Consolidation reference manual

Taxing wholly-owned corporate groups as single entities

15 July 2011

Australian Government
Australian Taxation Office

Our commitment to you

We are committed to providing you with accurate, consistent and clear information to help you understand your rights and entitlements and meet your obligations.

If you follow our information in this publication and it turns out to be incorrect, or it is misleading and you make a mistake as a result, we must still apply the law correctly. If that means you owe us money, we must ask you to pay it but we will not charge you a penalty. Also, if you acted reasonably and in good faith we will not charge you interest.

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If correcting the mistake means we owe you money, we will pay it to you. We will also pay you any interest you are entitled to.

If you feel that this publication does not fully cover your circumstances, or you are unsure how it applies to you, you can seek further assistance from us.

Individual sections of this manual are updated from time to time to take account of changes to the law and related administrative arrangements, so make sure you have the latest information. The information in each section is current at the date shown on the bottom right-hand corner of each page. If you are unsure whether you have the latest information, you can check for a more recent version on our website at www.ato.gov.au or contact us.

Proposed changes

Proposed changes to consolidation announced by Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to consolidation).

More information

If you come to us asking for advice or guidance, the levels of protection are set out in **Law Administration Practice Statement PS LA 2008/3 – Provision of advice and guidance by the Tax Office**. A **Guide to Technical Assistance** is available on the ATO website.

For tax technical enquiries and to obtain copies of consolidation products:

- phone the Business Tax Reform Infoline on **13 24 78**
- phone the Tax Agent Infoline on **13 72 86 FKC 25**, or
- look under 'consolidation' at **www.ato.gov.au**

If you do not speak English well and need help from the ATO, phone the Translating and Interpreting Service (TIS) on **13 14 50**.

If you are **deaf** or have a **hearing or speech impairment**, phone the ATO through the **National Relay Service (NRS)** on the numbers listed below, and ask for the ATO number you need:

- TTY users, phone **13 36 77**. For ATO 1800 free call numbers, phone **1800 555 677**.
- Speak and Listen (speech-to-speech relay) users, phone **1300 555 727**. For ATO 1800 free call numbers, phone **1800 555 677**.
- Internet relay users, connect to the NRS at **www.relayservice.com.au**

Foreword

This *Consolidation reference manual* has been designed to provide corporate groups and their tax advisers with an accessible, integrated and up-to-date guide to consolidation for income tax purposes.

Originally issued as a draft to accompany the introduction into Parliament of the consolidation legislation, the manual has been extensively road tested by users. We have drawn on both formal user testing and extensive feedback from the business community to further develop the content and refine the design.

This approach reflects the development of the consolidation measure itself. As a major initiative of the Review of Business Taxation, consolidation has been designed in partnership between the Government and the business community. The involvement of users is fundamental to developing measures that realise the Government's policy intent, are properly integrated into the tax law and are practical in their implementation.

The processes and products outlined in this manual are the tangible representation of that co-design effort. Thank you to the many individuals and firms that have generously given their time to the design process, and in providing feedback generally.

For the Tax Office's part, this manual reflects our continuing efforts to provide taxpayers and their advisers with practical tools and information to help minimise the cost of compliance with the tax law and provide greater certainty in its application.

I am sure you will find this an invaluable guide to understanding and implementing the consolidation regime.

Michael Carmody
Commissioner of Taxation

2 December 2002

About this manual

This *Consolidation reference manual* provides business managers and their tax advisers with a users' guide to consolidating corporate groups for income tax.

The manual is published in three parts:

- Part A – Contents and Glossary
- Part B – overview for business managers and tax practitioners with cross-references to detailed information in Part C
- Part C – detailed technical information for tax practitioners.

Steps in the consolidation pathway (Part B) are colour-coded to link with the detailed information (Part C).

Getting started

If you are reading about consolidation for the first time, a good place to start is the 'Key points' at the beginning of Part B: 'Consolidation pathway'.

Referencing

The symbol → is used throughout the manual to indicate a reference to more information in another section of the manual or to the consolidation legislation – for example:

→ 'Paying PAYG instalments', B3-2

The references to consolidation legislation refer to elements of the *Income Tax Assessment Act 1997*, *Income Tax Assessment Act 1936, Income Tax (Transitional Provisions) Act 1997* and other Acts affected by the consolidation legislation – for example:

→ section 707-310, *Income Tax Assessment Act 1997*

→ section 170-45, *Income Tax (Transitional Provisions) Act 1997*

To make it easier to find the relevant legislative source, the lists of references at the end of each section in Part C cite both the relevant element of the amended Acts and the corresponding piece of consolidation legislation – for example:

- *Income Tax Assessment Act 1997*, section 707-310; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *Income Tax (Transitional Provisions) Act 1997*, section 170-45; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 12

Revision history

Every page of the *Consolidation reference manual* has a currency date in the bottom right corner. The detailed table of contents (→ A1) lists the currency date of each section.

At the end of each section there is a revision history explaining when that section was first published and what updates (if any) have been published.

The manual itself was originally published (excluding drafts) in December 2002. Subsequent updates have been published on the internet (see 'Updates') and were most recently consolidated into a single electronic version of the manual on 15 July 2011.

Updates

The manual is updated as more consolidation information becomes available, and you should make sure you have the latest information.

Updates of individual sections are published on the ATO website at:

> **www.ato.gov.au** (search for 'consolidation updates')

Updates are periodically consolidated into a single electronic document, which is also published on the ATO website.

How do I keep my print version up to date?

If you have a printed copy of the manual, you can keep it current by downloading, printing and inserting updated sections.

The main table of contents (section A1) is the key. It lists the currency date of every section of the manual, so any time a section is updated, the contents is also updated.

Go to the ATO website (**www.ato.gov.au** – search for 'consolidation updates') and check the currency date of the contents (section A1). Compare it to the currency date of the contents in your print version (the currency date is in the bottom right corner of the page).

- If the website has a later version of the contents than the copy in your manual there are updated sections you don't have. Download, print and insert the sections (including the contents itself) that are dated later than your copy of the contents.
- If the website version of the contents has the same date as your version, you should be up to date.

Email updates and RSS news feeds

Once your print version is up to date, you can arrange to be notified of updates by subscribing to the ATO's email updates or RSS news feed services. On the ATO website home page, click on 'Subscribe', then follow the instructions. For RSS news feeds, select the category 'ATO – corporate'. For email updates, select the category 'Large corporates and multinationals'. When anything in the relevant parts of the website changes – including consolidation – you'll receive a news feed or email alert with a link to the new information.

Status

This edition of the *Consolidation reference manual* supersedes all previous editions and the *Consolidation guidelines for corporate groups* (the latter was published in February 2002 to accompany an exposure draft of consolidation legislation).

The information in the manual is based on enacted law. Where appropriate, notes are inserted in the relevant sections of the manual alerting users to the potential impact of proposed legislation and government policy. Further information on proposed changes to consolidation legislation can generally be found at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Consolidation and integrated tax design

Process

The Review of Business Taxation (1999) strongly recommended a more integrated design process for developing tax measures.

Accordingly, the consolidation project sought to design systems and rules that respond to both the measure's policy intent and user needs. This process included:

- interdisciplinary teams to undertake the various tasks associated with designing and delivering changes to the tax system
- user-centred design, which requires an early focus on users and the formal testing of product prototypes
- co-designing change with the community, and
- adopting a disciplined but flexible approach to design.

Steps were taken to ensure that all project team members had a shared understanding of Government policy intent. The Government's intent was clearly documented and subject to formal change control procedures.

Blueprint

An interdisciplinary team was formed to create a blueprint of the overall design for the consolidation measure, including its integration with the broader suite of products and services for this group of users. This blueprint was used to facilitate formal decision-making processes within the Treasury and ATO and to talk with members of the community about the practical implications of the proposed design. The blueprint included the 'consolidation pathway' (→ 'Consolidation – key points and pathway', B0-1), on which the structure of this manual is based.

Co-design

Joint design teams and focus groups were established to work with the ATO to co-design the processes and products required to give effect to the Government's policy intent. These teams/groups comprised representatives from the business community, professional bodies representing accounting and legal advisers to business, the Treasury and the ATO.

Testing products

Iterative testing and refinement of prototype products is a key feature of the product development process that is being used for consolidation products, including this manual.

Revision history

This section first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
23.12.03	Amendments to clarify status of manual and publishing/updating process.	Proposed changes to consolidation not included in manual until such time as they become law. Updates to manual published electronically, not in print.
14.7.04	Amendments to clarify status of manual.	Alert notes included in sections affected by recently enacted legislation or proposed changes to consolidation rules.
26.10.05	Changes to table of legislation and publishing details.	To reflect legislative program and current publishing practice.
30.6.09	Delete tables of amending legislation.	Tables designed to show legislative program during introduction of consolidation.
15.7.11	Cyclical update of the publication date of a new single electronic version of the CRM. Update the procedures associated with clients receiving e-mail updates and RSS feeds. Remove the reference to the CRM Index.	Amendment to reflect the publication of a new single electronic version of the CRM and the removal of the Index.

Proposed changes to consolidation

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A: Contents and glossary

Summary contents

Detailed contents

Current version:

Part C Detailed information

Current version:

C3 Losses

Current version:

The *Consolidation reference manual* has been designed for easy updating as new information becomes available. This means there are 'gaps' in the numbering sequence where sections have been reserved for future information.

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Glossary

Abbreviations

ABN	Australian business number
ACA	allocable cost amount
ADF	approved deposit fund
ADI	authorised deposit-taking institution
AF	available fraction
APA	advance pricing arrangement
ATO	Australian Taxation Office
CFC	controlled foreign corporation
CGT	capital gains tax
COT	continuity of ownership test
CTE	chosen transitional entity
ESAS	employee share acquisition scheme
FBT	fringe benefits tax
FDA	foreign dividend account
FIF	foreign investment fund
FLP	foreign life assurance policy
FTC	foreign tax credit
GIC	general interest charge
GST	goods and services tax
GVSR	General value shifting regime
IFRE	interposed foreign-resident entity
IGL	intragroup liability
ITAA	*Income Tax Assessment Act*
IT(TP)A	*Income Tax (Transitional Provisions) Act 1997*
LDB	loss denial balance
LDP	loss denial pool
LIM	loss integrity measures
MEC	multiple entry consolidated (group)
MI	membership interest
MMV	modified market value
MV	modified value
NAL	non-arm's length (transaction)
NCS	non-chosen subsidiary
OBU	offshore banking unit
PAYG	pay as you go
PDF	pooled development fund
PHC	provisional head company
PST	pooled superannuation trust
RCB	reduced cost base
RUNL	residual unrealised net loss
SAP	substituted accounting period
SBT	same business test
STS	simplified tax system
TCSA	tax cost setting amount
TFHS	transitional foreign-held subsidiary
TFN	tax file number
TSA	tax sharing agreement
TV	terminating value
UNL	unrealised net loss

Terms

Adjustable value
A depreciating asset's cost less its decline in value since it was first used, or installed ready for use, for any purpose whether business or private.

Adjusted market value of the consolidated group
The market value of the consolidated group at the joining time, ignoring any losses and assuming a nil franking account balance.

Allocable cost amount
The amount that is allocated to the assets of an entity joining a consolidated group, or to the assets of a member of a consolidated group on formation, to determine the tax costs of those assets at that time. The allocable cost amount reflects the cost to the joined group of acquiring the joining entity. It does not apply where the transitional option of using terminating value has been chosen.

Alteration time
Broadly, an alteration time (within sections 165-115L and 165-115M) occurs just before majority ownership in respect of the company's voting power, dividends or capital distributions is not maintained or there is a change in control of voting power. It can also occur if the liquidator of a company declares that shares in the company are worthless and in certain other situations (see sections 165-115N-Q).

Asset based model
A model developed to design rules for determining the costs for assets brought into a consolidated group and for reconstructing the equity cost base on exit (recommended in *A tax system redesigned*). The cost setting rules are based on this model.

Australian branch of a foreign bank
An Australian branch in relation to a foreign bank means a permanent establishment in Australia through which the foreign bank carries on banking business.

Available amount
The ACA step 2 amount (subsection 705-70(1)) that would be worked out if you ignored both the special rules under section 705-59 for linked assets and liabilities and the accounting standards that apply to them. → subsection 705-59(3)

Available fraction
An available fraction is worked out for each bundle of losses and is used to limit the rate at which transferred losses may be recouped by the head company. The available fraction is the modified market value of the loss entity as a proportion of the adjusted market value of the consolidated group at the joining time.

