TR 2004/D9 - Income tax: the meaning of an asset for the purposes of Part 3-90 of the Income Tax Assessment Act 1997

This document has been finalised by TR 2004/13.

Draft Taxation Ruling

Income tax: the meaning of an asset for the purposes of Part 3-90 of the *Income Tax Assessment Act 1997*

Contents Para

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 IVAAA of the ***Taxation Administration Act 1953****. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office.*

What this Ruling is about

1. This Ruling addresses the question of what is an asset for the purposes of the tax cost setting rules in Part 3-90 of the Income *Tax Assessment Act 1997* (ITAA 1997).

Date of effect

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

Ruling

3. The meaning of an asset in Part 3-90 is not defined in the ITAA 1997. In contrast the meaning of a liability is defined in subsection 705-70(1). A liability is recognised and measured in accordance with the Australian Accounting Standards Board ("AASB") accounting standards and statements of accounting concepts. The inclusion of a definition of a liability and the omission of a definition of an asset is consistent with the word 'asset' being given its ordinary commercial or business meaning.

4. The meaning of the word 'asset' is found within the commercial or business context that applies where a single entity joins an existing consolidated group (Subdivision 705-A of the ITAA

1997). Assets are recognised for the purposes of the consolidation tax cost setting rules on the basis that a head company of a consolidated group is acquiring a joining entity. All the assets of the joining entity therefore need to be recognised. The total costs (both direct and indirect) of acquiring the joining entity are allocated to the underlying assets of the joining entity.

5. Accordingly, an asset for the purpose of the tax cost setting rules is anything recognised in commerce and business as having economic value to the joining entity at the joining time.

6. The commercial or business meaning of an asset in Part 3-90 is not limited to assets that would be recognised under accounting standards or statements of accounting concepts. There may be situations, however, where accounting principles and practice influence the commercial or business meaning.

7. Internally generated assets would not normally be recognised in the financial statements of a joining entity prepared in accordance with generally accepted accounting principles. These assets are not recognised for accounting purposes when they do not possess a cost or other value that can be measured reliably. However, internally generated assets would be recognised under the wider criteria that apply for the consolidation tax cost setting rules.

8. Assets recognised under the *Income Tax Assessment Act 1936* ('ITAA 1936') and the ITAA 1997 would come within the ordinary commercial or business meaning of an asset for Part 3-90 of the ITAA 1997. Assets within these categories would include items of trading stock, revenue assets, traditional and qualifying securities, depreciating assets and CGT assets.

9. There are other assets that would be recognised under Part 3-90 because they are things of economic value in commerce and business that are not recognised under other Parts of the ITAA 1936 and ITAA 1997. An asset within this category could be know-how. Tax cost setting amounts also have to be worked out for these commercial or business assets.

10. All assets of the joining entity are recognised at the joining time. The recognition of the assets is on the basis that the single entity rule does not apply to cause them to be assets of the head company at the joining time.

11. All items of trading stock, revenue assets, traditional and qualifying securities, depreciating assets and CGT assets that are identified as a commercial or business asset of the joining entity at the joining time would have at least some economic value, and consequently are recognised as assets in Part 3-90 of the ITAA 1997.

Explanation

12. Subsection 705-35(1) of the ITAA 1997 provides:

> 'For each asset of the joining entity (*a* ***reset cost base asset***) that is not a *retained cost base asset or an asset (an ***excluded asset***) covered by subsection (2) the asset's *tax cost setting amount is worked out by:
>
> (a) first working out the joined groups *allocable cost amount for the joining entity in accordance with section 705-60; and
>
> (b) then reducing that amount by the total of the *tax cost setting amounts in accordance with section 705-25 for each retained cost base asset (but not below zero); and
>
> (c) finally, allocating the result to each of the joining entity's reset cost base assets (other than excluded assets) in proportion to their *market values.

13. The meaning of the word 'asset' is not defined in subsection 705-35(1) or elsewhere in the consolidation provisions. The Explanatory Memorandum to the *New Business Tax System (Consolidation) Bill (No. 1) 2002* states at paragraph 5.19 that:

> '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 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.'

14. In contrast, the word liability is defined in subsection 705-70(1) of the ITAA 1997 as being the amount of each thing that:

> '… in accordance with *accounting standards, or statements of accounting concepts made by the Australian Accounting Standards Board, is a liability of the joining entity at the joining time that can or must be recognised in the entity's statement of financial position.'

15. The presence of a legislative definition of a liability and the absence of such a definition for an asset, shows that the identification and recognition of an asset for tax cost setting rules is not simply to be found by reference to definitions in accounting standards and statements of accounting concepts.

16. Divisions 701 and 705 of Part 3-90 of the ITAA 1997 provide rules for setting the tax cost of the assets of entities that become members of a consolidated group (subject to transitional arrangements in the *Income Tax (Transitional Provisions) Act 1997*). These rules are based on an asset-based model which aligns the cost of the assets of a joining entity with the cost to the group of acquiring membership interests in the joining entity.

