



Australian Government  
Australian Taxation Office

## Consolidation – Core rules

Division 701 of ITAA 1997

---

**Presented by:**  
Professional Excellence Branch – New Law (OCTC)  
Australian Taxation Office

The following abbreviations are used extensively throughout this presentation:

ACA	Allocable cost amount
CGT	Capital gains tax
ESAS	Employee share acquisition scheme
FBT	Fringe benefits tax
GST	Goods and services tax
HC	Head company
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
IT(TP)A	<i>Income Tax (Transitional Provisions) Act 1997</i>
PAYG (W)	Pay as you go (withholding)

**Disclaimer**

This training presentation has been designed for Tax Office internal purposes. It has been made publicly available at the request of professional bodies who have indicated that it may be of use to tax practitioners with similar training requirements.

No attempt has been made to adapt the material to meet the specific needs of tax professionals. However, you may find it of value, particularly when used in conjunction with the *Consolidation reference manual*, which has been specifically designed for tax practitioners and their clients.

The Tax Office invites tax professionals to use this material for their own internal purposes, subject to conditions of copyright. The information is provided in good faith, and any business decisions based on this material remain the sole responsibility of the enquiring party or anybody seeking to rely on it.

**© Commonwealth of Australia 2004**

This work is copyright. You may download, display, print and reproduce this material in unaltered form only (retaining this notice) for your personal, non-commercial use or use within your organisation. Apart from any use as permitted under the *Copyright Act 1968*, all other rights are reserved. Requests for further authorisation should be directed to the Commonwealth Copyright Administration, Intellectual Property Branch, Department of Communications, Information Technology and the Arts, GPO Box 2154, Canberra ACT 2601 or posted at <http://www.dcita.gov.au/cca>

**Acknowledgment**

Professional Workforce Development – New Law (OCTC) acknowledge and thank the Consolidation Centres of Expertise for their input and assistance.

## Consolidation – training materials

This presentation is part of a sequence of presentations:

- membership
- core rules
- cost setting
- losses

The material should be used in conjunction with the:

- *Training pack*
- *Presenter's pack*

This presentation is part of a sequence of training presentations for topics related to the consolidation legislation. The presentations can be delivered either as part of a program or as individual modules.

The materials that support the slide presentations are packaged together in the:

- **Training pack** for participants – includes the exercises to be used during the presentations
- **Presenter's pack** – includes general instructions for the presenter and solutions to the exercises.

The support materials are available for download on the ATO website at the same location as the presentations.

## **Learning objectives**

- Demonstrate an understanding of core rule general concepts
- Apply the single entity rule
- Apply the inherited history rules
- Demonstrate an understanding of the core rules in relation to trading stock and the setting of an asset's tax cost
- Calculate the taxable income where an entity is not a subsidiary member for the whole of the income year
- Demonstrate an understanding of the exceptions to the core rules
- Demonstrate an understanding of how deductions and income are spread over a period

These are the learning objectives, detailing the knowledge and skills that participants are expected to acquire in this training session.

## Session outline

### Application of the core rules on entry into a group:

- head company's perspective
- subsidiary member's perspective

### Application of the core rules on exiting a group

### Other core rules provisions

In essence the core rules set the ground rules for the consolidation regime and provide a gateway to the other legislative provisions.

The main aim of the core rules is to address the problems associated with the taxation of wholly-owned groups, identified by Ralph in *A Tax System Redesigned*, such as:

- **high compliance costs** – in accounting for intragroup transactions
- **double taxation** – gains realised in ordinary transactions are taxed again on the disposal of equity
- **tax avoidance** – through intragroup dealings
- **loss cascading** – creation of multiple losses through a chain of companies, and
- **loss duplication** – losses in carrying on a business or on disposal of assets are realised again on disposal of equity.

## Session outline

- ▶ **Application of the core rules on entry into a group:**
  - head company's perspective
  - subsidiary member's perspective

**Application of the core rules on exiting a group**

**Other core rules provisions**

Let's look at the core rules as they apply to an entity joining a consolidated group.

First, we'll see this from the head company's point of view, and then we'll look at it from the angle of the joining subsidiary.

## Role of the core rules provisions

- One entity after consolidation (section 701-1)
- Subsidiary taxed only for time outside the group (note to subsection 701-1(3))
- Tax neutral transfer of assets and liabilities
  - from entity to head company upon joining (section 701-35)
  - from head company to entity upon leaving (section 701-25)
- Tax cost of an entity's assets reflects cost to head company of acquiring its membership interests (section 701-10)
- Free movement of assets within the group
- Cost of equity in a leaving entity based on the assets and liabilities that leave with it (section 701-15)

**One entity:** Achieves the single entity principle that, for income tax purposes, treats the subsidiary members as parts of the head entity [single entity rule section 701-1].

**Subsidiary taxed:** Subsidiary member still liable for income tax for a period when it was not a subsidiary member [note to subsection 701-1(3)].

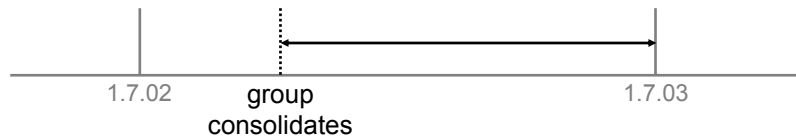
**Tax neutral:** Not looking to crystallise any gains or losses at the points of transfer. This ensures that there is no disposal for CGT purposes [sections 701-25 and 701-35].

**Asset values:** In transitional years (1 July 2002 – 30 June 2004), head companies will have option to set asset values at tax cost setting amount or existing tax values. After 30 June 2004, asset values will be aligned with the costs associated in acquiring the entity that holds them [section 701-10 of ITAA 1997 and section 701-15 of IT(TP)A]. Note that the head company itself always enters consolidation with existing asset values.

**Free movement:** In a similar fashion to a company moving assets and businesses between its divisions under the current rules, there are no tax consequences for movement between group members.

**Equity values:** For a leaving entity the cost of equity to the head company is set on the basis of the values of the net assets it takes with it [section 701-15] .

## Core rules – impact on head company



- Single entity rule applies to group
- Entry history rule applies
- Certain tax attributes transferred to head company
- Assets and liabilities treated as head company's
  - but need to set tax cost of assets

Consolidation – Core rules

[www.ato.gov.au](http://www.ato.gov.au)

- Single entity rule applies to the group (this is discussed on the next slide).
- Entry history rule (also discussed later).
- Certain attributes transferred to HC – losses, franking credits and foreign tax credits.
- Assets and liabilities treated as HC's, but need to set tax cost of asset either via the tax cost setting method (i.e. calculating ACA) or the transitional method (i.e. existing tax values).

## **Single entity principle (section 701-1)**

### Subsection 701-1(1)

- a subsidiary member of a consolidated group for any period is taken for core purposes\* to be a part of the head company rather than a separate entity during that period

\* head company core purposes and entity core purposes: subsections (2) and (3)

## **Single entity rule [section 701-1]**

In calculating a head company's tax liability and/or tax losses, the 'single entity rule' applies whereby subsidiary entities are taken to be 'parts of the head company...rather than separate entities'.

An entity is treated, for the core purposes, as part of the head company while it is a subsidiary member of the group.

The core purposes are:

- for the head company – working out its income tax liability or loss for any period during which it is the head company of a consolidated group, or any later income year, and
- for a subsidiary member – working out its income tax liability or loss for any period during which it is a subsidiary member of a consolidated group, or any later income year.

The single entity principle only applies for core purposes and does not apply to other tax responsibilities of a member entity. Therefore, member entities must be in a position to meet their FBT, GST and PAYG (W) obligations, as well as any liability relating to a non-membership period.

### Consequences of single entity principle

- Head company lodges single income tax return for the group
- Assets and liabilities are treated as assets and liabilities of the head company
- Actions of subsidiaries are treated as actions of the head company
- Intragroup transactions are ignored

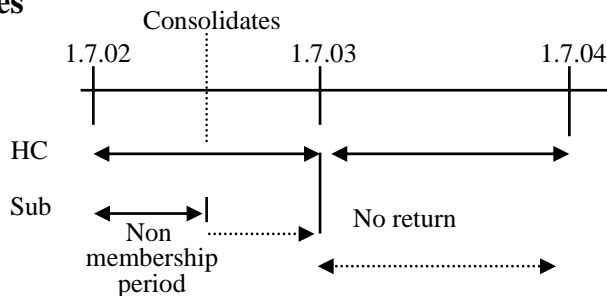
The following are some of the consequences of single entity treatment for working out the group's income tax liability or losses:

- A single income tax return is lodged by the head company and the subsidiary members are only required to lodge returns for any non-membership periods.
- Assets and liabilities of the subsidiary members are treated as if they were assets and liabilities of the head company.
- Actions of the subsidiary members (e.g. acquisition or disposal of assets) are treated as if they had been undertaken by the head company.
- Intragroup transactions are ignored for income tax purposes.
- Intragroup debt and shareholdings are ignored.
- Intragroup group dividends are not assessable or subject to the franking regime.
- Intragroup sales of trading stock are treated as consumables.
- Assets can be transferred within the group free of any tax consequences.

More information: see TR 2004/D2.

