TD 2006/57 - Income tax: consolidation: what is an excluded asset under subsection 705-35(2) of the Income Tax Assessment Act 1997?

Taxation Determination

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

This publication provides you with the following level of protection:

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*. A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes. If you rely on this ruling, we must apply the law to you in the way set out in the ruling (or in a way that is more favourable for you if we are satisfied that the ruling is incorrect and disadvantages you, and we are not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

[Note: This is a consolidated version of this document. Refer to the Legal Database (http://law.ato.gov.au) to check its currency and to view the details of all changes.]

Ruling

1. A future income tax benefit asset that constitutes a commercial or business asset is 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.[1] An asset other than a future income tax benefit asset cannot be an excluded asset.

2. A future income tax benefit asset can be an asset recognised in commerce or business. This asset may not be the same as the deferred tax asset (DTA) or future income tax benefit (FITB) recognised in a balance sheet prepared in accordance with the accounting standards issued by the Australian Accounting Standards Board (AASB). A DTA would be recognised under AASB 112 *Income Taxes* or AASB 1020 *Income Taxes* to record a timing difference between the carrying amount of an asset or liability in the balance sheet and the corresponding tax base of that asset or liability. A DTA would also be recognised for the carryforward of unused tax losses and tax credits where there is a probability that future taxable profits will be available to utilise them. An FITB would have been recognised under AASB 1020 *Accounting for Income Tax (Tax-Effect Accounting)* to recognise timing differences between pre-tax accounting profit or loss and the taxable income or tax loss for a reporting period and the future savings in income tax likely to arise as the result of the recoupment of carried forward tax losses that satisfy recognition

[1] All references are to the ITAA 1997 unless otherwise stated.

criteria. Whether a DTA or FITB recognised in a balance sheet for accounting purposes also represents a commercial or business asset that should be recognised for tax cost setting purposes depends on the existence and likelihood of a future economic benefit and the extent that the economic benefit is attributable to the joining entity.

3. A future income tax benefit asset is not 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.

4. There are therefore two tests to be satisfied in order for a future income tax benefit asset 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). 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. 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. 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 or undistributed profits taken into account under subsections 705-70(1) and 705-90(2) respectively.

5. The ACA must be reduced by an application of one of the steps in the table in section 705-60 rather than merely as an effect of an application of another provision in the ITAA 1997. Any reduction to the ACA in respect of a future income tax benefit asset 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. For example under section 705-70 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.

Example 1

6. *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 112 Income Tax. The joining entity’s future entitlement to an income tax deduction for long service leave is a future income tax benefit asset and would be an excluded asset. This is because the amount of accounting liability added at step 2 is reduced by an amount in respect of that asset by subsection 705-75(1). However, if section 705-80 fully reverses the adjustment made under subsection 705-75(1), the future income tax benefit asset would not be an excluded asset and would be a reset cost base asset.*

Example 2

7. *On 1 July 2003, Sub Co borrowed $500 from a bank and incurred borrowing expenses of $100 which are deductible over a 5 year period. During the year, Sub Co had trading income of $150 and its statement of financial position at 30 June 2004 was:*

	$		$
Cash	550	Capital	500
Asset 1	500	Bank Loan	500
DTA – Borrowing exp	24	Provision for tax	39
		Retained Earnings	35
	1,074		1,074

A valuer has determined that the market value of Asset 1 is $500 and that the market value of the future income tax benefit asset is $24 being the same amount that is recorded in the balance sheet in respect of the DTA.

8. *On 1 July 2004, H Co, the head company of a consolidated group acquired the membership interests in Sub Co for $535.*

ACA for Sub Co	$	**Comments**
Step 1	535	
Step 2	539	Bank Loan ($500) and Provision for tax ($39)
Steps 3 – 6	0	
Step 7	(24)	Acquired deduction for borrowing expenses ($80) multiplied by the company tax rate (30%).
ACA	1,050	
Less cash	550	Retained cost base asset
	500	

9. *H Co, the head company of a consolidated group, inherits the balance of the future deductions for the borrowing expenses ($80). There is a reduction in Sub Co's ACA under step 7 (inherited deductions) equal to the tax value of the borrowing expenses. The future income tax benefit asset associated with the borrowing expenses incurred by Sub Co, is an excluded asset because the ACA for Sub Co is reduced by amounts in respect of the inherited deduction under one of the steps, step 7. The balance of ACA ($500) will be allocated to Asset 1.*

Date of effect

10. This Determination applies to years commencing both before and after its date of issue. However, it does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of the Determination.