Bundle of losses
All the losses of a joining entity that are transferred to the head company at the same time.

Cessation event – provisional head company
A cessation event happens to a provisional head company of a MEC group if:

- the company ceases to satisfy the qualifying conditions for being a provisional head company, or
- the company ceases to exist.

Changeover time

Broadly, a changeover time (within sections 165-115C and 165-115D) occurs just before majority ownership in respect of a company's voting power, dividends or capital distributions is not maintained or there is a change in control of voting power.

Chosen transitional entity

An entity for which the head company chooses to retain the existing tax values of assets instead of applying the tax cost setting rules on formation.

Concessional losses

Losses transferred as a result of passing the continuity of ownership test and the control test and that the head company chooses to use over three years. These are subject to the following prerequisites:

- the losses were actually incurred by a company in an income year ending on or before 21 September 1999
- the group consolidates during the transitional period – that is, between 1 July 2002 and 30 June 2004, and
- the loss company joins the consolidated group at the time when the consolidated group comes into existence.

Consolidatable group

A group of entities that is eligible to be consolidated. A consolidatable group consists of a head company and all of the subsidiary members of the group, and will exist providing that there is, in addition to the head company, at least one subsidiary member.

Consolidated group

A head company and all of the subsidiary members of the group (if any).

In general, before a consolidated group can be brought into existence, there must be:

- a consolidatable group in existence, and
- an effective choice made by the head company of the consolidatable group to consolidate the group.

A consolidated group that is formed in this way comes into existence from the date specified in the notice of choice given to the Commissioner of Taxation.

Continuing majority-owned entity

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.

→ subsection 701A-1(1), IT(TP)A 1997

Continuity of ownership test

Broadly, a company satisfies the continuity of ownership test if, from the start of the income year in which a loss was incurred until the end of the income year in which the loss is sought to be deducted, the same individuals have, directly or indirectly (through the continuous holding of the same shares or interests):

- control of more than 50% of the voting power in the company
- rights to more than 50% of the company's dividends, and
- rights to more than 50% of the company's capital distributions.

The rules surrounding the continuity of ownership test in relation to companies are contained in Division 165 of the ITAA 1997. However, in certain circumstances the rules are modified in relation to listed public companies. These modified rules are contained in Division 166 of the ITAA 1997.

Continuity of ownership test (COT) transfer

The transfer of a loss from a company to the head company because the continuity of ownership test is passed and the control test is not failed.

Control test

The control test in relation to companies is contained in section 165-15 of the ITAA 1997. It is failed if a person starts to control the entity's voting power during the period in which the continuity of ownership test is applied for the purposes of gaining a benefit or advantage in relation to the application of the ITAA.

The control test in relation to non-fixed trusts is contained in section 269-95 of Schedule 2F to the ITAA 1936. It is failed if, at any time during the test period, a group commences to control the trust (for example, so it can obtain beneficial enjoyment of the capital or income of the trust).

Cost setting rules

The rules dealing with income tax treatment of assets of subsidiary entities that join or leave a consolidated group. → 'Assets', C2

Debt interest

Debt interest has the meaning given by Subdivision 974-B of the ITAA 1997.

Deferred attribution credit

An attributable taxpayer can elect to defer the timing of an attribution credit that relates to the attribution of an unrealised gain on assets (the notional gain) where a controlled foreign corporation changes residence from an unlisted country to a listed country.

Eligible tier-1 company

A tier-1 company that meets certain requirements as to the ownership of its membership interests.

→ see also 'Tier-1 company', 'New eligible tier-1 members of a MEC group'

Excluded assets

An asset is an excluded asset for consolidation purposes if an amount has been deducted in respect of the asset in working out the allocable cost amount.

Fifty per cent (50%) stake test

This operates in a broadly similar manner in relation to trusts as the continuity of ownership test does in relation to companies. A trust satisfies the 50% stake test if, at all relevant times during the test period:

- the same individuals have fixed entitlements, directly or indirectly, to more than 50% of the income of the trust, and
- the same individuals have fixed entitlements, directly or indirectly, to more than 50% of the capital of the trust (these individuals need not be the same as those who hold fixed entitlements to income).

The rules relating to the 50% stake test are contained in Schedule 2F to the ITAA 1936.

First subsidiary A subsidiary member of the group that holds membership interests in another subsidiary member of the group (second subsidiary). → section 705-145, ITAA 1997

Focal company The company seeking to utilise a loss where special rules for meeting the continuity of ownership test apply to a MEC group. The focal company is the head company of a MEC group at some time in its ownership test period for the loss.

Foreign-owned group → see 'Multiple entry consolidated (MEC) group'

Formation residual unrealised net loss (formation RUNL) A formation RUNL is the amount that would have been a company's residual unrealised net loss just before the time of formation of a consolidated group (e.g. paragraph 715-50(1)(c) and section 715-35)

Formation time When a consolidated group comes into existence.

General modifying rule Each eligible tier-1 company of a MEC group is treated as if it were a part of the head company rather than a separate entity.

General value shifting regime (GVSR) The GVSR consists of direct value shifting rules and indirect value shifting rules that impact primarily on equity and loan interests in companies and trusts. The GVSR will generally apply to arrangements that materially change the market value of interests in entities. → Divisions 723, 725, 727; and Subdivisions 715-G, 715-H & 719-T

Group losses Losses that have been generated by the consolidated group.

Head company – consolidated group A head company must be an Australian-resident company that has all or some of its taxable income taxed at a rate that is or equals the general company tax rate. It cannot be a prescribed dual resident or a subsidiary member of a consolidatable or consolidated group. A head company also cannot be a company that receives special tax treatment relative to an ordinary Australian-resident company (examples of such companies include tax exempt companies, certain credit unions, pooled developments funds (PDFs) and film licensed investment companies). However, a non-profit company can be a head company.

Head company – MEC group An eligible tier-1 company that has been nominated by all other eligible tier-1 companies of the MEC group to be the provisional head company of the group, and in which no membership interests are held by other members of the group. The provisional head company at the end of the income year is taken to have been the head company of the MEC group for the income year or for the period the MEC group was in existence.

→ see also 'Provisional head company', 'Multiple entry consolidated (MEC) groups'

Joining entity Any eligible entity that joins a consolidated group.

Joining time The time a joining entity becomes a member of a consolidated group.

Leaving entity A member of a consolidated group that ceases to be eligible to be a member of that group and so automatically leaves the group.

Leaving residual unrealised net loss (leaving RUNL) A leaving RUNL is the amount that would have been the head company's residual unrealised net loss at the time an entity leaves a consolidated group (e.g. paragraph 715-95(1)(e) and section 715-35).

Leaving time The time at which a leaving entity ceases to be eligible to be a member of a particular consolidated group.

Linked assets and liabilities A set of linked assets and liabilities consists of at least one asset and at least one liability that the accounting standards or statements of accounting concepts require to be:

- set-off against each other in preparing an entity's statements of financial position, and
- presented in that statement as a net amount.

→ subsection 705-59(2)

Linked entities Entities that are linked through membership interests (and at least one of them is linked with an existing consolidated group) and join the consolidated group at the same time because of an event that happens to one of them.

Loss → see 'Sort of loss'

Loss denial pool A loss denial pool of the head company may be created at the formation or joining time (section 715-60). Loss denial pools of a leaving entity can also be created at the leaving time (section 715-110 and section 715-135).

Loss integrity measures (LIM) The loss integrity measures deal with the realised and unrealised losses of companies (see Subdivisions 165-CC and 165-CD of the ITAA). These measures address loss duplication where there is a change in ownership or control, and treat unrealised losses of a company in a similar way to realised losses.

Loss reduction method Broadly, the loss reduction method applies to certain interests in consolidated and MEC groups to which Subdivision 165-CD and the general value shifting rules cannot apply on their normal terms. Losses on such interests are generally denied. → Subdivisions 715-H & 719-T

Majority owners A person or persons are the majority owners of an entity if they beneficially own, directly or indirectly through one or more interposed entities, more than 50% of the market value of all the membership interests in the entity.
→ subsection 701A-1(2), IT(TP)A

Market value of reset interests (for pooling purposes) The market value of reset interests in a trigger company is the market value of all reset interests (just before trigger time). → subsection 719-570(1), ITAA 1997

Market value of a MEC group (for pooling purposes)

Where each eligible tier-1 company that is a member of the group just before the trigger time is a trigger company, the market value of the group is the sum of the market values (just before the trigger time).

Otherwise, the market value of the reset interests as a whole (including the market value of synergies arising from the combination of those interests) just before the trigger time is more than nil.

→ subsection 719-570(1) and paragraph 719-555(1)(c)

Member of a group

An entity is a member of a consolidated group, consolidatable group or MEC group while the entity satisfies the conditions for being either the head company or a subsidiary member of that group. → see also 'Subsidiary member of a consolidated or consolidatable group', 'Subsidiary member of a MEC group'

Members of entities

The following table shows the members of various entities.

Entity	Member
Company	a member of the company or a stockholder in the company
Partnership	a partner in the partnership
trust (except a corporate unit trust or a public trading trust)	a beneficiary, unitholder or object of the trust
corporate unit trust	a unitholder of the trust
public trading trust	a unitholder of the trust

If two or more entities jointly hold interests or rights that give rise to membership of another entity, each of them is a member of the other entity.

An entity is not a member of another entity merely because it holds interests or rights in that other entity that are debt interests.

Membership interest held continuously

A membership interest is continuously held where the beneficial owner of the particular membership interest has been the same entity from the time that interest was first acquired to the specific reference date. There are some exceptions to this principle.

Membership interest in an entity

For the purposes of determining whether an entity is a wholly-owned subsidiary of the head company, the term 'membership interest' means each interest or set of interests in the entity or each right or set of rights in relation to the entity that makes one a member of the entity. Membership interests do not include interests held solely as a debt interest.

Modified market value

The modified market value of a joining entity is its market value, assuming:

- the entity has no losses and the balance of its franking account is nil
- the subsidiary members of the group at the joining time are separate entities and not divisions or parts of the head company at the joining time
- the entity's market value did not include an amount attributable to a membership interest in a member of the group that is a corporate tax entity or an entity that transferred losses to the head company, and

- a trust (other than a corporate tax entity or a trust with losses) contributes to the joining entity's market value only to the extent attributable to fixed entitlements (at joining time) to income or capital of the trust that is not attributable (directly or indirectly) to membership interests in another member of the group that is a corporate tax entity or a trust with losses.

Multiple entry consolidated (MEC) group

Where two or more eligible Australian-resident companies (and their wholly-owned subsidiaries, if any) are wholly owned by a common foreign parent company, and do not have a common Australian parent company, they may choose to form a multiple entry consolidated (MEC) group. A MEC group is treated as a consolidated group for income tax purposes.

New eligible tier-1 members of a MEC group

A company will be a member of a MEC group as a new eligible tier-1 company if:

- after the MEC group is formed it becomes an eligible tier-1 company of the top company, and
- the provisional head company of the MEC group notifies the Commissioner of Taxation that the company is to become a member of the MEC group.

In some circumstances there may be additional requirements for the company to become a new eligible tier-1 member of a MEC group.

→ see also 'Eligible tier-1 company', 'Tier-1 company'

New head company

→ see 'Old head company / new head company'

Non-chosen subsidiary

Subsidiary members of a transitional group at the formation time that are not chosen transitional entities. → see also 'Chosen transitional entity'

Non-share equity interest

An equity interest in a company that is not solely a share.

Non-trigger companies

Eligible tier-1 companies that are members of a MEC group but are not trigger companies.

Notifiable events for a MEC group

An event about which an entity is required to notify the Tax Office in the approved form – for example:

- an entity becomes a member of a MEC group
- an entity ceases to be a member of a MEC group
- a cessation event happens to the provisional head company of a MEC group → section 719-80, ITAA 1997
- a MEC group is formed by a special conversion event → section 719-40, ITAA 1997.

Old head company/new head company

A MEC group has an old head company and a new head company where a company is the head company of a MEC group at the end of an income year and a different company is the head company of the group at the start of the next income year (the transition time). → section 719-85, ITAA 1997

One in, all in

Where a head company elects to form a consolidated group, all entities that qualify as subsidiary members must be included in the consolidated group from the time that the group forms or at their joining time. However, special rules apply to MEC groups.