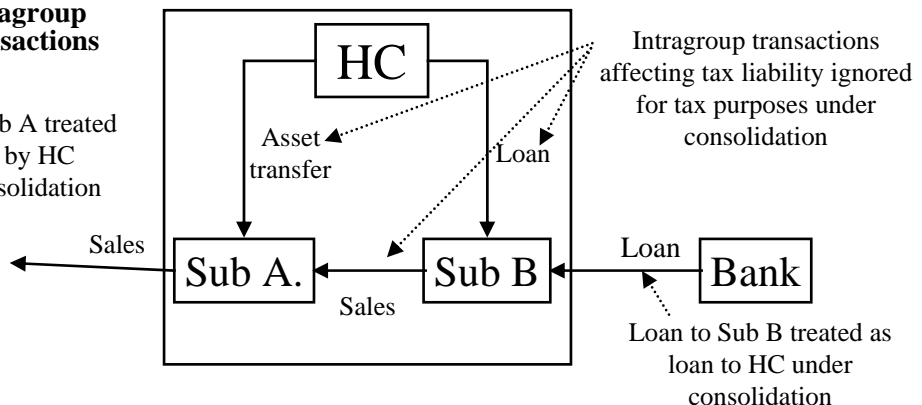
### White Board examples

#### • Returns



#### • Intragroup transactions

Sales by Sub A treated as sales by HC under consolidation



Intragroup transactions affecting tax liability ignored for tax purposes under consolidation

Loan to Sub B treated as loan to HC under consolidation

## Other consequences of single entity principle

- Head company liable for payment of tax
  - but see Division 721 for joint & several liability in case of default
- Record keeping obligations rest with head company
  - (section 262A of ITAA 1936)
  - (section 121-20 of ITAA 1997)

### Head company liable for income tax liability

Under the single entity rule, the head company is responsible for a consolidated group's income tax liability from the date of consolidation. However each member of the consolidated group remains separately liable for any tax-related liabilities that fall outside the consolidation regime.

Under the single entity principle, issues will arise when the head company within a group does not meet its tax liabilities. Consequently, Division 721 of ITAA 1997 allows the Commissioner to seek recovery from the subsidiary members where there is a default by the head company. This is described as 'joint and several liability' of the members of the group. Note however that the 'joint and several liability' approach is modified because there are some exceptions and limitations to the concept in Division 721.

### Record keeping – head company's obligation

The consolidation regime itself does not impose any new legislative record-keeping requirements. Rather they rely on the general legislative requirements contained in section 262A of ITAA 1936 and section 121-20 of ITAA 1997.

Section 262A requires taxpayers to keep:

- any documents that are relevant for the purposes of ascertaining the person's income and expenditure, and
- documents containing particulars of any election, estimate, determination or calculation made by the person and particulars showing the basis for and the method by which an estimate, determination or calculation was made.

Section 121-120 requires a taxpayer to maintain records of acts, transactions events or circumstances that are relevant to the calculation of a capital gain or loss.

### **Entry history rule (section 701-5)**

- For the head company core purposes, everything that happened in relation to the joining entity before it became a member is taken to have happened to the head company
- The entry history rule may be modified by other consolidation provisions, e.g:
  - depreciating assets (subsection 701-55(2))
  - asset cost base history (Division 705)
  - tax loss history (Division 707)

### **Under section 701-5 of ITAA 1997, a head company inherits the tax histories of the subsidiary members of the group.**

For head company core purposes, the head company inherits things that affect the calculation of its income tax liability or tax loss. The result is that a head company may be entitled to certain deductions for expenditure incurred by a joining entity prior to the time it joined the consolidated group.

Examples of things that may be inherited by the head company include:

- entitlements to deductions for the undeducted borrowing costs under section 25-25
- gift deductions spread over several years
- deductions for water facilities, connecting power or telephone lines etc (in other words, deductions that are spread over a period)
- prepayments received for services that are provided over several years (Arthur Murray)
- recoupment of expenditure [section 20-20]
- deduction for bad debts [section 25-35]
- the pre-CGT status of assets brought into the group.

### **Modifications to the entry history rule**

Certain modifications apply to the entry history rule within both Division 701 and other divisions. For example:

- Within Division 701 – assets are brought into a consolidated group at their tax cost setting amount [section 701-55]. To work out the tax cost setting amount we need to refer to Division 705.
- Special rules apply to set the cost of assets coming into a consolidated group under Division 705 of ITAA 1997.
- Special rules apply to the amount of losses that a joining entity can bring into the group under Division 707 of ITAA 1997.

### **Practical issues**

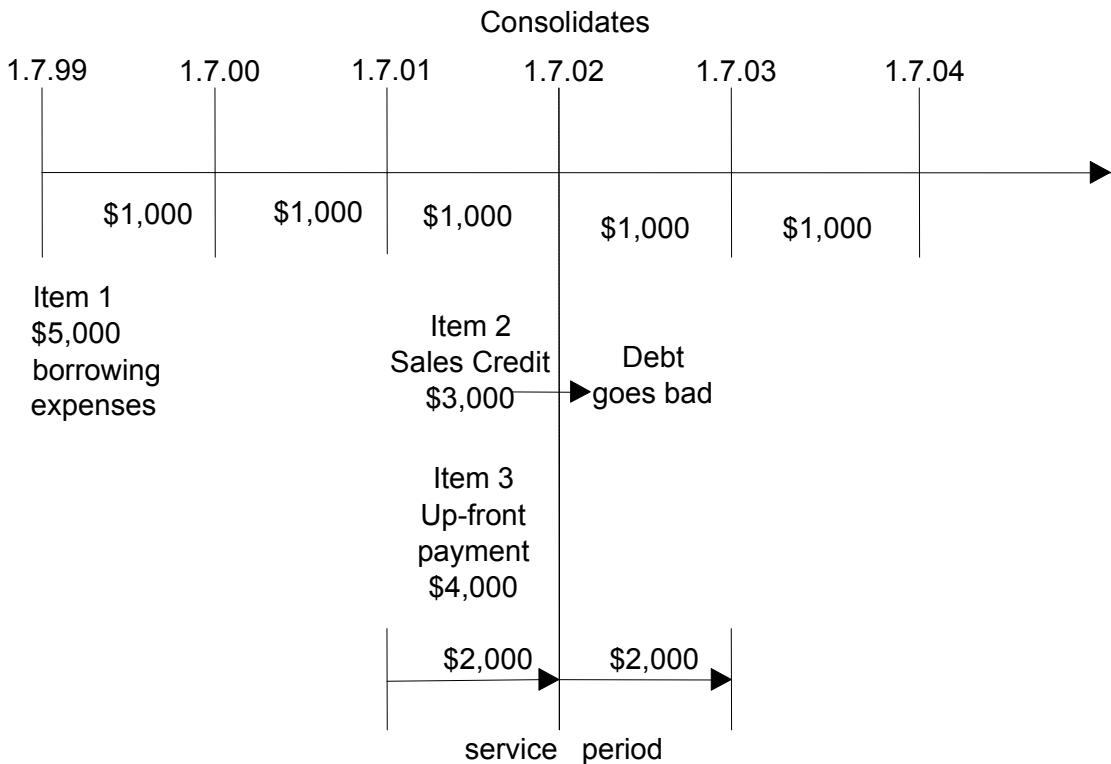
As a result of the entry history rule, a head company needs to keep track of any deductions that were claimed by joining entities pre-consolidation and that may continue to be claimed by the head company after consolidation. The same applies to any income or gains that the head company may need to return as a result of any spreading of income or recoupment of expenditure because of the tax treatment in an earlier tax period of a joining entity.

### Exercise 3: Core rules – entry history rule

Consolidation – Core rules

www.ato.gov.au

Presenter Note: Exercise 3 handout, allow 15-20 mins. The exercises are located in the *Training pack*, the solutions in the *Presenter's pack*. Exercises 1 and 2 relate to the membership rules, which are covered in a separate presentation.



## **Entry history rule**

### Private binding rulings

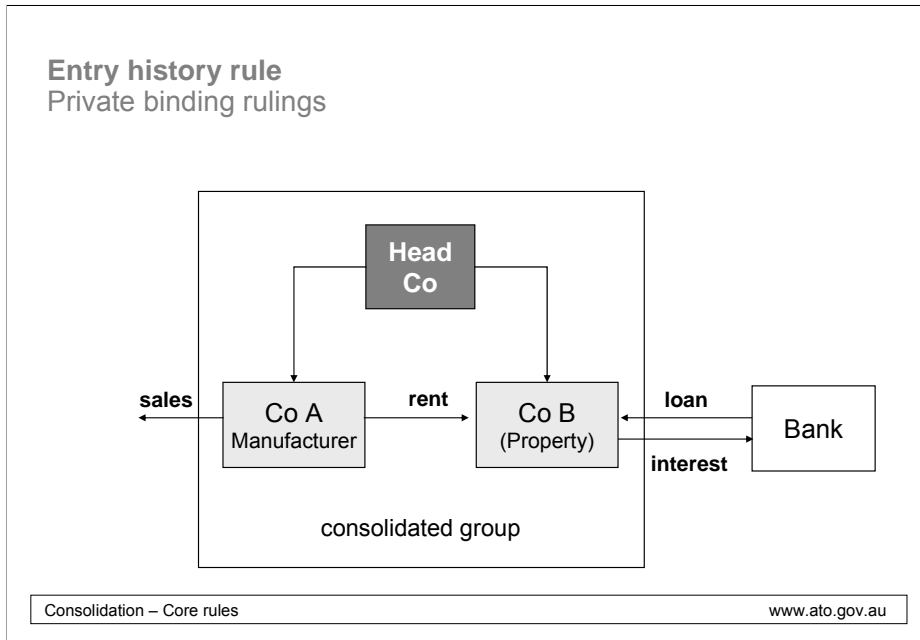
- Private binding rulings issued to the subsidiary member before consolidation can be relied on by the head company insofar as the relevant facts have not changed  
(EM paragraph 2.47)
- Significant practical problems identifying when the facts or arrangement have changed

### **Private binding rulings**

The entry history rule means that any private income tax rulings issued to an entity prior to joining the consolidated group will apply to the head company post-consolidation insofar as the relevant facts have not changed. However, where the ruling relates to an asset that leaves the group with an exiting entity, it will continue to apply to the exiting entity.