Commissioner of Taxation
20 September 2006

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.

Explanation

11. An asset in Part 3-90 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 2004/13 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.[2]

12. Lonergan[3] provides examples at page 617 of hidden assets that would be recognised by a valuer including: '… unrecognised future income tax benefits …'.

13. Entitlements to future income tax benefits that are commercial or business assets will often be excluded assets under subsection 705-35(2). 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.

14. To come within subsection 705-35(2) 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.

15. 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 subsection 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'.

---

[2] FITB and DTA refer to 'future income tax benefits' and 'deferred tax assets' respectively.
[3] Lonergan, W 2003, The Valuation of Businesses, Shares and Other Equity (4th ed.), Allen and Unwin, NSW.

16. 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.

17. Notwithstanding the existence of an entitlement to a future income 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.

18. 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.

19. [Omitted.]

20. 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) makes reductions to the step 2 liability amount that is added to the allocable cost amount under section 705-70 which can be reversed by section 705-80. 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 subsection 705-75(1) no reduction has been made under any of the steps of section 705-60.

21. 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 that can or must be recognised in a statement of financial position prepared in accordance with accounting standards or statements of accounting concepts issued by the AASB, provided it falls within the meaning of asset in Part 3-90. The note to subsection 705-35(2) 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.

22. The level at which assets are separately identified or are treated as composite items for the purpose of applying subsection 705-35(2) is the same as required by subsection 705-35(1) 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, subsection 705-70(1) 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 705-60 and related provisions of the ITAA 1997, it is the corresponding asset that is the excluded asset.

23. When an accounting entry is made for a FITB or DTA, the associated future income tax benefit asset must be recognised on a consistent basis. It is sufficient for separate commercial or business assets to be recognised at the level of aggregation and composition that has been applied in the entries to the accounting records for the relevant

reporting period (for example, at the level of a provision for annual leave, long service leave or some other benefit that has been recognised in the financial accounts of the entity). If a reduction is made, under subsection 705-75(1), to the step 2 amount for an accounting liability in relation to the total of employees' annual leave entitlements accruing in a year, then the corresponding future income tax benefit asset associated with these employees' annual leave entitlements would be an excluded asset. This treatment would not extend to all the other components of the total DTA balance disclosed in the joining entity's balance sheet just before the joining time.

24. 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 is allocated to it under paragraph 705-35(1)(c).

25. Where an asset of a joining entity within the meaning of asset in Part 3-90 consists of a future income tax benefit asset 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).

References

Previous draft:

TD 2005/D54

Related Rulings/Determinations:

TR 2004/13; TD 2006/56

Subject references:

- consolidation
- consolidation assets
- consolidation - forming

Legislative references:

- TAA 1953
- ITAA 1936 Pt III Div 3B
- ITAA 1997 Pt 3-90
- ITAA 1997 Subdiv 705-A
- ITAA 1997 705-35(1)
- ITAA 1997 705-35(1)(c)
- ITAA 1997 705-35(2)
- ITAA 1997 705-60
- ITAA 1997 705-70
- ITAA 1997 705-70(1)
- 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 Film Commission v. Mabey (1985) 59 ALR 25; 6 FCR 107; 11 IR 79
- Australian National University v. Burns (1982) 43 ALR 25; 5 ALD 67; 64 FLR 166
- Chan v. Cresdon Pty Ltd (1989) 168 CLR 242; 89 ALR 522; 64 ALJR 110
- Chittick v. Ackland (1984) 53 ALR 143; 6 ALD 255; 1 FCR 254
- Elmslie v. Federal Commissioner of Taxation 93 ATC 4964; 118 ALR 357; 26 ATR 611; (1993) 46 FCR 576
- 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)
- AASB 1020 Income Taxes
- AASB 112 Income Taxes
- Lonergan, W 2003, The Valuation of Businesses, Shares and Other Equity (4th ed.), Allen and Unwin, NSW
- Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002

ATO references

NO:	2005/16648
ISSN:	1038-8982
ATOlaw topic:	Income Tax ~~ Consolidation ~~ assets