Over-depreciation of an asset

An asset is over-depreciated at a particular time if there has been some depreciation (i.e. a reduction in its adjustable value) and its market value exceeds its adjustable value. The amount of over-depreciation of the asset is the excess of its market value over its adjustable value or the excess of its cost over adjustable value, whichever is greater.

Pattern of distributions test

A test that may need to be satisfied by certain non-fixed trusts before they can recoup tax losses. The rules relating to the pattern of distributions test are contained in Schedule 2F to the ITAA 1936.

Pooled cost amount

The sum of the cost bases of the reset interests in all the eligible tier-1 companies just before the trigger time.

Pooled interest

Broadly, a membership interest in an eligible tier-1 company of a MEC group held by an entity that is not a member of the group.

Pooling

The process whereby the cost base or reduced cost base of pooled interests is calculated when a trigger event occurs.

Potential MEC group

A potential MEC group derives from one or more eligible tier-1 companies of a top company and consists of those eligible tier-1 companies and all the eligible resident entities that are wholly-owned subsidiaries (if any) of those eligible tier-1 companies.

Pre-CGT factor

A factor attached at the joining time to each asset that is not a current asset to preserve the pre-CGT (capital gains tax) status of membership interests of a member while the member is in a consolidated group. At leaving time, the number of membership interests to be treated as pre-CGT interests are worked out in reference to the pre-CGT factor.

Pre-CGT factor asset

Any non-current asset that has a pre-CGT factor attached to it.

Provisional head company

An eligible tier-1 company of the top company that is jointly appointed by all other eligible tier-1 companies of the MEC group and in which no membership interests are beneficially owned by another member of the group. The provisional head company at the end of the income year is taken to have been the head company of the MEC group for the income year or for the period the MEC group was in existence. → see also 'Head company – MEC group', 'Cessation event – provisional head company'

Relationship test
The loss company and the income company must be in existence and members of the same wholly-owned group during the loss year, the deduction year and any intervening income year.

Reset cost base asset
Any asset that is not a retained cost base asset or an excluded asset.

Reset interests
Each pooled interest for which a cost setting amount is worked out.

Residual unrealised net loss (RUNL)
→ see 'Formation RUNL' and 'Leaving RUNL'

Retained cost base asset
Australian currency (other than trading stock or collectables) or a right to receive a specified amount of Australian currency (other than a right that is a marketable security within the meaning of section 70B of the ITAA 1936) or an entitlement that is subject to a prepayment.

Revenue asset
A CGT asset is a revenue asset if, and only if:

- the profit or loss on disposing of the asset, ceasing to own it, or otherwise realising it, would be taken into account, in calculating assessable income or tax loss, otherwise than as a capital gain or capital loss, and
- the asset is neither trading stock nor a depreciating asset.

→ section 977-50, ITAA 1997

Revenue-like asset
Refers in this manual to three classes of assets:

- trading stock
- depreciating assets
- revenue assets.

Note that trading stock, depreciating assets and revenue assets are referred to in the consolidation legislation as 'assets held on revenue account' and 'revenue etc. assets'. A partly constructed asset that has a limited effective life is a depreciating asset for the purposes of Division 40 of the ITAA 1997.

Same business test
A company that fails the continuity of ownership or control test may nonetheless utilise losses if it passes the 'same business test'. Basically, the same business test is passed if the business an entity carries on during the income year in which it seeks to utilise the loss is the same as the one it carried on immediately before the test time. The rules surrounding the same business test are contained in Division 165 of the ITAA 1997.

Second subsidiary
A subsidiary member of a group whose membership interests are held by a first subsidiary. → section 705-145, ITAA 1997

Segregated exempt assets A life insurance company can segregate assets for the sole purpose of discharging its exempt life insurance policy liabilities (Subdivision 320-H, ITAA 1997). Broadly, segregated assets are assets that support immediate annuity and current pension business and business from constitutionally protected superannuation funds.

Life insurance companies are exempt from tax on amounts of ordinary income and statutory income derived on segregated exempt assets.

Where a consolidated group includes one or more members that are life insurance companies during the income year, the head company is taken to be a life insurance company for the purposes of applying the income tax law.

Single entity rule A consolidation core rule under which the members of a consolidated group are taken to be parts of the head company of the group for certain income tax purposes defined in consolidation legislation.

Sort (of loss) A sort of a loss can be a:

- tax loss
- film loss
- net capital loss.

Special conversion event The conversion of a consolidated group to a MEC group in the following circumstance: if a top company that owns a consolidated group acquires one or more eligible tier-1 companies, the head company of the consolidated group may be able to form a MEC group with the newly acquired company or companies.

Spreading period The period used to work out how certain income and deductions are divided between a head company and a subsidiary member if the law attributes the income or deduction to a period rather than to a particular moment and the entity is in the consolidated group for only part of a year.

→ section 716-25, ITAA 1997

Subdivision 165-CC tagged assets Broadly, a Subdivision 165-CC tagged asset of a company (within the meaning of section 715-30) is a CGT asset taken into account for the most recent changeover time for the company and that is still held by the company, or is a CGT asset covered by paragraph 165-115A(1A)(b) that relates to a Subdivision 170-D amount that has not been recognised by the company before consolidation.

Subdivision 170-D deferred loss These are capital losses and deductions, resulting from some CGT events involving related entities, that are disregarded under Subdivision 170-D.

Sub-group A sub-group is a chosen transitional entity and all non-chosen subsidiaries that the chosen transitional entity holds membership interests in, either directly or indirectly through one or more other entities.

Sub-group membership interests

The sub-group membership interests in relation to the sub-group comprise:

- the membership interests that the chosen transitional entity holds directly in the non-chosen subsidiary and any of the interposed non-chosen subsidiaries, and
- the membership interests that each interposed non-chosen subsidiary holds directly in the non-chosen subsidiary or in any of the other interposed non-chosen subsidiaries.

Subsidiary member of a consolidated or consolidatable group

Broadly, an entity is a subsidiary member of a consolidated or consolidatable group if:

- it is a resident company, trust or partnership
- it is a wholly-owned subsidiary of the head company
- it would/does not effectively gain or lose concessional tax treatment by being a subsidiary member of a consolidated group, and
- any entities that are interposed between it and the head company of the group are subsidiary members (of the group), nominees or certain non-resident entities.

Examples of entities that would effectively gain or lose concessional treatment by being a subsidiary member of a consolidated group include tax exempt entities, certain credit unions, non-profit companies, pooled development funds, film licensed investment companies, non-complying approved deposit funds and superannuation funds and complying superannuation entities.

Subsidiary member of a MEC group

Broadly, an entity is a subsidiary member of a MEC group if it is a:

- tier-1 company other than a tier-1 company that is the head company of the group, or
- resident company, trust or partnership that is a wholly-owned subsidiary of a tier-1 company, and:
  - it would/does not effectively gain or lose concessional tax treatment by being a subsidiary member of the MEC group, and
  - any entities that are interposed between it and the tier-1 company of the group are subsidiary members (of the group), nominees or certain non-resident entities. (Note: additional entity requirements apply where an interposed foreign resident entity is involved.)

Terminating value for a head company

The amount that would need to be received for an asset to result in no tax consequences for the consolidated group as a result of the asset leaving the group via a disposal of membership interests. Terminating value is used to determine the group's cost of the membership interests in the entity that leaves the group, at the leaving time.

Terminating value for a joining entity

The amount that would result in a tax-neutral consequence for the entity ceasing to hold assets when it joins a group. → see also section 705-30, ITAA 1997

Test company The company that is tested to determine whether the continuity of ownership test is passed, where the company seeking to utilise the loss is either the focal company or the company that made the loss because of a COT transfer.

Tier-1 company A company will be a tier-1 company if:

- it is a qualifying wholly-owned Australian resident subsidiary of the ultimate foreign holding company, and
- it is not a wholly-owned subsidiary of a company that is an Australian resident which could be a member of the MEC group.

→ see also 'Eligible tier-1 company' and 'New eligible tier-1 members of a MEC group'

Top company A top company must be a foreign company and must not be a wholly-owned subsidiary of another company other than a company that is a prescribed dual resident.

Transfer tests Before a joining entity can transfer losses to the head company of a consolidated group it must pass modified versions of the existing loss recoupment tests, such as the continuity of ownership test, control test or same business test. These modified tests are referred to as 'transfer tests'. The main modification involves replacing the loss claim year with the trial year. Other modifications relate to the testing points/periods in relation to the same business test. → see also 'Control test', Continuity of ownership test', 'Same business test'

Transferred losses Losses that have been made outside the consolidated group and transferred into the group by an entity when it joins the group.

Transitional entity A transitional entity is one that is a wholly-owned member of a transitional group on or before 30 June 2003 and does not at any time after 1 July 2002 leave the group and then subsequently rejoin.

Transitional foreign-held subsidiary [TFHS] An Australian-resident company that becomes a member of a consolidated or MEC group under the transitional foreign-held membership rules and has some or all of its membership interests directly owned by non-resident entities or their nominees.

Transitional foreign-held indirect subsidiary [TFHIS] An Australian-resident entity that becomes a member of a consolidated or MEC group under the transitional foreign-held membership rules and has some or all of its membership interests owned directly or indirectly by a TFHS and any remaining membership interests by the other members of the consolidated or MEC group or their nominees.

Transitional group Broadly, a transitional group exists under the following circumstances:

- The group comes into existence on 1 July 2002.
- The group comes into existence after 1 July 2002 but before 1 July 2003, and there is at least one transitional entity that becomes a subsidiary member of the group on the day the group comes into existence.
- The group comes into existence during the financial year starting on 1 July 2003, and at least one transitional entity becomes a subsidiary member of the group on the day the group comes into existence.

Trial year
The period starting at the latest of:

- the time 12 months before the joining time
- the time the joining entity came into existence, or
- if the joining entity has been a stand-alone entity since exiting a consolidated group, the time of its exit from that group

and ending just after the joining time.

Trigger company
An eligible tier-1 company in relation to which a trigger event occurs.

Trigger events
An eligible tier-1 company leaving a MEC group or a CGT event happening in relation to one or more reset interests in the company.

Trigger time
The time when an eligible tier-1 company leaves a MEC group or a CGT event happens in relation to a reset interest in the company.

Unused carry-forward losses
The losses that would be available to be utilised by a joining entity if it did not join a consolidated group.

Utilisation tests
In certain circumstances a loss company and an income company must not be prevented from deducting or applying a loss as part of the requirements for transferring losses between members of the same wholly-owned group.

Utilise (a loss)
An entity utilises a loss:

- in the case of a tax loss – to the extent it is deducted from an amount of the entity's assessable income or exempt income
- in the case of a net capital loss – to the extent that it is applied to reduce an amount of the entity's capital gains.

Value donor
A company that is able to donate all or part of its modified market value to a loss company under the transitional concessions surrounding the calculation of the available fraction.

Value shifting
If value is shifted between certain owners' interests then those interests (e.g. cost bases) are adjusted to prevent inappropriate losses or gains from arising when the interests are later realised.

Virtual PST
A virtual pooled superannuation trust. A life insurance company can segregate assets for the sole purpose of discharging its virtual PST liabilities (Subdivision 320-F, ITAA 1997). These segregated assets are together known as a virtual PST. The virtual PST component is included in the complying superannuation class of taxable income of a life insurance company.

Where a consolidated group includes one or more members that are life insurance companies during the income year, the head company is taken to be a life insurance company for the purposes of applying the income tax law. Therefore, the virtual PST component is included in the complying superannuation class of taxable income of the head company.

Wholly-owned subsidiary

An entity is a wholly-owned subsidiary of its holding entity if all the membership interests in it are beneficially owned by:

- the holding entity
- one or more wholly-owned subsidiaries of the holding entity, or
- a combination of the holding entity and one or more wholly-owned subsidiaries of the holding entity.

Special rules allow an entity to be treated as a wholly-owned subsidiary in circumstances that would otherwise prevent the entity from being a wholly-owned subsidiary. For example, in certain circumstances, an entity will be treated as if it were a wholly-owned subsidiary where employee share ownership does not exceed 1% and certain conditions are met; or where there is a non-fixed trust interposed between the entity and the head company. Membership interests do not include interests held solely as a debt interest.