There may, however, be significant practical problems in determining when the facts or arrangement have changed.

- See next slide for an example.



Before consolidation, Co B purchases a factory that is used by Co A in its manufacturing business. Co B funds the acquisition with a bank loan and duly pays interest on the loan. Co A pays Co B rent for the use of the factory.

**Question:** Would the interest paid to the bank be deductible?

- Pre-consolidation
  - Yes, Co B has incurred expenditure (interest) in the gaining or producing of assessable income (i.e. rent from Co A).
- Post-consolidation
  - Head company would be the relevant taxpayer. The head company could not argue that the interest paid on the loan is incurred for the gaining of rental income because under consolidation the rent from Co A to Co B is no longer recognised as all intragroup transactions are ignored for income tax purposes under the single entity rule. However, the head company may successfully argue that the interest is necessarily incurred in carrying on the business of the consolidated group.

## **Tax attributes transfer**

- Tax attributes of a joining entity are transferred to the head company
- Examples:
  - losses (Division 707)
  - franking credits (Subdivision 709-A)
  - foreign tax credits (Subdivision 717-A)
  - franking deficit tax offset (Subdivision 709-C)
- These are subject to specific rules
- Remain with head company when subsidiary leaves

Tax attributes such as losses, franking credits, foreign tax credits and excess franking deficit tax offset are transferred and pooled by the head company. Specific legislative provisions outline how these tax attributes are transferred to a head company.

- Losses Division 707
- Franking credits Subdivision 709-A
- Foreign tax credits Subdivision 717-A
- Franking Deficit Tax Offset Subdivision 709-C

The need for the head company to operate a single record for each attribute, rather than separate records for each attribute of each entity, will result in compliance cost savings.

When a subsidiary leaves, these tax attributes remain with the group.

## **Transfer of assets and liabilities (section 701-10)**

- Assets of the joining entity are reset assuming the single entity rule does not apply (subsection 701-10(2))
- 'Tax cost' set for each asset of the entity when it joins the group (i.e. at 'tax cost setting amount') (subsection 701-10(4))
  - Note: this may not apply for groups that consolidate in the transitional period
- Table in section 701-60 sets out circumstances in which the assets tax cost is set

### **Transfer of assets and liabilities**

Subsection 701-10(2) applies to each asset that would be an asset of the joining entity at the time it becomes a subsidiary member of the group assuming the single entity rule does not apply.

This subsection has been amended to ensure that assets that do not become assets of the head company have their tax cost set and that an ACA is allocated to these assets.

The cost to the head company of the assets reflects the cost to the group of acquiring the joining entity [refer subsection 701-10(3)].

Under the cost setting rules, the cost of assets for the joining entity are set at the tax cost setting amount [refer subsection 701-10(4)] unless the head company chooses to apply the transitional provisions [refer section 701-15 of IT(TP)A]. Note that the head company always retains existing tax values for its assets.

The table in section 701-60 sets out what is the asset's 'tax cost setting amount' in particular circumstances. This cost is calculated and allocated to the individual assets in accordance with the rules in Division 705 [see next slide].

### Tax cost setting amount (section 701-60)

<b>If tax cost set by:</b>	<b>Tax cost setting amount:</b>
1 cost to head company of asset brought in	go to Division 705
2 cost to head company of membership interests in leaving entity	go to section 711-15 or section 711-55
3 cost to head company of assets being liabilities owed within group by leaving entity (or of liabilities owed to leaving entity)	market value of asset
4 cost to head company of membership interests held by leaving entity	go to section 711-55

Consolidation – Core rules

[www.ato.gov.au](http://www.ato.gov.au)

### Tax cost setting amount for assets brought into the group

An assets tax cost setting amount is worked out by using the table in section 701-60 of ITAA 1997.

If we are trying to set the tax cost of assets that are brought into a consolidated group by a subsidiary member we are directed to Division 705 to work out the asset's tax cost setting amount.

- Note existing tax values can be used if the transitional rules are applicable and the head company has chosen to apply them. The choice can be made on a subsidiary-by-subsiary basis.

Under Division 705 a head company allocates the cost of acquiring a joining entity to the assets of the joining entity.

**Certain assumptions made when 'tax cost is set'**  
(section 701-55)

- Depreciating asset provisions
- Trading stock provisions
- Qualifying security provisions
- Capital gain and loss provisions
- Other provisions (catch-all)

Note: Subsections 701-55(2) to 701-55(6) do not apply where an asset satisfies the conditions of section 701-58.

Consolidation – Core rules

[www.ato.gov.au](http://www.ato.gov.au)

**Section 701-55 explains the meaning of the expression 'a tax cost is set'.**

**It is important to note that the entry history rule is overridden by section 701-55 (unless the head company sticks with tax values during the transitional period).**

**The extent to which it is overridden depends on the type of asset.**

This provision sets up the way in which other provisions of the ITAA operate when the tax cost is set.

**Depreciating asset provisions** [such as Subdivision 40-A to 40-D (capital allowance), sections 40-425 to 40-445 (low-value pools), Subdivision 328-D (STS taxpayers) and sections 73BA and 73BF (R&D expenditure) of ITAA 1936] operate as if:

- (a) the HC had acquired the asset at the joining time for its tax cost setting amount
  - (b) the same method of working out decline in value were chosen
- and ...
- (c), (d) and (e) operate to fix the effective life for the purpose of the Division 40 formulas.
  - An example of how this provision operates is provided in later slides.

**Trading stock provisions** apply as if trading stock were trading stock of the head company at the start of the income year in which the entity joins the group.

- An example of how this provision operates is provided in later slides.

**Qualifying security provisions** (Division 16E) apply as if the head company acquired the securities for a payment equal to the tax cost setting amount at the joining time.

**CGT provisions** apply as if, in the hands of the head company, the cost base or reduced cost base of the asset at the joining time is its tax cost setting amount.

**Catch-all:** in any other case the asset's cost (in the hands of the head company) = tax cost setting amount.

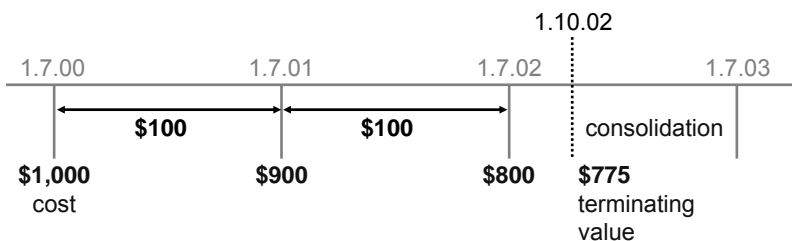
**Presenter note:**

- In today's session we will only look at the first two of the above –depreciating assets and trading stock.
- Section 701-58 was inserted into the ITAA 1997 to ensure that the tax cost that is set for assets that do not become assets of the head company because of the single entity rule are not taken into account in applying the provisions of subsections 701-55(2) to 701-55(6).

## Depreciating assets

### Prime cost

- Example: Subco holds assets A and B and joins consolidated group under Headco on 1.10.02
- Depreciating asset A –
  - effective life 10 years, prime cost method applied
  - no accelerated depreciation



Consolidation – Core rules

www.ato.gov.au

Let's look at an example of how section 701-55 applies to a depreciating asset.

- Depreciating asset A was purchased by Subco on 1 July 2000 for \$1,000.
- It has an effective life of 10 years and the prime cost method was applied to the asset, with no accelerated depreciation.
- Its decline in value for each of the income years ended 30 June 2001 and 2002 is \$100 per year.
- Subco joins a consolidated group on 1 October 2002. At this time it has an adjustable value or terminating value of \$775 after allowing for a decline in value of \$25 for the period from 1 July 2002 until 30 September 2002.
- Asset A's terminating value at the time of consolidation = adjustable value = \$775.

## Depreciating assets

### Prime cost

- Operation of the core rules provisions
- Core rule section 701-10(4):
  - \***tax cost = \*tax cost setting amount**
- Section 701-60 table
- Subdivision 705-A
  - spreads allocable cost amount across assets
  - assume under Div 705 asset A's tax cost setting amount is \$750
- Subsection 701-55(2) – operation of depreciating asset provisions

Section 701-10 applies in relation to each asset that becomes an asset of the head company because the single entity rule applies to the asset under subsection 701-1(1).

Subsection 701-10(4) sets the tax cost for each asset of an entity at the time the entity becomes a subsidiary member of the group at the asset's 'tax cost setting amount' (unless transitional measures apply).

The assets 'tax cost setting amount' is worked out using the table in section 701-60. In our example, item 1 applies because the asset's tax cost is set by section 701-10 (which is about the cost to the head company of assets that an entity brings into the group). Item 1 in the table calculates the asset's tax cost setting amount by reference to Division 705.

#### Division 705-A

- calculates the tax cost setting amounts for the basic case of a single entity joining a consolidated group
- spreads allocable cost amount (ACA) across assets in proportion to their market values (for the sake of our example, assume that the tax cost setting amount has been set for depreciating asset A at \$750).

Once the tax cost setting amount has been calculated for asset A we apply subsection 701-55(2) to determine how the depreciating asset provisions (i.e. capital allowance provisions under Division 40) apply to that asset within a consolidated group.

**Note:** If we were concerned with the CGT treatment of asset A we would go to subsection 701-55(5) or if asset A were trading stock we would refer to subsection 701-55(3).

## Depreciating assets

### Prime cost

Applying subsection 701-55(2) to asset A:

- Headco is taken to acquire asset A on 1 Oct 2002 for its tax cost setting amount – paragraph (a) applies
- prime cost method applies – paragraph (b) applies
- asset A's tax cost setting amount (\$750) does not exceed the terminating value (\$775) – paragraph (c) applies.