17. The basic case under the asset-based model is where a single entity joins a consolidated group and the assets of the subsidiary member become assets of the head company. Subsection 701-10(3) of the ITAA 1997 provides that the object of Division 705 '…is to recognise the cost to the *head company of such assets as an amount reflecting the group's cost of acquiring the entity.'

18. Further detail is provided in the Objects clauses to Subdivision 705-A of the ITAA 1997 in section 705-10 which state:

> '**705-10(2)** The object of this Subdivision is to recognise the *head company's cost of becoming the holder of the joining entity's assets as an amount reflecting the group's cost of acquiring the entity. That amount consists of the cost of the group's *membership interests in the joining entity, increased by the joining entity's liabilities and adjusted to take account of the joining entity's retained profits, distributions of profits, deductions and losses.
>
> **705-10(3)** The reason for recognising the *head company's cost in this way is to align the costs of assets with the costs of *membership interests, and to allow for the preservation of this alignment until the entity ceases to be a *subsidiary member …'

19. Paragraph 2.49 of the Explanatory Memorandum to the *New Business Tax System (Consolidation) Bill (No 1) 2002* states that:

> 'The assets of subsidiary members, which are treated during consolidation as being assets of the head company, have their cost for tax purposes set at the joining time. The cost is set under rules that treat the head company's cost of acquiring the entity as its cost of acquiring the entity's assets, including its businesses.'

20. Paragraph 5.18 of the Explanatory Memorandum to the *New Business Tax System (Consolidation) Bill (No 1) 2002* confirms that:

> 'A joined group's cost of acquiring a joining entity is treated as the head company's cost of acquiring the assets of the joining entity.'

21. A joined group's allocable cost amount that is calculated in respect of a head company acquiring a joining entity is treated as being the cost of the assets of the joining entity. This applies not only for the basic case in Subdivision 705-A, but also for Subdivisions 705-B, 705-C and 705-D of the ITAA 1997 which are modifications of the basic case.

22. The financial statements of a joining entity would not usually record assets such as goodwill, mining information, patents, licences, and copyrights which have been generated internally. These assets are not recognised when they do not have a cost or other value that can be measured reliably. However this presumption is reversed when an entity or business is acquired.

23. The value of internally generated assets will be reflected in the cost to the group of acquiring the membership interests in the joining entity. In addition these assets are of economic value to the joining entity. When an entity is acquired (which is the model on which the cost setting provisions are based) it is irrelevant whether the assets being recognised were originally acquired by the joining entity or were generated internally. Consequently, in the case of internally generated assets, the definition of an asset for the tax cost setting rules varies from the definition that would apply under accounting principles.

24. The Macquarie Dictionary (revised 3rd ed) defines assets in the following terms:

> '**1.** *Commerce* resources available to a business or an individual for future economic benefits or service potential, and consisting of such items as real property, machinery, inventory, cash and securities, etc (**tangible assets**), and of patents, trademarks and goodwill (**intangible assets**). **2.** property or effects (opposed to *liabilities*). **3.** *Accounting* the detailed listing of property owned by a firm and money owing to it. **4.** *Law* **a.** property in the hands of an executor or administrator sufficient to pay the debts or legacies of the testator or intestate. **b.** any property available for paying debts, etc.'

25. In *Commissioner of Taxes (SA) v Executor Trustee and Agency Co. of Australia Ltd (Carden's case)* (1938) 63 CLR 108, at pp 152-3, Dixon J stated that:

> 'The courts have always regarded the ascertainment of income as governed by the principles recognized or followed in business and commerce, unless the legislature has itself made some specific provision affecting a particular matter or question. Familiar but striking examples of this necessary reliance upon commercial principles and general business understanding may be found in the case law dealing with expenditure laid out for the purpose of trade, with outgoings on account of capital, with capital profits, and with the question whether items should be taken into consideration for any given accounting period rather than for that which follows or perhaps for that which preceded.…'

The reasoning of Dixon J equally applies to the identification of the assets that are to be subject to the tax cost setting rules. Inherent in this approach is that business and commercial conventions in classifying assets are also observed so that, for example, each asset that is ordinarily recognised as a discrete asset is separately identified. Goodwill is recognised as a residual asset.

Each asset of the joining entity

26. The use of the expression 'each asset of the joining entity' in subsection 705-35(1) of the ITAA 1997 and the explanation in the explanatory memorandum that an asset is 'anything of economic value' show that an asset for cost setting purposes is anything of economic value to the joining entity. That the asset must be of economic value to the joining entity within the terms of subsection 705-35(1) of the ITAA 1997 is reinforced by subsection 705-35(3) of the ITAA 1997. That subsection recognises that a component of goodwill that makes up part of the value of the membership interests of the joining entity but is not of economic value to the joining entity itself is not within the meaning of asset in subsection 705-35(1) of the ITAA 1997. In this case the goodwill asset is deemed to be an asset of the joining entity.