Revision history

Section A2 first published (excluding drafts) 2 December 2002 and updated 28 May 2003. Further revisions are described below.

Date	Amendment	Reason
14.1.04	Revenue-like asset – revise definition to include note that a partly constructed asset that has a limited effective life is a depreciating asset for the purposes of Division 40 of the ITAA 1997.	Section C2-4-530 revised to illustrate treatment of partly constructed assets.
	Insert definitions of transitional foreign-held subsidiary (TFHS) and transitional foreign-held indirect subsidiary (TFHIS).	These terms introduced in extensive revision of section C10-2-120.
14.7.04	Insert definitions of 'available amount' and 'linked assets and liabilities'.	Definitions support revisions to section C2 Assets.
30.6.09	Amend definitions of 'Sort (of loss)' and 'Utilise (a loss)' to reflect new rules for treatment of foreign losses.	Legislative amendment.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

B: **Consolidation pathway**

Consolidation – key points and pathway

- **From 1 July 2002, eligible wholly-owned groups can consolidate – to operate as a single entity for income tax purposes.**

  The head company pays PAYG instalments and self-assesses a single annual income tax liability on behalf of the whole group.

  Consolidation does not affect other tax obligations such as GST, FBT and PAYG withholding.

- **A consolidated group can be formed by a single, Australian-resident head company and all its eligible wholly-owned Australian-resident subsidiaries.**

  The subsidiaries may be companies, partnerships or trusts.

  A foreign-owned group of Australian-resident subsidiaries that do not have a single Australian-resident head company may also be able to form a multiple entry consolidated (MEC) group.

- **Participation is optional but irrevocable.**

  The head company of a consolidatable group makes a choice in writing for itself and all its eligible wholly-owned Australian subsidiaries to be treated as a consolidated group for income tax purposes.

  The head company notifies the ATO of its choice to consolidate by the time it lodges the group's first consolidated income tax return.

  The choice to consolidate generally remains in effect until the head company ceases to be a head company.

  The existence of a consolidated group is not affected by changes in the subsidiary membership from time to time.

- **The consolidation rules replace the grouping provisions for wholly-owned groups.**

  Corporate groups will generally not have the option of continuing with the grouping provisions beyond 30 June 2003. They must consolidate if they want access to any form of single entity treatment.

- **Consolidation makes business simpler and improves the integrity of the tax system.**

  Consolidation simplifies the taxation of wholly-owned groups and reduces compliance costs by:

  - ignoring intragroup transactions for tax purposes
  - pooling losses, franking credits and foreign tax credits
  - aligning PAYG instalments with annual income tax obligations, and
  - replacing multiple reporting requirements with a single income tax return and PAYG instalments for the entire group.

  Consolidation also reduces opportunities for tax avoidance through loss creation and value shifting.

Consolidation pathway

Forming and operating as a consolidated group involves a series of steps.

As part of the integrated tax design process, the ATO in consultation with business representatives and advisers developed a blueprint of these steps, which is summarised in the consolidation 'pathway' → next page. The pathway is essentially an overview of the consolidation process from the taxpayer's point of view.

The key steps are described briefly below.

Choosing

Consolidation is optional. A group needs to determine its eligibility, analyse the costs and benefits of consolidating, and choose whether and when to consolidate. The choice to consolidate is irrevocable once it is made.

→ 'Choosing', B1-1

Forming a consolidated group

Consolidating a group involves planning and implementing new systems and calculating a consolidated income tax position for the group as a whole. Among other things, the head company needs to:

- determine asset values for joining subsidiaries
- transfer losses and calculate a utilisation rate
- transfer franking credits and foreign tax credits, and
- deal with the other tax attributes of the joining subsidiaries.

→ 'Forming', B2-0

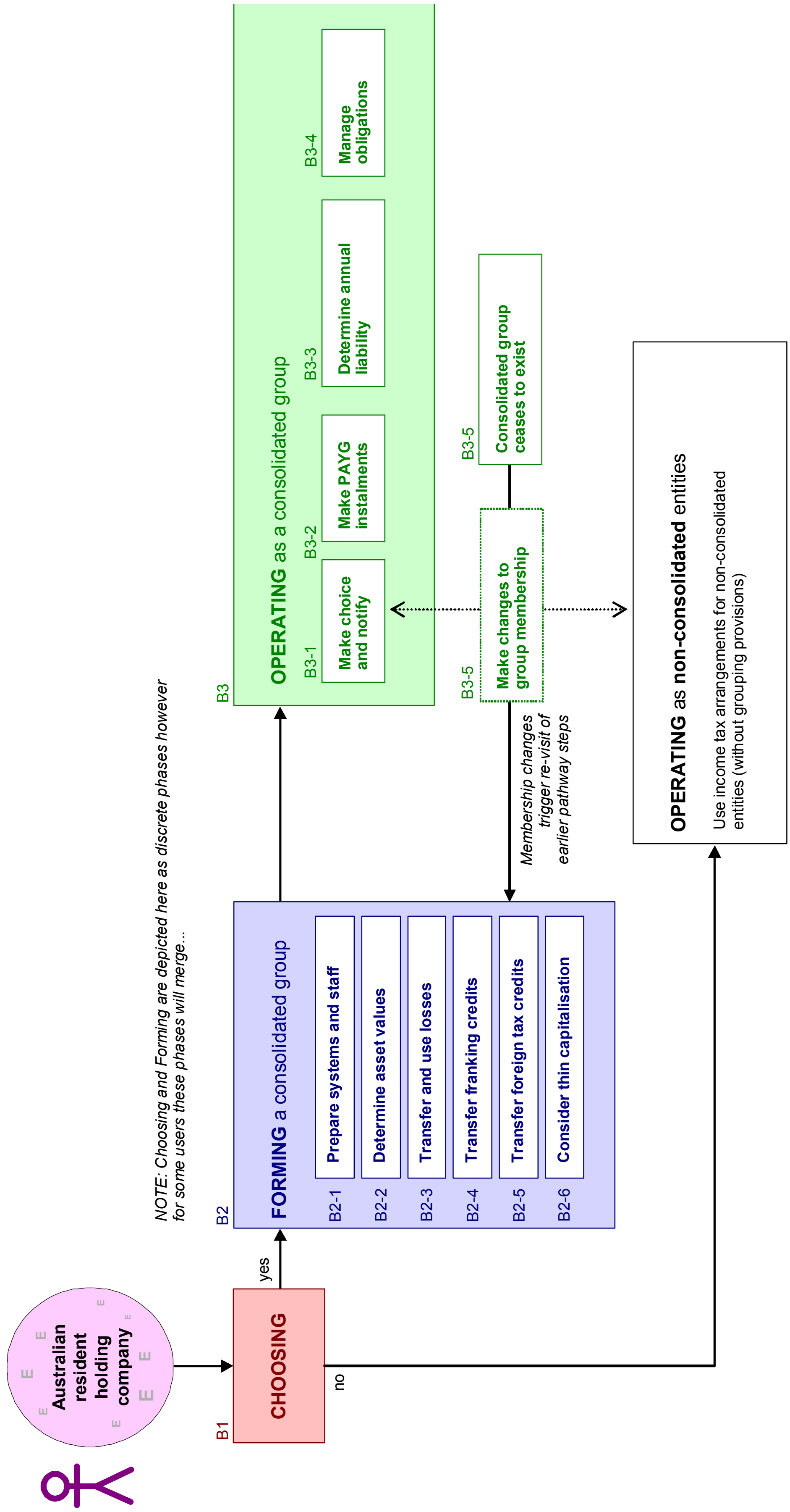
Operating as a consolidated group

Operating as a consolidated group requires the head company to, among other things:

- make a choice in writing to form a consolidated group with effect from a certain date
- notify the ATO of its choice to consolidate in the approved form within the prescribed time
- calculate, report and pay the group's PAYG instalments
- determine, report and make any balancing adjustments to meet the group's annual income tax liabilities
- manage any ongoing income tax liabilities and supply income tax information to the ATO when required, and
- manage the entry and exit of subsidiary members, including notifying the ATO.

→ 'Operating', B3-0

Figure 1: Consolidation pathway



Revision history

Section B0-1 first published (excluding drafts) 2 December 2002. Further revisions are described below.

Date	Amendment	Reason
6.5.11	Minor revisions to reflect changes to choice to consolidate rules.	Legislative amendments.

Introduction to consolidation

The Commonwealth Government introduced consolidated income taxation of corporate groups – that is, taxing wholly-owned groups as single entities – on 1 July 2002 as part of the Business Tax Reform package.

Before the introduction of consolidation, the income tax system treated each company in a wholly-owned group as a separate entity (subject to certain grouping provisions). Taxing member entities separately means that each entity must separately account for intragroup transactions and debt and equity interests. For business, this imposes extra compliance costs and sometimes stands in the way of the most efficient business structures. From the community's perspective, the grouping provisions for wholly-owned groups have provided opportunities for tax avoidance through artificial arrangements.

Consolidation improves efficiency and reduces ongoing compliance costs by facilitating group restructuring and providing a business environment in which some highly complex business structures are no longer seen as necessary.

Does this affect my business?

Any eligible business group can consolidate regardless of size. If a business consists of two or more eligible entities (for example, one company wholly owns another company), it can choose to consolidate. The head of a consolidatable group must be a company – it cannot be a trust or partnership.

Most small businesses involve single entities and are not affected by the consolidation measure. Consolidation is only relevant where a company wholly owns one or more other entities. Consolidation is not relevant to the business activities of individuals (such as people operating as sole traders).

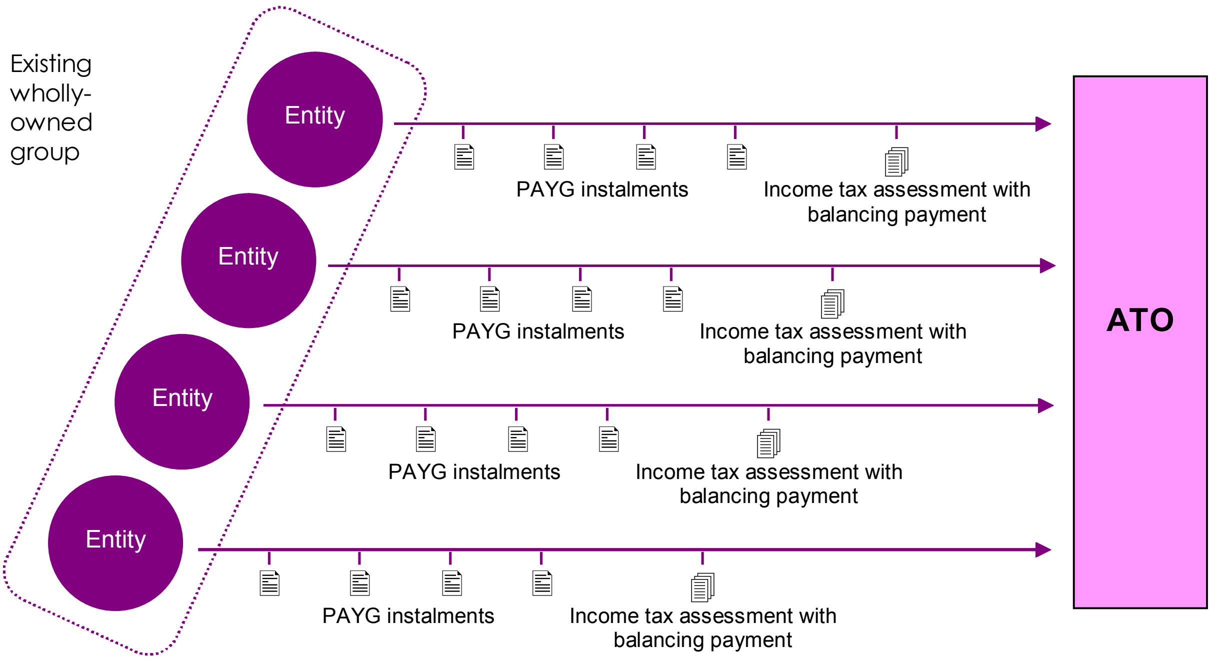
If a business group has been using the grouping provisions for wholly-owned groups, which end for most taxpayers on 30 June 2003, they will need to consider their structure and income tax arrangements.