Effective life = remainder of effective life just before the joining time =  $7\frac{3}{4}$  years

Applying subsection 701-55(2) to asset A results in the following outcome:

- Under paragraph 701-55(2)(a), Headco is taken to have acquired asset A on 1 October 2002 (i.e. the particular time) for its tax cost setting amount (calculated under Subdivision 705-A), which we have assumed to be \$750.
- Paragraph 701-55(2)(b) applies the same method of working out the decline in value from 1 October 2002 that was chosen before 1 October 2002. In our example this would be the prime cost method.

Because the prime cost method was applicable to this asset before 1 October 2002 we need to determine whether paragraph 701-55(2)(c) or 701-55(2)(d) applies. To determine which paragraph is relevant we need to compare asset A's tax cost setting amount (TCSA) with its terminating value.

If the tax cost setting amount does not exceed the asset's terminating value, then at 1 October 2002 an effective life is chosen for the asset equal to the *remainder* of the effective life of the asset just before 1 October 2002.

If the tax cost setting amount exceeds the asset's terminating value, then at 1 October 2002 the head company is required to choose an effective life for the asset in accordance with section 40-95 (other than subsections (2) and (5)) and any choice of an effective life determined by the Commissioner is limited to one in force at 1 October 2002.

In our example, the tax cost setting amount of \$750 does not exceed the terminating value of the asset of \$775, hence paragraph 701-55(2)(c) applies. Therefore the effective life that is applicable to asset A is the remainder of the effective life just before 1 October 2002. The remaining effective life is  $7\frac{3}{4}$  years.

**Depreciating assets**  
Prime cost

On 30 June 2003 Headco will apply section 40-75 as follows:

$$\$ 750 \times \frac{273}{365} \times \frac{100 \%}{7\frac{3}{4} \text{ years}} = 72$$

Adjusted value at 30 June 03: \$750 – \$72 = \$678

**Note:** the former adjusted value of \$775 in the hands of Subco is no longer relevant. For all future calculations, effective life is set at 7¾ years

Section 40-75 refers to the prime cost method in the capital allowance provisions of ITAA 1997. The decline in value of a \*depreciating asset for an income year using the prime cost method is worked out in this way:

where:

$$\text{Asset's *cost} \times \frac{\text{Days held}}{365} \times \frac{100\%}{\text{Asset's *effective life}}$$

$$= \$750 \times \frac{273}{365} \times \frac{100\%}{7\frac{3}{4} \text{ years}}$$

$$= \$72$$

\* this is the tax cost setting amount of the asset

**Presenter note:** The difference between the terminating value of \$775 and the tax cost setting amount of \$750 (i.e. \$25) is lost to the head company.

If the head company were eligible to apply the transitional provisions and elected to do so, the terminating value (or adjustable value) of the asset would equal \$775, and the head company would use this tax value to continue to claim a deduction for any decline in value of the asset.



## Depreciating assets

### Diminishing value

Applying subsection 701-55(2):

- asset B acquired by Headco on 1 Oct 2002 for its tax cost setting amount (say, \$420)
- diminishing value method still applies
- paragraph (e) applies:
  - effective life = effective life just before joining time = 12 yrs
  - but...
  - accelerated depreciation provision (section 701-80)

Subsection 701-55(2) tells us how the capital allowances provisions operate for the head company.

- Under the single entity principle, asset B is now taken to be an asset of the head company from 1 October 2002. Assume that the tax cost setting amount for this asset calculated under Division 705-A was \$420.

Applying subsection 701-55(2):

- Paragraph 701-55(2)(a): Acquired by head company at the joining time (i.e. 1 October 2002) for its tax cost setting amount of \$420.
- Paragraph 701-55(2)(b): Same method of depreciation to apply (prime cost or diminishing value) – in the case of this example, diminishing value.
- Paragraphs 701-55(2)(c) & (d): Do not apply as these deal only with prime cost method.
- Paragraph 701-55(2)(e): Effective life at 1 October 2002 remains the same as the asset's effective life just before 1 October 2002 (i.e. 12 years).

#### **Note:**

Prior to consolidation asset B was eligible for accelerated depreciation.

However, because paragraph 701-55(2)(a) deems the asset to have been acquired by the head company on 1 October 2002 asset B is no longer eligible for an accelerated rate of depreciation because it was acquired after 21 September 1999.

Accordingly, section 701-80 was enacted to preserve any entitlement to accelerated depreciation for assets that become those of the head company because of the single entity rule.

## **Accelerated depreciation**

### Special provision

- Section 701-80: preservation of accelerated depreciation – substitutes accelerated rate for Division 40 rate
  - Requirements
    - depreciating asset under Division 40 becomes that of head company because of single entity rule
    - entity was entitled under transitional provisions to use accelerated rates of depreciation immediately before joining time, and
    - tax cost setting amount not > terminating value
- As B's tax cost setting amount (\$420) exceeds its terminating value (\$395), section 701-80 does not apply

**but...**

Consolidation – Core rules

[www.ato.gov.au](http://www.ato.gov.au)

### **Application of section 701-80**

For accelerated depreciation to be preserved under section 701-80, certain conditions must be satisfied:

- a depreciating asset under Division 40 becomes that of the head company because of the single entity rule
- just before the entity became a subsidiary member, section 40-10 or subsection 40-12(3) of the IT(TP)A applied for the purposes of the entity working out the asset's decline in value under Division 4, and
- the asset's tax cost setting amount must not be more than the entity's terminating value for the asset [refer subsection 701-80(3)].

Asset B's tax cost setting amount of \$420 is greater than the asset's terminating value of \$395, therefore section 701-80 does not apply and hence accelerated depreciation for the asset would cease.

However – the taxpayer has a further option under section 705-45 (rather than losing accelerated depreciation) whereby:

- If tax cost setting amount of the asset is > terminating value of the asset, the head company can elect to set the asset's tax cost setting amount at the terminating value, thereby allowing section 701-80 to apply and allowing accelerated depreciation for the asset to continue.
- The amount of the reduction, in this case \$25 (i.e. \$420 less \$395), is lost to the head company.

## **Accelerated depreciation**

### Tax cost setting option

- Section 705-45 (in cost setting rules) – head company has a choice to limit the tax cost of accelerated depreciating asset to its terminating value
- this means section 701-80 applies

#### Result:

- Section 705-45 choice → section 701-80
  - overrides effective life provisions in subsection 701-55(2)
  - modifies operation of Division 40

As outlined in the previous slide, if the head company elects to limit the tax cost of the accelerated depreciating asset to its terminating value, all the conditions in section 701-80 will be met and hence it will apply to preserve any entitlement to accelerated depreciation.

Section 701-80 overrides the effective life provisions in subsection 701-55(2) and modifies the operation of subsection 40-70(1) and subsection 40-75(1) by using the effective life rates in the old section 42-160(1) and section 42-165(1).

Once made, the choice under section 705-45 is irrevocable.

The excess value cannot be redistributed amongst other assets – it is lost.

## Depreciating assets

Diminishing value – accelerated depreciation

- Head company chooses to apply section 705-45
- Applying section 701-80:
  - tax cost setting amount = \$395
  - on 30 Jun 2003, Headco will replace the section 40-70 formula to determine asset B's decline in value as follows:

$$\$ 395 \times \frac{273}{365} \times 25 \% = 74$$

Adjusted value at 30 June is \$395 – \$74 = \$321

If the head company chooses to apply section 705-45, the tax cost setting amount of asset B is set at \$395, which equates to the asset's terminating value for Subco.

Accordingly, section 701-80 will apply, since asset B's tax cost setting amount does not exceed its terminating value (as a result of the choice under section 705-45).

Subsection 701-80(4) provides that the formula in subsection 40-70(1) is replaced by the former accelerated depreciation rate – 25%.

On the following 30 June, Headco applies the formula in subsection 40-70(1) as follows to determine asset B's decline in value:

$$\begin{array}{l} \text{Base value} \times \frac{\text{Days held}}{365} \times \text{accelerated rate} \\ \\ \$395 \quad \times \quad \frac{273}{365} \quad \times \quad 25\% \quad = \quad \$74 \end{array}$$

## Depreciating assets

Diminishing value – no accelerated rate

- Head company chooses *not* to apply section 705-45
- Applying subsection 701-55(2):
  - On 30 Jun 2003, Headco will apply the section 40-70 formula to asset B as follows:

$$\$ 420 \times \frac{273}{365} \times \frac{150 \%}{12 \text{ years}} = 39$$

Adjusted value at 30 June is \$420 - \$39 = \$381

If the head company chooses *not* to apply the option available under section 705-45, section 701-80 cannot apply and hence section 701-55(2) will apply.

This means the head company will use the diminishing value method calculation outlined in section 40-70 of the ITAA 1997, with a base value of \$420 being asset B's tax cost setting amount.

### Section 40-70 diminishing value method

#### Subsection 40-70(1)

The decline in value of a \*depreciating asset for an income year using the diminishing value method is worked out as follows:

Base value	x	Days held	x	150%
		-----		-----
		365		Asset's *effective life
= \$420	x	273	x	150%
		-----		-----
		365		12 years
= \$39				

## Exercise 4: Core rules – depreciable asset

Consolidation – Core rules

[www.ato.gov.au](http://www.ato.gov.au)

Exercise 4 handout.

Allow 15-20 min.

The exercises are located in the *Training pack*, the solutions in the *Presenter's pack*.

