation of the financial reports prescribed by the *Corporations Act 2001* does not detract from the full deductibility of the expense under section 25-5 but also does not provide a basis to allow a deduction under the second limb of section 8-1.

Detailed contents list

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Commissioner of Taxation

10 March 2004

Previous draft:

TR 2003/D9

Related Rulings/Determinations:

TR 92/1; TR 97/16; TR 92/20;
TD 2003/10; TD 2003/11

Subject references:

- deductibility of market valuation
expenses
- consolidation

Legislative references:

- ITAA 1936 51
- ITAA 1936 69
- ITAA 1997 8-1
- ITAA 1997 25-5
- Corporations Act 2001
- Corporations Act 2001 Part 2M.3
- Corporations Act 2001 295
- Corporations Act 2001 296
- Corporations Act 2001 334(5)
- TAA 1953 Pt IVA

Case references:

- *Ronpibon Tin NL & Tongkah
Compound NL v. FCT of T* (1949) 78
CLR 47; 8 ATD 431
- *FC of T v. Green* (1950) 81 CLR
313; 4 AITR 471
- *John Fairfax & Sons Pty Ltd v. FC
of T* (1958-9) 101 CLR 30
- *Cliffs International Inc v. FC of T*
(1985) 85 ATC 4374; 16 ATR 601
- *Smith's Potato Estates Ltd v.
Bolland* [1948] AC 508; [1948] 2 All
ER 367

Other references:

- AASB 1020: Accounting for
Income Tax (Tax-Effect
Accounting); AASB 1020: Income
Taxes; AASB 1025: Application of
the Reporting Entity Concept and
Other Amendments;
- R W Parsons, *Income Taxation in
Australia* (Law Book Co 1985)

ATO references

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