The benefits of consolidation for a particular group will depend on factors such as the extent and current utilisation of group losses and franking credits, as well as compliance cost savings related to accounting for intragroup transactions and meeting multiple PAYG instalment obligations.

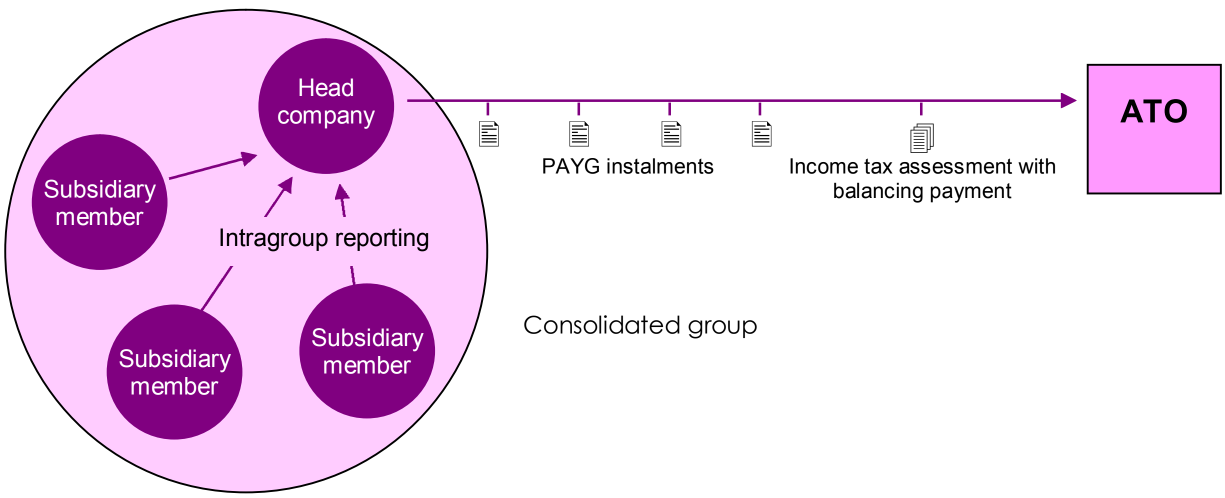
The cost of consolidation will include the cost of advice, collecting information about the group (including asset valuations) and setting up new accounting systems if necessary.

Figure 1: Reporting and payment of income tax

before consolidation . . .



. . . and after consolidation . . .



Impacts and consequences

Taxing the group as a single entity

Consolidation involves treating the wholly-owned group as a single tax entity, with the subsidiary members treated as parts of the head company. Intragroup transactions are disregarded for income tax purposes. This:

- allows pooling of losses and credits – simplifying obligations and delivering cost savings for consolidated groups
- eliminates many complex provisions applying to intragroup transactions, such as:
  - deemed dividend rules
  - rules for determining capital gains and losses
  - franking rules in relation to intragroup dividends
  - formal requirements for intragroup transfers
  - related anti-avoidance rules
- reduces impediments to group restructuring and allows:
  - movement of assets between group entities to be disregarded for income tax purposes with no formal rollover requirements
  - buying back shares without triggering a capital gain or loss
  - liquidating a member entity without triggering a deemed dividend or a capital gain or loss.

Treatment of assets

On consolidation, the assets of subsidiary members are treated as if they were assets of the head company, and may be transferred between members of the group without any income tax consequences. Intragroup debt and shareholding are also ignored for income tax purposes.

When a consolidated group forms or an entity joins a consolidated group, new tax costs (or tax values) for the assets of each subsidiary member are calculated, based on the tax costs of the membership interests (or equity) in that subsidiary member. The cost base of the membership interests in the joining entity is effectively transferred to the assets of the entity, aligning the tax costs of the entity's assets with the costs of its membership interests.

The new tax costs provide a cost base for depreciation and for calculating capital gains and losses on assets that are later disposed of outside the group, either directly or as a consequence of the disposal of equity in a member (which leads to that member's exit from the consolidated group).

The use of special cost setting rules is the normal method of determining the value of assets of joining subsidiary entities. However, groups consolidating during the transitional period may have the option of retaining the existing value of assets for tax purposes on a subsidiary-by-subsidiary basis → 'Timeframe', p. 5. The head company itself always enters consolidation with existing asset values.

Group inherits subsidiary member's history

For most purposes, a consolidated group inherits the tax history of its joining subsidiaries. Specifically, the entry history rule ensures that everything that happened in relation to a subsidiary member before joining a consolidated group is taken to have happened in relation to the head company for the purposes of calculating the head company's future income tax liability or tax losses.

For example, where an entity incurs borrowing expenses in a particular income year and then joins a consolidated group at the start of the next income year, the group's head company may be entitled to a deduction for any undeducted borrowing costs as if it had actually incurred the expenditure itself.

Note that the entry history rule:

- applies only for the purposes of working out the head company's income tax liability or tax loss
- relates only to the subsidiary member's history that affects or could affect the head company's tax liability. (Note that a franking surplus arising in the franking account of the subsidiary member immediately before the joining time is able to be transferred to the franking account of the head company under consolidation. However the transfer is not made under the entry history rule because the treatment of franking credits is not taken into account in determining the head company's tax liability. → B2-4)
- can be modified by the operation of other provisions – for example, special rules may affect an asset's cost base history or the amount of losses transferred to the head company when an entity joins a consolidated group
- does not mean that the head company is liable to pay income tax in relation to a subsidiary member for a period before it joined the group – each member entity remains liable for any income tax liability resulting from a period before it became part of the consolidated group.

Consolidation replaces the grouping provisions

As the grouping provisions for wholly-owned groups are withdrawn for most taxpayers from 1 July 2003, a business group that uses these provisions should carefully analyse the consequences of not consolidating. If a wholly-owned group chooses not to consolidate, the group will no longer be able to:

- transfer losses between entities in a group
- transfer assets between entities without triggering a capital gain or loss
- pay unfranked dividends within the group without tax being payable, or
- transfer excess foreign tax credits within the group.

In some cases relating to foreign bank branches, loss transfers continue to be available.

Where the head company has a substituted accounting period (SAP), the grouping provisions will continue to be available until the next balance date of the group after 30 June 2003, provided the group consolidates on the first day of the next SAP income year.

Prospective buyers

From 1 July 2002, the prospective buyer of a company needs to consider the company's consolidation status. At the time of acquisition, the buyer needs to be aware that a retrospective election to consolidate by the vendor could have implications for:

- who gets the company's tax attributes, such as losses and franking credits
- the cost base of the company's assets, and
- the company's tax liabilities.

These issues need to be considered as part of the normal due diligence process when buying and selling a business. → ATO fact sheet: Consolidation – implications when buying a wholly-owned business entity (Nat 8209)

Pre-membership and formation period tax liabilities

A member of a consolidated group is liable for the income tax liabilities incurred by it before becoming a member of the group. If the entity leaves the consolidated group it will still be liable for any debt incurred before it joined the group. A member is also liable for any outstanding PAYG instalment payments that are its responsibility during the formation period – that is, before the head company receives the group's consolidated PAYG instalment rate.

Group tax liabilities

A member of a consolidated group is jointly and severally liable for the group's tax liabilities incurred while it is a member to the extent that its liability is not limited to the amount determined by a valid tax sharing agreement (TSA) between group members.

After it leaves a consolidated group, an entity remains jointly and severally liable for the group's tax liabilities incurred while it was a member unless it meets certain 'clear exit' conditions, which include paying an amount allocated under a valid TSA (or a reasonable estimate of the amount) to the head company.

→ 'Managing obligations', B3-4

Timeframe

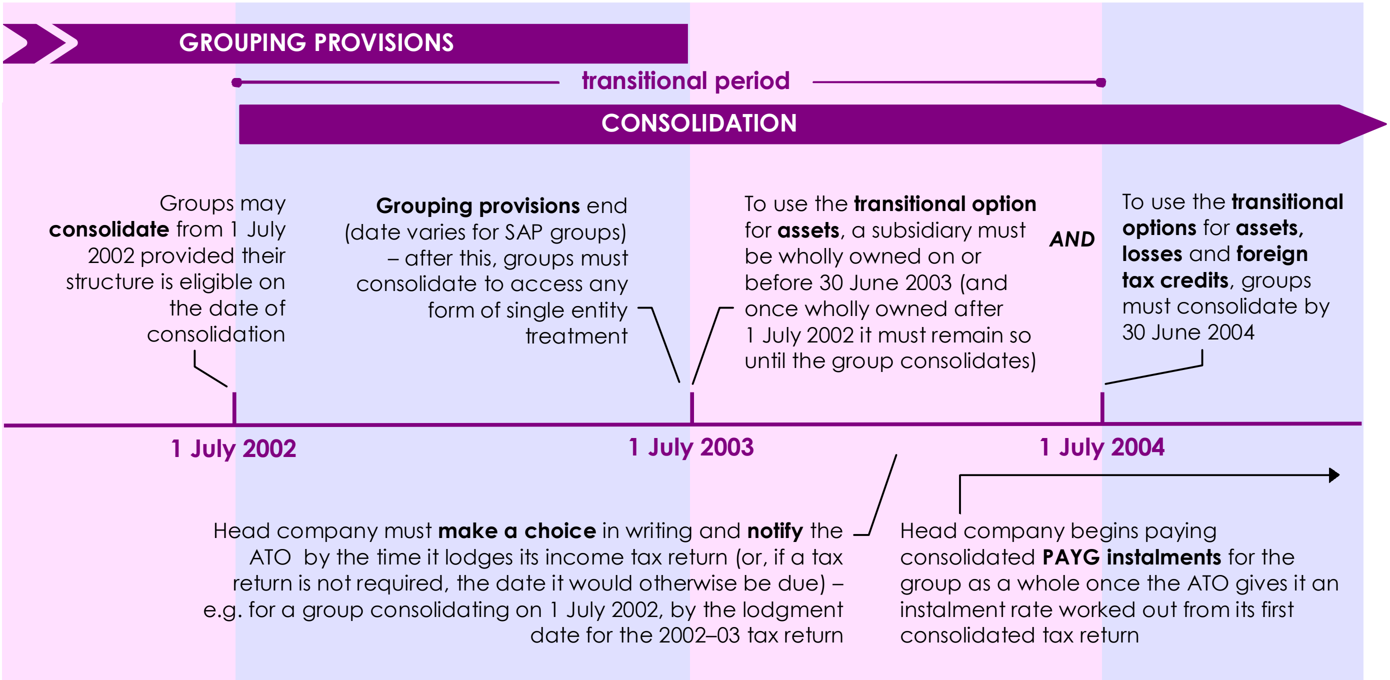
Consolidation takes effect from 1 July 2002 and eligible groups are able to consolidate from that date.

- The head company must make a choice in writing to form a consolidated group by the time it lodges its income tax return for the year in which the day specified in the choice occurs (or, if a return is not required, the date it would have otherwise been due). In addition, it must notify the ATO of its choice (using the appropriate notification form) within the same timeframe. → 'Making a choice to consolidate and notifying', B3-1
- Individual member entities continue to pay PAYG instalments until the head company lodges the group's first consolidated income tax return and receives its consolidated instalment rate. After this, the head company

pays consolidated PAYG instalments for the group as a whole. → 'Paying PAYG instalments', B3-2

- Transitional concessions for dealing with assets, losses and foreign tax credits may be available to groups consolidating during the transitional period (1 July 2002 to 30 June 2004). → 'Choosing', B1-1

Figure 2: Consolidation timeline



Revision history

Section B0-2 first published (excluding drafts) 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on recent changes to consolidation rules.	Legislative amendments.
26.10.05	Deletion of note on recent changes to consolidation rules.	Legislative amendments.
6.5.11	Minor revisions to reflect changes to choice to consolidate rules.	Legislative amendments.

B1: Choosing

Choosing

Key points

Consolidation is optional but irrevocable: If a group is eligible, its head company makes the decision whether to consolidate or not.

Choice in writing: Where the head company decides to form a consolidated group, the head company must document that choice in writing and notify the ATO.

Eligibility: Wholly-owned groups of Australian-resident companies, partnerships and trusts are generally eligible to consolidate. If a group consolidates, all of the head company's eligible resident wholly-owned subsidiaries must be included in the consolidated group.

The grouping provisions are withdrawn: Consolidation replaces the existing grouping provisions, which end for most taxpayers on 30 June 2003. Groups must consolidate if they want any form of single entity treatment for income tax purposes.