**Certain assumptions made when 'tax cost is set'  
(section 701-55)**

- Depreciating asset provisions
- Trading stock provisions
- Qualifying security provisions
- Capital gain and loss provisions
- Other provisions (catch-all)

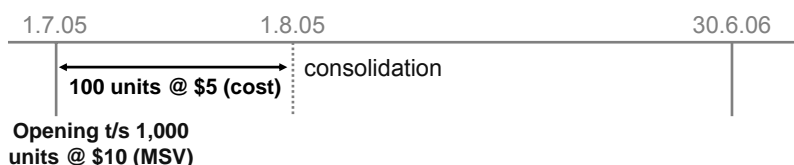
We will now look to see how section 701-55 applies the tax cost of an asset to the trading stock provisions.

## Example

### Core rules and trading stock

#### Company A

- Joins consolidated group on 1 August 2005
- 100 units manufactured prior to consolidation
- Market selling value of the trading stock is still \$10 on 1 August 2005



Consolidation – Core rules

[www.ato.gov.au](http://www.ato.gov.au)

Before we look at the operation of section 701-55 for the head company's treatment of trading stock at the joining time, let's see how the trading stock provisions apply to an entity just prior to consolidation.

Refer to section 701-35. This section provides a tax-neutral consequence for the entity of ceasing to hold trading stock when it joins a consolidated group.

- In our example Company A has a value for opening stock on hand on 1 July 2005 of \$10,000 (i.e. 1,000 units at a market selling value of \$10 per unit: sections 70-40 and 70-45).
- In addition, prior to 1 August 2005 the company manufactured 100 units at a cost of \$5 per unit.
- There were no sales recorded for the period 1 July 2005 – 31 July 2005.
- Closing stock on hand as at 31 July 2005 was 1,500 units.

The next few slides explain how the subsidiary member values its closing stock on hand to arrive at a tax neutral outcome in accordance with section 701-35.

### Example

#### Subsidiary member – tax neutral result

- Company A must lodge a return for the 2006 income year
- For the pre-consolidation period it must work out its taxable income and tax payable
- Taxable income is worked out as though the start and end of the non-membership period were the start and end of the income year (section 701-30)
- Company A must include the movement of trading stock in determining taxable income (section 70-35)

Refer to section 701-30 which requires Company A to work out its taxable income for those periods in the income year (i.e. non-membership periods) during which the entity is not a subsidiary member of any consolidated group.

For each non-membership period, Company A is to work out its taxable income or loss for that period as if the start and end of the period were the start and end of the income year.

In our example, Company A is required to calculate any taxable income or loss for the period from 1 July 2005 to 31 July 2005. Accordingly, in applying the trading stock provisions under Division 70 of ITAA 1997, Company A is required to value closing stock on hand as at 31 July 2005 at cost, market selling value or replacement value.

As a result of this valuation, Company A may be required to return in assessable income any excess of the value at the end of the income year over the value at the start of the income year [subsection 70-35(2)]. On the other hand, a deduction can be claimed for any excess of the value at the start of the income year over the value at the end of the income year [subsection 70-35(3)].

Section 701-35 ensures that there is no income tax consequence for Company A in respect of trading stock when it joins a consolidated group. Accordingly subsection 701-35(4) sets the value of trading stock at a tax-neutral amount by ensuring that the trading stock on hand at the end of the income year is equal to:

- if the asset was trading stock of the entity at the start of the income year – the asset's value at that time, or
- the amount of outgoing incurred by the entity in connection with the acquisition of the asset.

As a consequence of fixing the trading stock's value at the end of the income year under subsection (4), no election would be available under section 70-45 to value the trading stock at that time (unless the transitional provisions apply or the trading stock integrity measures apply under section 701A-5 of the IT(TP)A).

### Example Subsidiary member

Company A must value closing stock on a tax-neutral basis (section 701-35):

- units on hand at 1 July must be allocated their opening stock value, i.e. \$10,000
- the further 100 manufactured units must be given a value equal to outgoings in connection with their acquisition, i.e.  $100 \times \$5 = \$500$

Read subsection 701-35(4).

The opening stock was valued at 1,000 units @ \$10 per unit at market selling value.

The closing stock value under section 70-45 can be valued using cost, market selling value or replacement value. However, for consolidation purposes section 701-35 ensures that this option is not available (unless the taxpayer elects to use the transitional option or the trading stock integrity measures apply under section 701A-5 of IT(TP)A) by allocating the same cost for any stock that was on hand at the beginning of the year and remains on hand at the joining time. Similarly, any stock that was manufactured or purchased during the income year, and remains on hand at the joining time, will be allocated an amount equal to those outgoings.

#### Whiteboard example

Sales	<b>0</b>	
<u>Add</u>		
<b>Opening t/s</b>	<b>10,000</b>	
1000 units @ \$10		
<b>Closing t/s</b>	<b>10,500</b>	
1,000 units @ \$10		
100 units @ \$5	<b>500</b>	[section 70-35 assessable income]
<u>Less</u>		
<b>Costs of manufacture [s 8-1]</b>	<b><u>500</u></b>	
	<b><u>nil</u></b>	

**Example**  
Head company

- The head company must bring Company A's trading stock into its accounts because, under the single entity principle, it is treated as though it holds the assets of Company A after consolidation (sections 701-1, 701-10)
- The trading stock will be included in the head company's opening trading stock at 1 July 2005 at the tax cost setting amount (the value determined in accordance with Subdivision 705-A)
- When the same item of trading stock has its cost set more than once in the same income year for a head company, then only the last of the setting times is taken into account (subsection 701-10(5))

Consolidation – Core rules

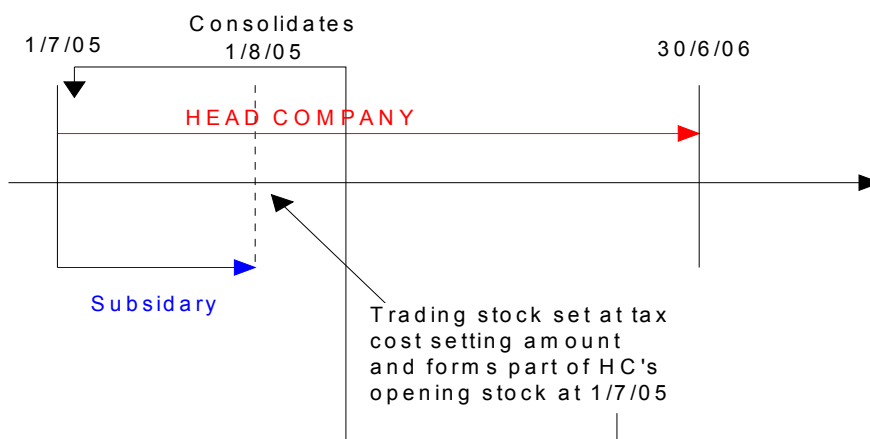
www.ato.gov.au

Let's now look at the trading stock treatment in the hands of the head company as at the joining time.

Under section 701-1 (the single entity principle), the head company holds the assets of Company A after consolidation. The head company sets the cost of trading stock in accordance with section 701-10 (unless the transitional provisions apply or the trading stock integrity measures apply). In turn, section 701-10 directs us to calculate the tax cost setting amount in accordance with Subdivision 705-A.

Subsection 701-55(3) ensures that the trading stock provisions under Division 70 apply so that as at the joining time the trading stock held by Company A is treated as the trading stock of the head company at the start of its income year for a value equal to its tax cost setting amount.

Note that where the same item of trading stock has its cost set on being brought into a consolidated group more than once in the same income year for a head company, only the amount at which the cost is set on the last of the times it is set is taken into account for the head company [subsection 701-10(5)].



Multiple resetting of the same item of trading stock may occur, for example, where the same item is brought into a consolidated group by an entity and that item is taken by an entity that leaves and rejoins the same consolidated group in the same income year. Only the last resetting is taken into account because under the cost setting rules this cost becomes the opening cost of the trading stock for the head company purposes and should only be taken into account once.

#### Trading stock integrity measure

Division 701A of IT(TP)A

- If an entity becomes a subsidiary member any time on or after 1 July 2002, and was majority owned from 27 June 2002 until the entity became a subsidiary member of the group, the entity is a 'continuing majority-owned entity'
- Trading stock will be treated as a retained cost base asset (rather than a reset cost base asset) for head company core purposes

Consolidation – Core rules

www.ato.gov.au

**The trading stock integrity measures are in Division 701A of the IT(TP)A.** When an entity becomes a subsidiary member of a consolidated group, its trading stock will generally be a reset cost base asset of that group. However, the government is concerned that groups will choose to reset costs for assets where this could result in a significant increase in the value of trading stock.

Therefore that trading stock will be treated as a retained cost base asset for head company core purposes if that entity was, at the time of becoming a subsidiary member, a 'continuing majority-owned entity'.

A 'continuing majority-owned entity' is an entity that was majority owned at all times from the start of 27 June 2002 until the entity became a subsidiary member of a consolidated group.

A person or persons are 'majority owners' of an entity if they are beneficial owners, directly or indirectly through one or more interposed entities, of more than 50% of the market value of all the membership interests in the entity.

The measure only applies to entities that were majority owned as at 27 June 2002 because, where a majority interest in the entity was acquired after that date, the cost to revenue from the increased tax value for trading stock will have been substantially offset by the higher market value of trading stock being reflected in the sale proceeds of vendors of that majority interest.

Section 705-40 would allow the tax cost setting amount to be the *greater of*:

- MV at joining time
- terminating value.

The integrity measure will prevent market valuations being used as a basis of the tax cost setting amount for wholly-owned entities as at 27 June 2002.

#### **Purpose of trading stock integrity measure**

The EM to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002 explains (at paragraph 1.124) that the purpose of this measure 'is to ensure that trading stock cannot be given an uplifted tax cost setting amount, thereby preventing unintended tax benefits (in this case, a tax deferral) arising on consolidation'.