When assets are recognised

27. Assets are recognised at the joining time for tax cost setting purposes as if the single entity rule was not in effect at that time to cause the assets of the joining entity to become the assets of the head company. This is made clear by subsection 701-10(2) which provides:

> *'Assets to which section applies*
>
> This section applies in relation to each asset that would be an asset of the entity at the time it becomes a *subsidiary member of the group, assuming that subsection 701-1(1) (the single entity rule) did not apply.'

[Subsection 701-10(2) of the ITAA 1997 was amended by *Tax Laws Amendment (2004 Measures No. 2) Act 2004* which received Royal Assent on 25 June 2004.]

It is irrelevant to the identification of assets for cost setting purposes that, under accounting rules, some assets may only be recognised in consolidated accounts when an entity is acquired.

28. The Explanatory Memorandum to *Tax Laws Amendment (2004 Measures No 2) Bill 2004* emphasises that all the assets of the joining entity are recognised:

> '2.58 The amendment ensures that assets of the joining entity, at the time it becomes a subsidiary member of the group, have their tax cost set – assuming that the single entity rule did not apply. The exclusion of the operation of the single entity rule ensures that intra-group assets and other assets that would be ignored as a consequence of the single entity rule have their tax cost reset.'

Assets that the head company holds

29. Assets of the joining entity that are recognised for income tax purposes will have their tax cost setting amounts recognised when working out the income tax liability of the head company. Such assets include trading stock, revenue assets, traditional and qualifying securities, depreciating assets, and CGT assets. The mechanism provided in the legislation is that things of economic value that would be recognised in commerce and business as assets of the joining entity have their tax cost set under section 701-10. The income tax effect of setting the costs of assets is set out in section 701-55 of the ITAA 1997. The costs will be taken into account in working out the income tax liability of the head company where the assets come within the head company core purposes in subsection 701-1(2) of the ITAA 1997.

Assets that the head company does not hold

30. Not all the assets of a joining entity will be assets that are otherwise recognised for income tax purposes. Some things of economic value that would be recognised as assets in commerce and business are not recognised for income tax purposes (outside of Part 3-90 of the ITAA 1997). They nevertheless have their tax cost set under section 701-10. Section 701-55 of the ITAA 1997, which sets out the income tax effects of having the tax cost of an asset set, does not apply to such assets. Because they are not recognised as assets under income tax laws they do not come within the head company core purposes (subsection 701-1(2) of the ITAA 1997). Any cost set for such assets will not be taken into account in determining the head company's liability for income tax. Know-how held by the joining entity could be such an asset.

31. Where a reference is made to a consolidated group in this ruling it includes a MEC (multiple entry consolidated) group.

Your comments

32. We invite you to comment on this draft Taxation Ruling. Please forward your comments to the contact officer by the due date.

Due date:	**6 August 2004**
Contact officer:	**Andrew Lindsay**
E-mail address:	**Andrew.Lindsay@ato.gov.au**
Telephone:	**(02) 62161969**
Facsimile:	**(02) 62161509**
Address:	**Consolidation Centre of Expertise**
	Office of the Chief Tax Counsel
	1st floor, East Tower
	2 Constitution Avenue
	Canberra ACT 2601

Detailed contents list

33. Below is a detailed contents list for this draft Taxation Ruling:

Commissioner of Taxation
7 July 2004

Previous draft:

Related Rulings/Determinations:
TR 92/20

Previous Rulings/Determinations:

Subject references:
- Consolidation
- Consolidated Group
- Asset
- Joining Entity

Legislative references:
- TAA 1953 Part IVAAA
- ITAA 1936
- ITAA 1997 Part 3-90
- ITAA 1997 Division 701
- ITAA 1997 701-1(1)
- ITAA 1997 701-1(2)
- ITAA 1997 701-10
- ITAA 1997 701-10(2)
- ITAA 1997 701-10(3)
- ITAA 1977 701-55
- ITAA 1997 Division 705
- ITAA 1997 Subdivision 705-A
- ITAA 1997 Subdivision 705-B
- ITAA 1997 Subdivision 705-C
- ITAA 1997 Subdivision 705-D
- ITAA 1997 705-10
- ITAA 1997 705-10(2)
- ITAA 1997 705-10(3)
- ITAA 1997 705-25
- ITAA 1997 705-35(1)
- ITTA 1997 705-35(3)
- ITAA 1997 705-60
- ITAA 1997 705-70(1)

Case references:
- Commissioner of Taxes (SA) v. Executor Trustee and Agency Co of Australia Ltd (Carden's case) (1938) 63 CLR 108

Other references:
- Macquire Dictionary Revised 3rd Edition
- Explanatory Memorandum to Tax Law Amendment (2004 Measures No.2) Bill 2004
- Explanatory Memorandum to the New Business Tax System (Consolidation) Bill No.1 2002

ATO references
NO: 2004/9100
ISSN: 1039-0731