Is detailed analysis warranted? An eligible group will need to decide whether to invest resources in a detailed analysis of the costs and benefits of consolidation.

Benefits and costs of consolidation will vary from group to group.

Timing and transitional provisions: Generally, eligible groups can consolidate at any time from 1 July 2002, but the transitional provisions as well as practical considerations such as your accounting and record keeping processes may affect the timing.

Eligibility

To consolidate, a group must consist of an Australian-resident head company and at least one eligible resident subsidiary – a company, trust or partnership – wholly owned by the head company.

There is no limit to the size of a consolidatable group, and the 'one in, all in' principle applies, which means that if a group consolidates all eligible members must be included in the consolidated group.

A foreign-owned group of Australian-resident subsidiaries that do not have a single resident head company may instead choose to consolidate by forming a multiple entry consolidated (MEC) group. → C10-0

Head company

The head company *must*:

- be an Australian-resident company (but not a prescribed dual resident) and
- have at least some of its taxable income (if it has any) taxed at the general company tax rate.

The head company *must not* be:

- a subsidiary member of a consolidatable or consolidated group
- a member of a MEC group, or
- an entity specifically excluded from being part of a consolidated group → p. 2.

There are additional requirements for head companies of MEC groups. → C10-0

Note

A **corporate unit trust** or a **public trading trust** that satisfies the above eligibility criteria for being a head company (except that it is not a company) may choose to form a consolidated group as if the trust were a company. If it makes such an election, it will forever after be treated as a company for income tax purposes, even if the group later deconsolidates. → Subdivision 713-C, ITAA 1997

Subsidiary member

A subsidiary member *must:*

- be a company, trust or partnership
- be a wholly-owned subsidiary of the head company (disregarding up to 1% of ordinary shares that meet certain employee share scheme requirements)
- be an Australian resident (but not a prescribed dual resident) and
- have at least some of its taxable income (if it has any) taxed at the general company tax rate (if a company).

A subsidiary member *must not:*

- be an entity specifically excluded from being part of a consolidated group (see below).

Excluded entities

The following entities that receive special tax treatment relative to ordinary Australian-resident companies cannot be a head company or a subsidiary member of a consolidated group:

- exempt entities (i.e. total ordinary and statutory income is exempt)
- pooled development funds (PDFs)
- film licensed investment companies, and
- certain credit unions.

The following entities are also specifically excluded from being a subsidiary member of a consolidated group:

- non-profit companies (which include certain unincorporated clubs and associations)
- trusts that are complying and non-complying superannuation entities, and
- trusts that are non-complying approved deposit funds (ADFs).

Some exclusions have been made to prevent certain types of entities from losing their concessional tax treatment. Others act as an integrity measure to generally prevent certain entities from gaining relative concessional treatment.

One effect of these rules is that a superannuation fund generally cannot be a head company or subsidiary member of a consolidatable group.

What is meant by wholly owned?

An entity will be a wholly-owned subsidiary of the head company if all of the membership interests in it are beneficially owned by the head company, other wholly-owned subsidiaries of the head company, or a combination of both.

The term membership interest refers to all the interests and rights that you have in a company, partnership or trust by virtue of which you are a member → table 1.

Table 1: Members of different entity types

Entity	Member
Company	A member of a company or a stockholder in the company
Partnership	A partner in the partnership
Trust (except a corporate unit trust or a public trading trust)	A beneficiary, unitholder or object of the trust
Corporate unit trust	A unitholder of the trust
Public trading trust	A unitholder of the trust

Debt interests do not constitute membership interests. An entity is not a member of another entity just because it holds interests or rights in that entity that are debt interests. The term 'debt interest' has the meaning given in Subdivision 974-B of the *Income Tax Assessment Act 1997*.

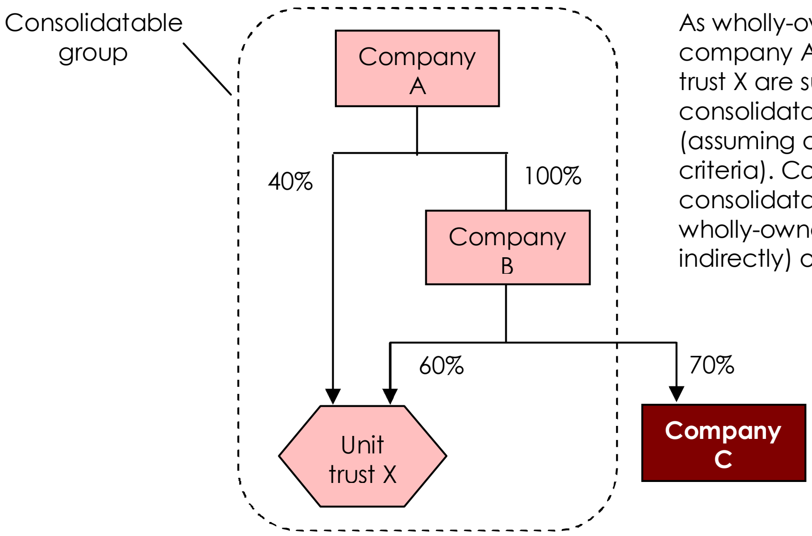
Note

An entity does not cease being the beneficial owner of a membership interest in another entity merely because the first entity is in the process of being **wound up**, is in **receivership** or is under **administration**. → 'Wholly-owned subsidiary – the general test' in 'Eligibility tests and rules', C1-1

Trusts

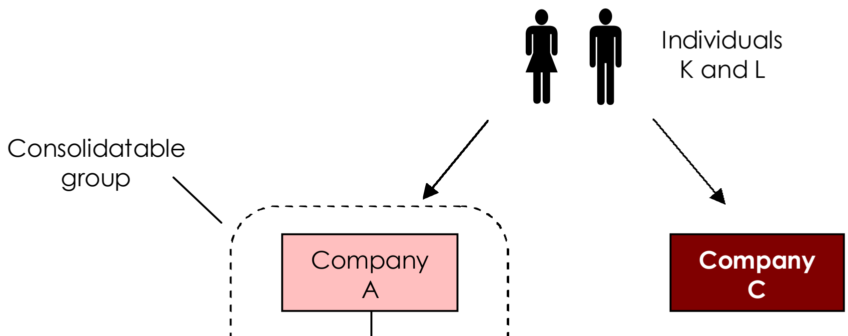
Note that the beneficiaries, unitholders or objects of a trust are the beneficial owners of its membership interests for the purposes of consolidation. If *any* beneficiaries of a trust are individuals, the trust cannot be wholly owned directly or indirectly by a head company, and therefore cannot be a member of a consolidatable group → figure 7: 'Corporate trustee is not the head company', p. 8. Discretionary trusts may be members of a consolidatable group, provided their objects are confined to members of the group.

Figure 1: Only wholly-owned entities are part of a consolidatable group



As wholly-owned subsidiaries of company A, company B and unit trust X are subsidiary members of a consolidatable group headed by A (assuming all three meet the eligibility criteria). Company C is not part of the consolidatable group as it is not a wholly-owned subsidiary (directly or indirectly) of company A.

Figure 2: Common ownership is not sufficient



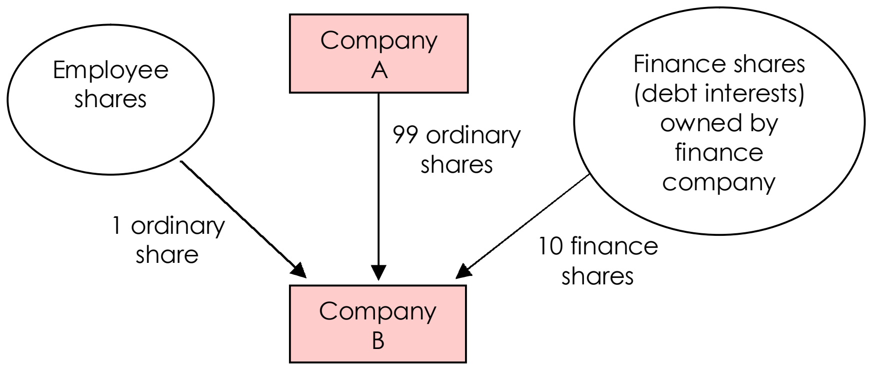
Company A (head company) and company B make up the consolidatable group. Company C is not eligible to be part of the group as it is not directly owned by A (i.e. common ownership is not sufficient).

Shares issued under an arrangement for employee shareholdings

An exception to the general rule that all membership interests in a company must be beneficially owned by members of the group applies to certain ordinary shares issued under an arrangement for employee shareholdings. Where the total of these ordinary shares issued under an arrangement for employee shareholdings represents 1% or less of the ordinary shares in the company, these shares can be disregarded in determining whether members of the consolidatable group beneficially own all of the membership interests in that company.

Figure 3: Qualifying employee shares and debt interests are ignored

Companies A (head company) and B are part of the same consolidatable group. Both the 1% of qualifying ordinary shares that are issued under an arrangement for employee shareholdings and the finance company's finance shares (which constitute debt interests) are ignored for the purposes of determining whether company B is a wholly-owned subsidiary of company A. As the finance company holds the finance shares as a debt interest, it is not a member of company B and consequently does not beneficially own any membership interests in it.



Entity held through non-fixed trust

In determining whether an entity is a wholly-owned subsidiary, special rules ensure that an entity held through a non-fixed trust is not prevented from being treated as a wholly-owned subsidiary.

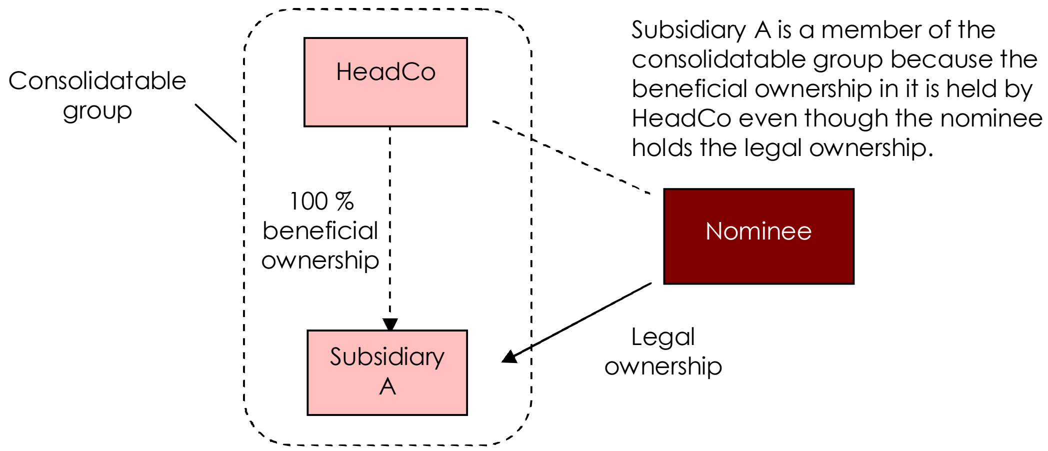
Interposed entities

Generally, a company, trust or partnership will only be a subsidiary member of the group where all the entities interposed between it and the head company are also subsidiary members of the group. However, there are two exceptions to this rule:

1 Where an interposed entity holds membership interests in a subsidiary member only as a nominee of either the head company or one or more subsidiary members of the group, the nominee (which has legal but not beneficial ownership of the interests) is not a member of the group, but the entity in which the nominee holds membership interests is a member of the group. → figure 4

2 In certain circumstances an Australian-resident entity may still qualify as a subsidiary member even where one or more non-member foreign-resident entities are interposed between it and the head company. These rules operate differently depending on whether the Australian-resident entity being tested is a company, trust or partnership. These provisions are transitional and only apply where the group is consolidated before 1 July 2004 and the Australian-resident entity is a subsidiary member of that group at the formation time.

Figure 4: An interposed nominee may not affect the existence of a consolidatable group



Business structures that cannot consolidate

Your business structure will be ineligible to consolidate if any of the following statements are true:

- You carry on business as a sole trader.
- You carry on business as a partnership where at least one of the partners is an individual.
- Your business structure does not include a company.
- Your business structure includes one or more companies but these do not beneficially own any other companies, trusts or partnerships.

This is not a consolidatable group, as a trust is ineligible to be the head company of a consolidatable group.