The upper limit on the tax cost setting amount for a reset cost base asset imposed by section 705 (i.e. the greater of market value and terminating value) usually ensures tax neutrality when an asset becomes an asset of a head company. However, Division 70 does not require an entity becoming a subsidiary member to choose the market value of its trading stock as its closing value. As the EM goes on to state (at paragraph 1.125), this means:

- 'a tax deferral will arise if the market value of the trading stock at the time of the entity becoming a subsidiary member exceeds its terminating value as this excess will not have been subject to tax in the hands of the entity prior to consolidation'

and (at paragraph 1.130):

- 'Retaining the value of trading stock means that the closing value of trading stock on hand immediately prior to consolidation will equal the opening value of the trading stock on hand immediately after consolidation. Consequently, subsection 701-35(4) does not need to apply to ensure that Division 70 does not give rise to any tax consequence for trading stock that remains on hand at the end of the income year preceding consolidation.'

## Example of how integrity measures work:

### Joining entity

Opening stock

10 items @ \$10 = \$100

Purchases

5 items @ \$15 = \$75

Sold 9 items during non-membership period @ \$20 = \$180.

Assuming FIFO basis of accounting.

Closing stock

[1 item @ \$10] plus

[5 items @ \$15] = \$85

### Trading stock integrity measure New Division 701A

- If an entity becomes a subsidiary member any time on or after 1 July 2002, and was majority owned from 27 June 2002 until the entity became a subsidiary member of the group, the entity is a 'continuing majority-owned entity'
- Trading stock will be treated as a retained cost base asset (rather than a reset cost base asset) for head company core purposes

Consolidation – Core rules

www.ato.gov.au

Section 701-30 applies such that the joining entity must work out taxable income as if the period were the start and end of the income year. Subsection 701-35(4) states that the value of closing stock is:

- if on hand at the start of the income year – the asset's value at that time (1 item @ \$10), or
- in any other case – the amount of outgoing incurred by the entity in connection with the acquisition of the asset (5 items @ 15 = \$85 in total).

The assessable income of the joining entity will include \$180 (sales) and allowable deductions would be purchases of \$75 [section 8-1] and the difference between opening stock and closing stock of \$15 (\$100-\$85) [section 70-35].

Assume that, at the joining time, trading stock has a market value of \$120 and a tax cost setting amount as a result of the 'push-down' of \$110. Assume all the conditions specified in section 701-5 are met.

### **In the absence of the integrity measure:**

Trading stock is a reset cost base asset.

Opening stock in the hands of the head company becomes \$110 [as per subsection 701-55(3)], which is an uplift of \$25 (i.e. \$110 – \$85). This difference has not been assessed in the hands of the joining entity prior to entry.

In addition, the \$110 does not actually represent the 'cost' to the group of acquiring the trading stock. As a result of trading stock having a high market value at the joining time, ACA has been pulled away from other assets into trading stock. By inflating opening stock, revenue gains that would normally be assessed under section 70-35 escape tax. Other assets, however (say capital assets), that come in at the joining time have less ACA allocated to them and will, if and when disposed of, result in a higher capital gain or a lower capital loss being crystallised. However, these types of assets are, in the main, turned-over at a slower pace. Hence the tax deferral.

### **With the integrity measure:**

Section 701-30 applies. The joining entity must work out the taxable income for a non-membership period as if it were the start and end of the income period.

Subsection 701A-5(2) states that for the entity core purposes, subsection 701-35(4) doesn't apply (no need to apply because normal trading stock provisions, coupled with the fact that closing stock in the hands of the joining entity just before consolidation will equal opening stock in the hands of the head company, operate to ensure tax neutral consequences).

Closing stock will be determined in accordance with trading stock provisions [section 70-45 etc]. Closing stock is valued at cost under section 70-45 (@ \$85 as above).

The difference between closing stock and opening stock (\$15) is deductible under section 70-35.

Purchases (\$75) are deductible under section 8-1.

Assessable income of the joining entity for the non-membership period will include sales of \$180.

At the joining time, trading stock in the hands of the head company is treated as a retained cost base asset. In accordance with subsection 701A-5(3), the tax cost setting amount for trading stock will be the closing stock as valued in the hands of the joining entity. As such, opening stock will be given a tax cost setting amount of \$85 in the hands of the head company.

Assuming no purchases and no sales during the remainder of the income year, the closing stock is valued by the head company in accordance with section 70-45 @ \$85 (being cost). As closing stock equals opening stock, no amount is included in assessable income or allowed as a deduction under section 70-35.

## Session outline

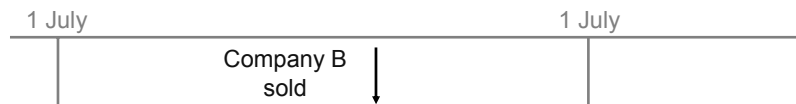
### Application of the core rules on entry into a group:

- head company's perspective
- subsidiary member's perspective

### ▶ Application of the core rules on exiting a group

### Other core rules provisions

## Core rules – impact on head company when entity leaves group



1. Leaving entity's membership interests are aligned with assets taken by it (section 701-15)
2. Cost to head company of liabilities owed by leaving entity to group (section 701-20)
3. Assets taken out are tax-neutral for head company (section 701-25)
4. Exit history rule applies

**Presenter note:** These four dot points are discussed in more detail in the slides that follow.

The entity may have to leave because:

- it ceases to satisfy the requirements to be a subsidiary member, or
- the head company ceases to satisfy the requirements to be a head company.

## 1. Cost of membership interests

- For head company core purposes (i.e. CGT consequences of disposing of membership interests in subsidiary)
- Membership interests are again recognised just before leaving
- Cost is calculated by reference to the head company's cost for the net assets taken out by the leaving entity
- Tax cost of membership interests is set at 'tax cost setting amount' (section 701-60)

During consolidation any membership interests between members of a consolidated group are ignored under the single entity principle. When a subsidiary member leaves a consolidated group, at that time the head company recognises its membership interest in the exiting entity.

The cost of these membership interests = cost of the leaving entity's assets less its liabilities.

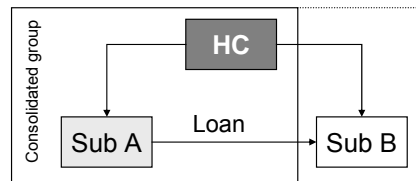
The cost of membership interests is calculated in accordance with the table in section 701-60 – 'tax cost setting amount' (not applicable where a consolidated group joins another consolidated group – Subdivision 705-C).

The table in section 701-60 directs us to section 711-15 (tax cost setting amount where no multiple exit) or section 711-55 (tax cost setting amount for membership interests where multiple exit). The table also outlines that market value is to be attributed to any liabilities owed by the leaving entity to the head company or owed by the head company to the leaving entity.

**Tax cost setting amount**  
(section 701-60)

<b>If tax cost set by:</b>	<b>Tax cost setting amount:</b>
1 cost to head company of asset brought in	go to Division 705
2 cost to head company of membership interests in leaving entity	go to section 711-15 or section 711-55
3 cost to head company of assets being liabilities owed within group by leaving entity (or of liabilities owed to leaving entity)	market value of asset
4 cost to head company of membership interests held by leaving entity	go to section 711-55

## 2. Liabilities owed to group by leaving entity (section 701-20)



- Subsidiary member B leaves consolidated group with a liability owing to a member of the group
- The liability is recognised for income tax purposes as an asset of HC just before the time it leaves
- The 'tax cost setting amount' of this asset is set at its market value at the leaving time (section 701-60)

Where a subsidiary member leaves a consolidated group with a liability owing to a member of the group, the liability is recognised for income tax purposes as an asset of the head company just before the time it leaves.

The asset would not be recognised while the entity was a group member because intragroup transactions are ignored under the single entity rule.

The cost for income tax purposes of such an asset at the time the subsidiary leaves is set at its market value at that time [see the table in section 701-60].

### 3. Tax neutrality when entity leaves group (section 701-25)

- No income tax consequences for the head company because outgoing assets cease to be taken to be its assets (i.e. no disposal)
  - **Exception:** Where a leaving entity provides services (e.g. loan, lease) for a remaining member of the group (section 701-75)
- Where an entity leaves with trading stock, the head company must value the trading stock on a tax neutral basis (section 701-25)

Consolidation – Core rules

www.ato.gov.au

#### Refer to section 701-25.

Refer to note at subsection 701-25(3) – no CGT or other tax consequences to the head company from ceasing to hold assets (other than trading stock) when an entity leaves the group.

- **Exception:** Where a leaving entity provides services (e.g. loan, lease) for a remaining member of the group (or vice versa), special rules ensure that the income tax positions of the entities are aligned to prevent any imbalance being preserved after identities merge or separate [sections 701-70 and 701-75]. This will be discussed later.

#### Trading stock

Section 701-25 applies if:

- the asset is 'trading stock' of the head company, and
- the single entity rule ceases to apply because the entity ceases to be a subsidiary member of the group, and
- the asset is not again an asset of the head company at or before the end of the income year.

If the above conditions are met then the closing stock on hand of the head company in respect of the asset is taken to be at a tax neutral amount. This is achieved under subsection 701-25(4) by ensuring that the trading stock that leaves with the entity is taken to be trading stock of the head company at the end of the income year (but not at the start of the next income year) and its value is taken to be equal to:

- if the asset was trading stock of the head company at the start of the income year (including as a result of tax cost being set) – the asset's value at that time, or
- natural increase of livestock – cost, or
- in any other case – the amount of the outgoing in acquiring that asset

plus any further outgoing that forms part of the cost of the asset that was incurred by the head company.

In effect, this provision ensures that the head company does not obtain a tax deduction for the same trading stock brought into the group and which leaves the group during the same income year. Accordingly, an adjustment to the closing stock of the head company is required to give a tax neutral outcome. However, this adjustment to the closing stock figure of the head company does not carry forward to the next income year.