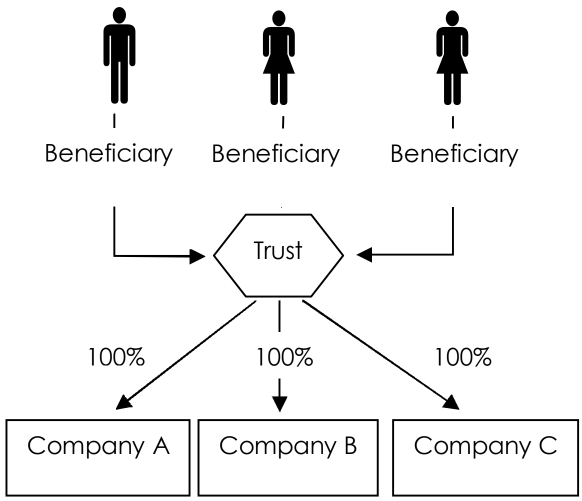


Figure 5: Groups headed by a trust cannot consolidate[1]

This is not a consolidatable group even though the same individuals beneficially own all three companies. Consolidation can only occur where one *company* (head company) beneficially owns all of the membership interests (e.g. shares and units) in at least one other company, trust or partnership.

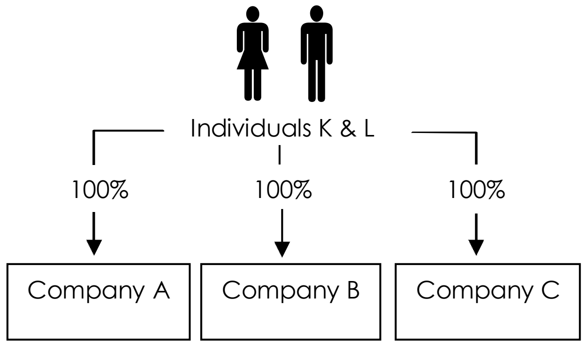
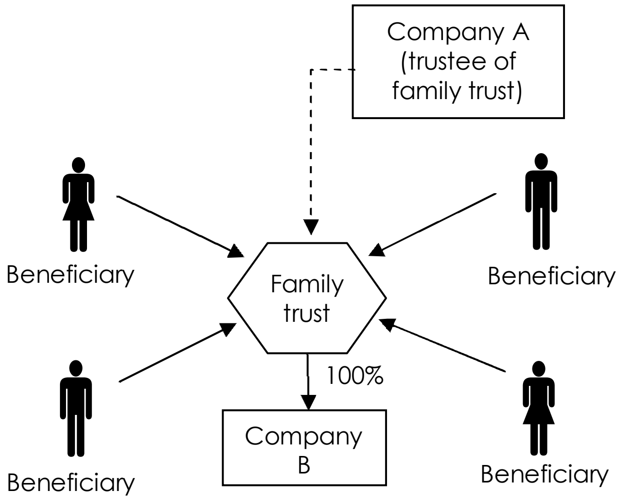


Figure 6: Common ownership is not sufficient for consolidation

[1] However, a corporate unit trust or a public trading trust may form a consolidated group in certain circumstances. → 'Head company', p. 2

Figure 7: Corporate trustee is not the head company

In this example, the family trust owns company B. Company A is not the head company of a consolidatable group that includes this trust as A is merely the trustee. It does not beneficially own any membership interests in the trust.



More information

For more information and tests to determine the eligibility of entities and structures see → C1-0.

Grouping provisions withdrawn

The consolidation measure effectively replaces and expands on the grouping provisions for wholly-owned groups. Groups will no longer have access to:

- capital gains tax (CGT) rollover relief for asset transfers between companies that are part of the same wholly-owned group unless the rollover is from or to a foreign resident of the group
- loss transfers between companies that are part of the same wholly-owned group (although loss transfers will be retained for Australian branches of foreign banks in some cases)
- the inter-corporate dividend rebate for unfranked dividends paid between companies that are part of the same wholly-owned group
- transfers of excess foreign tax credits between companies that are part of the same wholly-owned group, and
- grouping provisions in the thin capitalisation regime.

The grouping provisions end on 30 June 2003 or on the date of consolidation, whichever comes first. However, where the head company has a substituted accounting period (SAP), the grouping provisions continue to be available until the next balance date of the group after 30 June 2003, provided the group consolidates on the first day of the next SAP income year.

With some exceptions, the thin capitalisation grouping provisions continue to operate until the end of the 2002-03 income year for entities that consolidate. Where entities do not consolidate the existing grouping rules cease to operate from 1 July 2003. → 'Consolidation and the thin capitalisation rules', B2-6

→ *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), various schedules

Checklist – is detailed analysis warranted?

A detailed analysis of the costs and benefits of consolidation may require a considerable investment of resources → figure 8: Consolidation pathway, p. 13. Consideration of the following issues may help a taxpayer decide whether to undertake such an analysis, in the light of their individual circumstances and assuming that their group is eligible:

- To what extent does the group rely on the grouping provisions?
- To what extent do the integrity measures that do not apply to consolidated groups – including cost base adjustment requirements, debt forgiveness provisions and loss deferral measures – present difficulties to the group?
- What are the potential benefits of resetting asset cost bases and tax values on a subsidiary-by-subsidiary basis?
- What would be the impact of consolidation on existing tax attributes such as access to and the speed at which losses can be utilised, existing group franking credits, CGT status and depreciation claims?
- What would be the impact of consolidation on access to future tax attributes such as losses and franking credits?
- What are the likely costs and resource requirements for the process of consolidating?

Potential benefits and costs

Benefits

Intragroup transactions are ignored for income tax purposes:

- This enables groups to better align pay as you go (PAYG) instalments with annual income tax obligations.

Losses, franking credits and foreign tax credits are pooled:

- Losses, franking credits and foreign tax credits remain with the head company even if a member leaves the group.
- Intragroup dividends are not subject to imputation rules.

→ 'Transferring and using losses', B2-3; 'Transferring franking credits', B2-4; ''Treatment of foreign income tax offsets, excess foreign tax credits, attribution surpluses, conduit foreign income and irrevocable elections', B2-5

The status of pre-CGT assets of the joining entity will be preserved after they are taken to be held by the head company under the single entity principle.

Certain complex integrity provisions (including those relating to cost base adjustments, loss deferral and debt forgiveness) do not apply to intragroup transactions within consolidated groups.

Tax-related impediments to group restructuring are reduced:

- Shares may be bought back into a group company without giving rise to a capital gain or loss.

- The liquidation of a member company does not trigger either a deemed dividend or capital gain or loss.
- Assets can be moved between group entities without any rollover requirements.

Groups consolidating during the transitional period (1 July 2002 to 30 June 2004) may have the option of retaining existing tax costs for the assets of subsidiaries (which minimises compliance costs) instead of setting new tax costs (which in some circumstances may allow assets to be depreciated at higher amounts). → 'Timing and transitional provisions', p. 11

→ 'Determining asset values', B2-2

Rules that allow certain Australian-resident wholly-owned subsidiaries of the head company to be subsidiary members of a consolidated group, despite one or more non-resident entities being interposed between the head company and the resident subsidiaries, only apply where the group consolidates during the transitional period (1 July 2002 to 30 June 2004).

Ongoing compliance costs are reduced:

- The group has only one income tax accounting period.
- The group has to maintain only one franking account.
- The group self-assesses a single income tax liability.
- The group makes consolidated PAYG instalments after lodging its first consolidated return and receiving an instalment rate.

Costs

The consolidation process may initially be costly (software changes, obtaining information, accounting/legal fees).

Some aspects of consolidation may involve up-front compliance costs:

- Determining asset values of joining subsidiary entities: collating the required data and obtaining valuations may be costly, as complex calculations are required. To minimise these compliance costs a transitional method for determining asset values is available.
  → 'Determining asset values', B2-2
- Available fraction: a group's available fraction may need to be calculated when a loss entity joins the group. This requires valuations of the loss entity and the whole group as at the joining time. → 'Transferring and using losses', B2-3

Timing and transitional provisions

Groups can consolidate at any time from 1 July 2002, but the availability of transitional concessions as well as the practical implications of consolidation for accounting and record keeping processes may affect the preferred timing:

- The grouping provisions are withdrawn from 30 June 2003 (for groups with SAPs, from the first day of their next SAP income year commencing after 1 July 2003, provided that the group consolidates from that first day). → p. 8
- The head company must allocate a cost amount to the assets of subsidiary entities. Provided that the group consolidates during the transitional period (1 July 2002 to 30 June 2004), the head company has a choice of either retaining existing tax values for the assets brought in by a qualifying subsidiary or using the cost setting rules. After this period, the cost setting rules must be used. The transitional option (retaining existing tax values) can be exercised on a subsidiary-by-subsidiary basis on formation, provided the subsidiary is wholly owned on or before 30 June 2003 (and once wholly owned after 1 July 2002 it must remain so until the group consolidates). → 'Treatment of assets', C2-1
- Losses that pass the continuity of ownership test made in an income year ending on or before 21 September 1999 may be used by the head company over three years instead of their use being limited by an 'available fraction' of the head company's income and gains. Also, losses that could have been transferred under the existing grouping provisions may be claimed using a larger available fraction. To use these transitional options the group must consolidate during the transitional period and the loss company must join the group at the time it consolidates. → 'Treatment of losses', C3-1
- When a consolidated group forms or an entity joins an existing consolidated group, any pre-commencement excess foreign income tax of the joining entity is transferred to the head company. The head company can use transferred pre-commencement excess foreign income tax in an income year that starts at or after the joining time. → 'Treatment of foreign income tax offsets, attribution surpluses and conduit foreign income', C6-1
- The head company can choose to consolidate at any time up to the day it lodges its income tax return for the income year in which the group is formed (or, if a return is not required, the date it would otherwise have been due). To give effect to a decision to consolidate, a head company must make a choice in writing that it is forming a consolidated group from a particular date. Once a written choice has been made, the choice to consolidate cannot be revoked and the date specified in the choice cannot be amended. The head company must also notify the ATO of this choice using the appropriate form → 'Making a choice to consolidate and notifying', B3-1. Although notification may be retrospective to an extent, changes to accounting and record keeping systems may need to be made well beforehand.

References

Income Tax Assessment Act 1997, Subdivisions 126-B, 170-A and 170-B; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 3, Part 3

Income Tax Assessment Act 1997, Subdivision 820-FA; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 13

New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002 (No. 117 of 2002), Schedule 14 (consequential provisions for removal of grouping)

Income Tax Assessment Act 1997, Subdivision 713-C; as inserted by *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (No. 83 of 2004), Schedule 2, Part 2

Income Tax Assessment Act 1997, subsection 703-30(3); as inserted by *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1, Part 2

Income Tax (Transitional Provisions) Act 1997, Subdivision 770-E; as inserted by Tax Laws Amendment (2007 Measures No. 4) Act 2007

Income Tax Assessment Act 1997, section 703-50; as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56), Schedule 5,

Income Tax Assessment Act 1997, section 703-58; as inserted by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56), Schedule 5