For example, if at the joining time Company A brings the only trading stock into the group with a tax cost setting amount of \$10,000, this trading stock forms the opening stock for the head company under subsection 701-55(3). If the same trading stock were to leave during the same income year and not return at or before the end of the income year, then in effect the closing stock on hand for the head company would be nil and the head company would be able to claim a deduction of \$10,000 under subsection 70-35(3). To rectify this position, paragraph 701-25(4)(a) would apply to this trading stock and value the closing stock of the head company at \$10,000 (although there are physically no units on hand), resulting in a tax neutral outcome. Furthermore, as there is no trading stock physically on hand at the end of the income year for the head company, we do not carry forward the amount of \$10,000 to the start of the next income year.

#### 4. Exit history rule (section 701-40)

- For the entity core purposes
- When an entity leaves the group taking with it an asset, liability or business
- Everything that happened to the asset etc. in the hands of the head company is taken to have happened as if it had been an asset etc. of the entity
- This includes anything that 'happened' by virtue of the entry history rule

Refer section 701-40 to discuss the points in this slide.

- Where a subsidiary member leaves a consolidated group the entity takes with it the history in relation to the assets, liabilities and businesses that cease to be part of the head company as a consequence of its leaving.
- The exit history rule is narrower than the entry history rule as it only applies to assets, liabilities and businesses.
- It is necessary to link the exit history to the assets, liabilities and business that leaves the group. Cannot take on all of the head company's history.
- Interpretive problems
  - *What type of link to an asset, liability or business do you need?*
  - *What is a business?*

CGT: Pre-CGT status of assets maintained by entry and exit history rules.

Note: tax attributes such as losses, franking credits and foreign tax credits cannot be taken out of the group.

## **Exercise 5**

Core rules – entry & exit history rule

Consolidation – Core rules

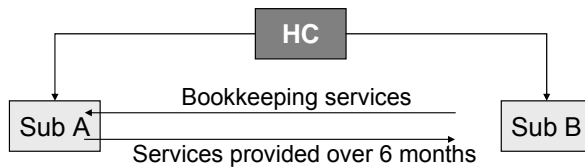
[www.ato.gov.au](http://www.ato.gov.au)

Exercise 5 handout.

Allow 15–20 minutes.

The exercises are located in the *Training pack*, the solutions in the *Presenter's pack*.

## Pre-existing and ongoing arrangements



- Sub A pays Sub B \$10,000 for book services on 1 July 2002, service to be provided over the next six months
- Group consolidates on 1 August 2002

### Exceptions to the core rules: Adjustments for pre-existing arrangements

Ongoing arrangements of various kinds involving income and expenditure can exist between a consolidated group and an entity that becomes a subsidiary member or ceases to be a subsidiary member of the group.

These arrangements, which can straddle the joining or leaving time, are disregarded for income tax purposes while the entity is a subsidiary member of the group. Accordingly, specific provisions are required to ensure that the appropriate amount of assessable income and deductions are brought to account under such arrangements.

- Section 701-70 (parties merge on joining) and section 701-75 (parties re-emerge on leaving).

#### Example

Both Sub A and Sub B are required to lodge returns for the 2003 income tax year. The returns will include income and deductions relevant to the period in that year that they were not part of a consolidated group.

- Sub A: Incurred cost of \$10,000 (fully deductible on 1 July 2002)
- Sub B: Returns \$1,685 as income on an accrual basis as follows:

$$\frac{(1 \text{ July} - 31 \text{ July})}{(1 \text{ July} - 31 \text{ December})} = \frac{31}{184} \times \$10,000 = \$1,685$$

After consolidation, intragroup transactions are ignored (single entity rule applies), therefore the remaining amount of income of \$8,315 for the period 1 August 2002 to 31 December 2002 is ignored for income tax purposes, which provides a permanent mismatch.

So how does section 701-70 rectify this mismatch?

## **Application of section 701-70 – Sub A**

**Step 1:** Does section 701-70 apply?

- When Sub A joined the group, was there an arrangement in force under which:
  - expenditure is to be or has been incurred for the doing of something, and
  - any other party to the agreement joined the group at the same time or was the head company?

**Answer:** Yes

## Application of section 701-70 – Sub A

**Step 2:** Is the deduction for the 'joining adjustment year' and all earlier years greater or less than the amount worked out in subsection 701-70(4)?

- Look at subsection 701-70(3) to determine the 'joining adjustment year'
  - In this case the joining adjustment year equates to the pre-consolidation period (1.7.2002 to 31.7.2002)
- Total deduction for Sub A in the joining adjustment year and all earlier years is \$10,000

## Application of section 701-70 – Sub A

**Step 2:** Is the deduction for the 'joining adjustment year' and all earlier years greater or less than the amount worked out in subsection 701-70(4)?

$$\begin{aligned} &= \text{Pre-joining time} \quad \times \quad \text{Total arrangement} \\ &\quad \text{services proportion} \quad \quad \quad \text{deductions} \\ &= \frac{31 \text{ days}}{184 \text{ days}} \quad \times \quad \$10,000 \\ &= \quad \quad \quad \mathbf{\$1,685} \end{aligned}$$

Therefore the total allowed in joining adjustment years (\$10,000) is greater than the amount worked out in subsection 701-70(4)

## Application of section 701-70 – Sub A

### **Step 3:** Adjustment required (subsection 701-70(3)(c) & (d))

- As the deduction allowed in the joining adjustment year and all earlier years (\$10,000) is greater than the amount calculated under subsection 701-70(4) (\$1,685), the difference is added to Sub A's assessable income for the joining adjustment year
  - i.e.  $(\$10,000 - \$1,685) = \$8,315$  included in Sub A's assessable income in the 2003 income year

## **Application of section 701-70 – Sub B**

**Step 1:** Does section 701-70 apply?

- When Sub B joined the group, was there an arrangement in force under which:
  - income is to be or has been derived for the doing of something, and
  - any other party to the agreement joined the group at the same time or was the head company?

**Answer:** Yes

How does the provision apply to Sub B?

## Application of section 701-70 – Sub B

**Step 2:** Is the income for the 'joining adjustment year' and all earlier years greater or less than the amount worked out in subsection 701-70(6)?

- Look at subsection 701-70(5) to determine the 'joining adjustment year'
  - In this case the joining adjustment year equates to the pre-consolidation period (1.7.2002 to 31.7.2002)
- Total income for Sub B in the joining adjustment year and all earlier years is \$1,685

## Application of section 701-70 – Sub B

**Step 2:** Is the income for the 'joining adjustment year' and all earlier years greater or less than the amount worked out in subsection 701-70(6)?

$$\begin{aligned} &= \text{Pre-joining time} \quad \times \quad \text{Total arrangement} \\ &\quad \text{services proportion} \quad \quad \quad \text{assessable income} \\ &= \quad \frac{31 \text{ days}}{184 \text{ days}} \quad \times \quad \$10,000 \\ &= \quad \mathbf{\$1,685} \end{aligned}$$

As the amount of assessable income returned by Sub B (\$1,685) equals the amount worked out in subsection 701-70(6), there is no adjustment

## Session outline

### Application of the core rules on entry into a group:

- head company's perspective
- subsidiary member's perspective

### Application of the core rules on exiting a group

- ▶ Other core rules provisions

### **Subsidiary member for only part of income year** (section 701-30)

- Applies when an entity is:
  - a subsidiary member of the group for only some of the income year, and
  - there are some non-membership periods during which the entity is not a subsidiary member of a consolidated group
- Requires the entity to:
  - calculate, for each non-membership period, the taxable income etc. for the period as if it were the start and end of an income year
- No netting off between two non-membership periods

The object of the section is to ensure that where an entity is not part of the group for periods during the income year, the entity core rules apply to each of the periods separately with no netting off between them.

The rule is required because the entity, on becoming a subsidiary member of a group, ceases to be a taxpayer in its own right.

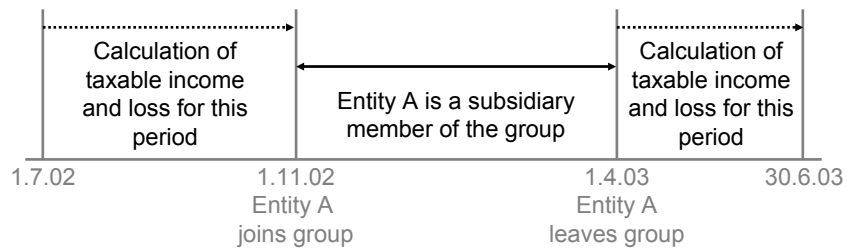
Both requirements must be met for the section to apply. If the entity transfers straight from one consolidated group to another the section does not apply.

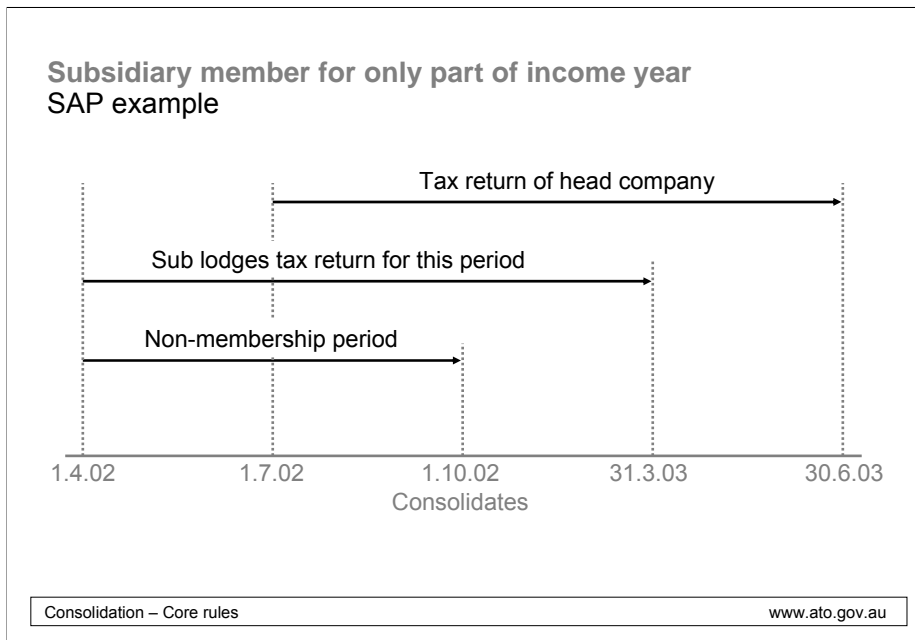
For each non-membership period the notional figures for the taxable income, income tax payable and any losses of each sort are worked out as if the start and end of the period were an income year. The tax liability for the financial year is calculated by adding the notional income tax liability figures for each period rather than referring to taxable income for the whole year.

**Note:**

- The head company of a group continues to be a taxpayer in its own right even after formation of the group. For this reason the above rules do not apply to a head company unless it becomes a subsidiary member of a consolidated group.
- The entity only has a loss of a particular sort if a non-membership period ends at the end of the income year. This is because losses accrued in previous periods are transferred to the head company of the joined group.

## Subsidiary member for only part of income year Example





This example shows how the provision works for a subsidiary member that uses a substituted accounting period (SAP):

- 30 June balancing head company
- 31 March subsidiary for the next 30 June (early balancer)
- consolidates on 1 October 2002.

In the example the subsidiary member has a substituted accounting period from 1.4.02 until 31.3.03.

The non-membership period for the subsidiary under section 701-30 is the period from 1.4.02 until 30.9.02.

The tax return lodged by the subsidiary will be for the period 1.4.02 – 31.3.03, however in calculating the taxable income for the subsidiary only the non-membership period will be relevant.

While the subsidiary is a member of the consolidated group it is not a taxpayer but part of the head company, and so does not have any taxable income for the period 1.10.02 – 30.6.03.

The head company will calculate its taxable income by referring to the period from 1.7.2002 to 30.6.2003.

### Subsidiary member for only part of income year (section 701-30)

- In working out taxable income/loss for the entity, other provisions may apply, such as:
  - Section 701-40 (exit history rule)
  - Subdivision 716-A (about assessable income and deductions spread over several membership or non-membership periods)
  - Section 716-850 (about grossing up threshold amounts for periods of less than 365 days)

#### Exit history rule:

- already been discussed in previous slides.

In today's session we will only be reviewing the basic operation of Subdivision 716-A. Section 716-850 will not be discussed.

#### Subdivision 716-A:

- The existing provisions in section 701-30 split income and deductions between an entity that joins or leaves a consolidated group part-way through an income year and the head company, but only deal with amounts that are brought to account when they are derived or incurred (i.e. at one single moment). They do not deal with amounts that are brought to account over a period. These amendments address those 'period' cases.
- For example: If a subsidiary entity is deducting a prepaid amount over two years, section 701-30 does not deal with what happens if the entity joins a consolidated group in the second of those years.
- The amendments divide such spread amounts between the entity that joins or has left a consolidated group and the head company. This is done for four particular cases (see next slide)

#### Note:

- All amounts in this Subdivision are brought to account over a period by a provision of the Act (i.e. a provision of the Act would spread an amount over two or more income years).
  - *Arthur Murray*-type amounts of assessable income do not fall within Subdivision 716-A.

### **Subdivision 716-A**

- Applies in four particular cases:
  - assessable income brought to account over two or more years
  - deductions spread over two or more years (excluding depreciation)
  - capital expenditure that is made deductible in a single year, and
  - shares of the net income or loss of a partnership or trust

Note:

- All the amounts in Subdivision 716-A are brought to account over a period by a provision of the Act
- Subdivision 716 also affects the tax position of the head company

Each of these cases deals with an amount that belongs to a period rather than just to a moment (i.e. derived or incurred) within a period.

#### **Spread assessable income:**

- Amounts of an entity's assessable income that are spread over more than one income year are split between the entity and the head company of a consolidated group that it joins or leaves in the year.
- The split is based on how much of the year the entity spent in the group. An example would include a taxpayer who elects to spread over five years the tax profit on disposal of diseased cattle, pursuant to section 385-105 of ITAA 1997.

#### **Spread deductions:**

- Similar outcome to the above.
- An example would include prepaid expenses that are spread over two or more years.
- Note: Deductions for depreciation are NOT covered by the spreading rule for deductions. It is not appropriate to include depreciation across the year because the tax cost of depreciating assets is reset when an entity joins a consolidated group. Accordingly, the head company and the joining (or leaving) entity will instead work out their own depreciation deduction for the part of the year that the asset is theirs.

#### **Capital expenditure:**

- Certain provisions of the Act allow an amount of capital expenditure to be fully deductible in a single income year (e.g. landcare expenditure on primary production land – Subdivision 40-G of ITAA 1997).
- The rule works the same way as for the spreading deduction rules. This way both the entity and the head company would deduct the full amount of the deductible capital expenditure.

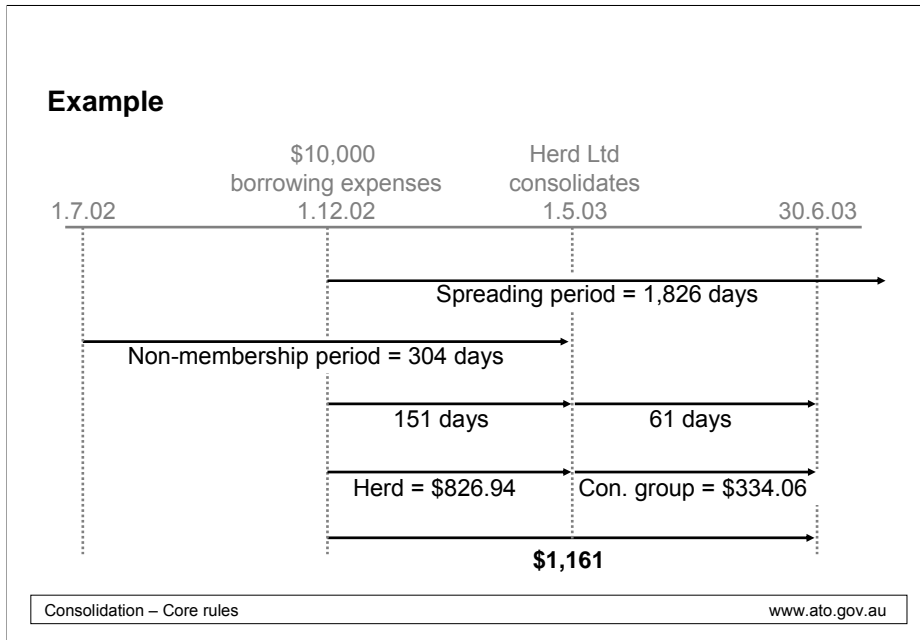
#### **Shares of the net income or loss of a partnership or trust:**

- Not discussed here.

## Example

- Herd Ltd operates a cattle stud
  - On 1 Dec 2002 it borrows \$130,000 for a term of 10 years
  - All the funds are applied to the primary production business
  - Borrowing expenses of \$10,000 were incurred on 1 December 2002 in relation to the loan
- Under section 25-25 of ITAA 1997, the period of the loan is taken to be five years and Herd is taken to deduct the full amount of borrowing expenses over this period
- On 1 May 2003, Herd Ltd joins a consolidated group headed by Farm Ltd
- As the borrowing expense is deductible over more than one income year, the spreading rules apply to split the deduction between Herd Ltd and Farm Ltd

Since the borrowing expenses give rise to deductions that are spread over two or more income years, Herd Ltd and Farm Ltd need to work out the amount of their deductions under Subdivision 716-A – more specifically, section 716-25.



**What is Farm Ltd’s deduction for the 2002-03 income year?**

Subsection 716-25(3) provides that Farm Ltd can deduct a proportion of the 2002-03 deduction for the borrowing expenses. The proportion is worked out under subsection 716-25(3) by reference to the part of the original amount of \$10,000 and the spreading period.

The part of the original amount is the maximum deduction for borrowing expenses for the 2002-03 income year. Herd’s maximum deduction under section 25-25 is worked out as follows:

$$\$10,000 \times 212/1,826 = \$1,161$$

Under subsection 716-25(7) the spreading period is the five-year period beginning 1 December 2002 and ending 30 November 2007 – this is the period by reference to which deductions are spread by section 25-25.

Under subsection 716-25(3) the proportion deductible to Farm Ltd is:

$$\$1,160 \times 61/212 = \$334.06$$

The 61 days represents the number of days in both the income year and the spreading period for which Herd was a subsidiary member of the consolidated group.

The 212 days represents the number of days that are in both the income year and the spreading period.

**What is Herd Ltd’s deduction for the 2002-03 income year?**

Subsection 716-25(5) provides that Herd can deduct a proportion of the 2002-03 deduction for the borrowing expenses. Under subsection 716-25(6) the proportion deductible to Herd is:

$$\$1,160 \times 151/212 = \$826.94$$

The 151 days represents the number of days that are in both the non-membership period and the spreading period.

The 212 days represents the number of days that are in both the income year and the spreading period

**The End**

Any questions?

Consolidation – Core rules

[www.ato.gov.au](http://www.ato.gov.au)

Further information on consolidation is available via the ATO website:  
[www.ato.gov.au](http://www.ato.gov.au)