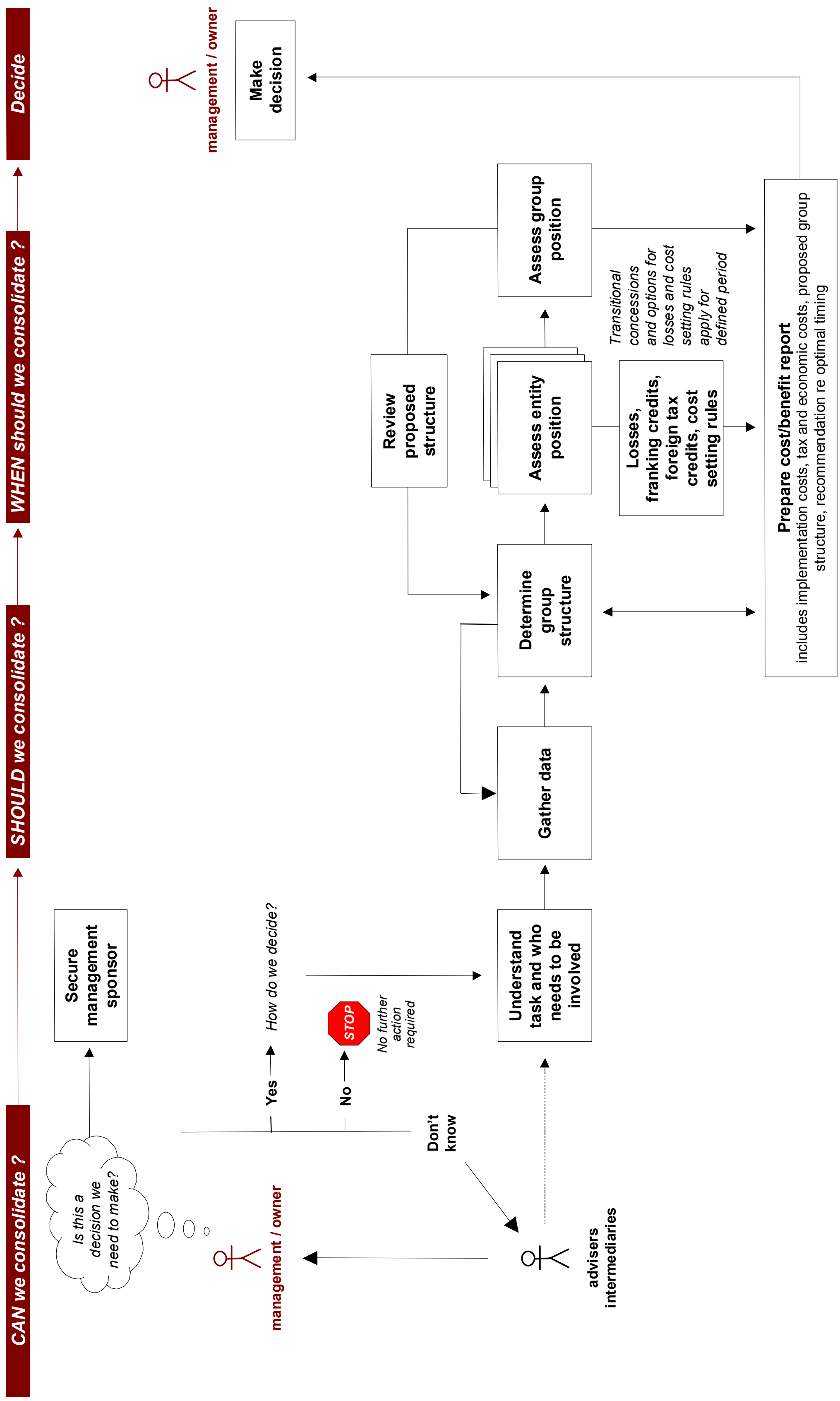
Revision history

Section B1-1 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Notes on recent and proposed changes to consolidation rules.	Recent and proposed legislative amendments.
26.10.05	Updates to above notes, pp. 2, 3.	Legislative amendments.
30.6.09	Updates for foreign income tax offset rules, p. 11.	Legislative amendments.
6.5.11	Revisions to reflect changes to choice to consolidate rules.	Legislative amendments.

Figure 8: Consolidation pathway: Choosing



B2: **Forming**

Forming

About this section

For income tax purposes, subsidiary members of a consolidated group are taken to be part of the head company. From the date of consolidation, the head company is the taxpayer representing the group.

Forming a consolidated group therefore involves determining a consolidated income tax position for the group at the time of consolidation.

It may also require staff training and system modifications to implement the change, meet group income tax obligations and realise potential compliance costs savings.

This section deals with:

- **Planning for systems and staff:** Record keeping, reporting and accounting systems, and associated information technology, may need to be changed to enable consolidated reporting of group income tax. Staff may also need training on the consolidation arrangements.
  → B2-1
- **Determining asset values:** Tax values must be set for each asset that each member brings into the group.
  → B2-2
- **Transferring and using losses:** Losses from subsidiary members may be brought into the group and used to offset group income, subject to certain tests.
  → B2-3
- **Transferring franking credits:** The franking surpluses of subsidiary members are effectively transferred to the head company, which operates a single franking account for the group.
  → B2-4
- **The treatment of foreign income tax offsets, excess foreign tax credits, attribution surpluses, conduit foreign income and irrevocable elections:** A foreign income tax offset can be claimed for tax paid by joining entities on amounts included in the head company's assessable income; excess foreign tax credits are transferred to the head company under special transitional rules; attribution account surpluses are also transferred to the head company; conduit foreign income of a joining entity becomes conduit foreign income of the head company.
  → B2-5
- **Application of thin capitalisation rules**: Thin capitalisation rules apply to a consolidated group as if it were a single entity.
  → B2-6

Revision history

Section B2-0 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

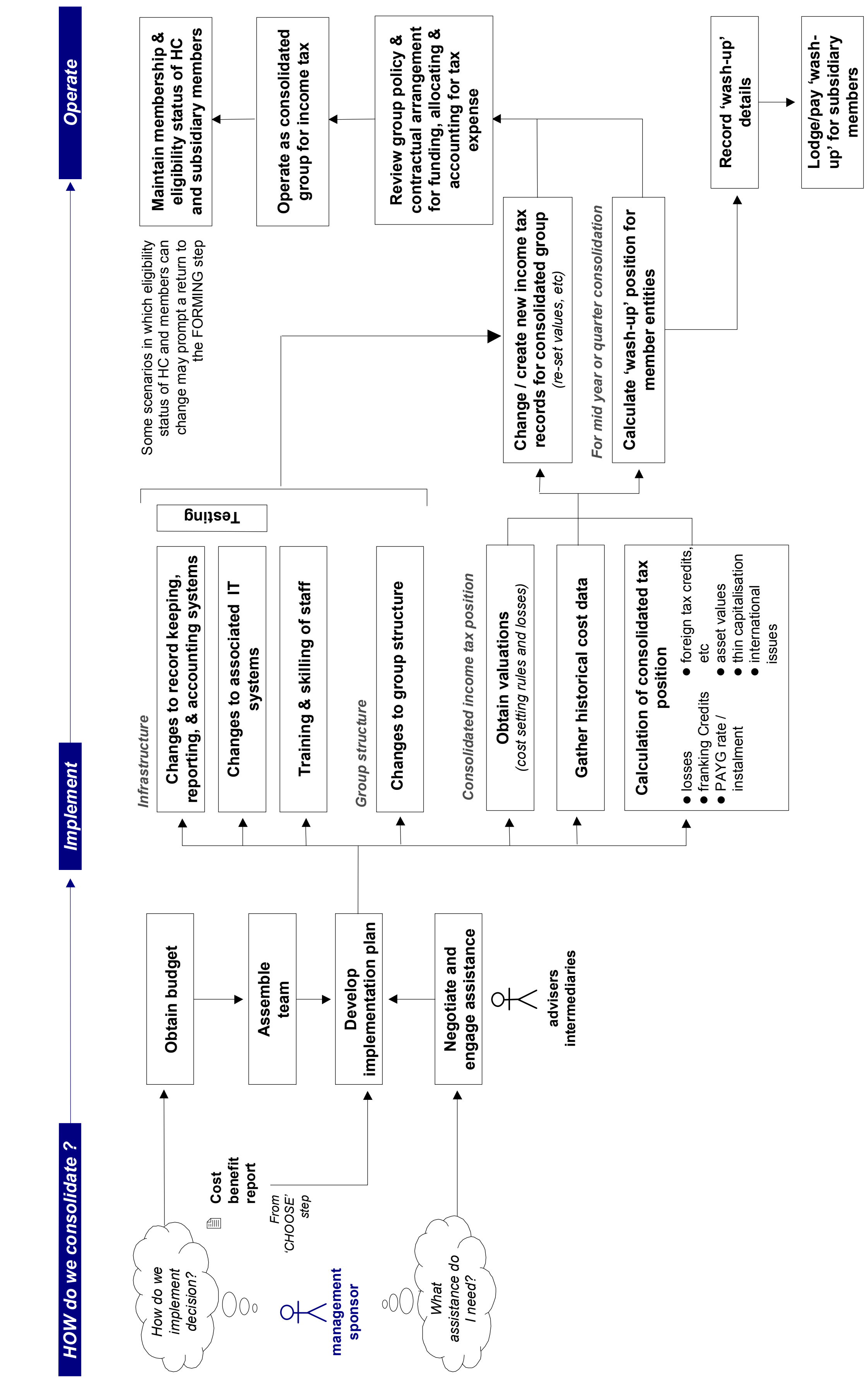
Date	Amendment	Reason
10.7.09	Updated p. 1 to take account of new rules for foreign income tax offsets, conduit foreign income and attributed tax accounts.	Amendments in *Tax Laws Amendment (2007 Measures No. 4) Act 2007* and *Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Act 2005*.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Figure 1: Consolidation pathway – Forming



Systems and staff

Key points

Depending on your circumstances, you may need to devote a specialist team to the task of becoming consolidated.

You may require changes to your information systems so they deliver the records required by the Tax Office when operating as a consolidated group – particularly records of asset valuations and the nature and source of all losses carried forward.

To implement consolidation, the group needs to undertake a number of change processes. The extent of the changes depends on the size, structure and complexity of the business and its existing financial and business systems. As a guide, all groups implementing the choice to consolidate should consider the following points:

- the need for an implementation strategy, including a project plan, budgets and project team
- developing and implementing changes to financial, accounting and record keeping systems → 'Record keeping guidelines and checklist', C9-2
- the time it will take to implement the move to a consolidated income tax system
- training and skilling of staff
- the need to gather historical asset cost base information
- the need to plan and implement changes to the group structure
- the approach to be taken to determining asset values, including the use of transitional options, and
- the need to determine the consolidated income tax position for attributes such as losses and franking credits.

Note

Reporting instalment income

For the head company to pay the group's quarterly PAYG instalments on time, it is important that subsidiary members of the group are prepared to report their contribution to the head company's instalment income shortly after the end of the head company's quarter.

If a subsidiary member has a different quarterly cycle to that of the head company, it may need to adjust its systems to be able to provide quarterly instalment income information according to the head company's quarterly cycle.

Business information to collect

Implementation of consolidation may require collection of records such as:

- market value of assets of a joining entity at the joining time
- market value of assets at the time membership interests were acquired
- CGT cost bases at the joining time
- opening trading stock values or purchase prices for trading stock on hand at the joining time
- adjustable values for depreciating assets at the joining time
- value of all liabilities of a joining entity that may be recognised by the Australian Accounting Standards or Statements of Accounting Concepts
- market value of a joining entity, and
- market value of the joined group.

→ 'Record keeping guidelines and checklist', C9-2

Note

Substituted accounting periods (SAPs)

Following a choice to consolidate, the head company continues to use its usual accounting period (which may be a substituted accounting period, or SAP). Where there is a change in head company in a MEC group, the replacement head company uses the same accounting period as the former head company.

Revision history

Section B2-1 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Determining asset values

Key points

On consolidation, the assets of subsidiary members are treated as if they were assets of the head company, and may be transferred between members of the group without any income tax consequences. Intragroup debt and shareholding are also ignored for income tax purposes.

New tax values must be determined for the assets that a subsidiary brings into a consolidated group. Head companies of groups forming during the transitional period (1 July 2002 to 30 June 2004) may have two options for doing this:

- retaining existing tax values (transitional option), or
- resetting asset values according to the cost setting rules.

Treatment of assets under single entity principle

The consequence of the single entity principle for the treatment of assets is that:

- The assets of the subsidiary members are treated as if they were assets of the head company.
- Assets acquired or disposed of by a subsidiary member are considered to be acquired or disposed of by the head company.
- Assets may be transferred between members of the same group without triggering capital gains or requiring cost base adjustments for membership interests.
- Intragroup debt and shareholdings are not recognised for income tax purposes.

Cost setting

When a consolidated group forms or one or more entities join a consolidated group, new tax costs (or tax values) for the assets of each joining subsidiary are calculated, based on the tax costs of the membership interests (or equity) in that subsidiary.[2] The cost base of the membership interests in the joining entity is effectively transferred to the assets of the entity, aligning the tax costs of the entity's assets with the costs of its membership interests. → figure 1, p. 2

This calculation is made by way of the cost setting process, which allocates the cost of the membership interests in the subsidiary to the assets it brings into the group in proportion to their market values.

On exit from the group, the process is reversed and the group's cost base of the equity is derived from the net assets of the leaving entity at the leaving time, as this is what is actually being taken out of the consolidated group.

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[2] Other than when a consolidating group exercises the transitional option of retaining existing asset values.

Note

Head company's assets

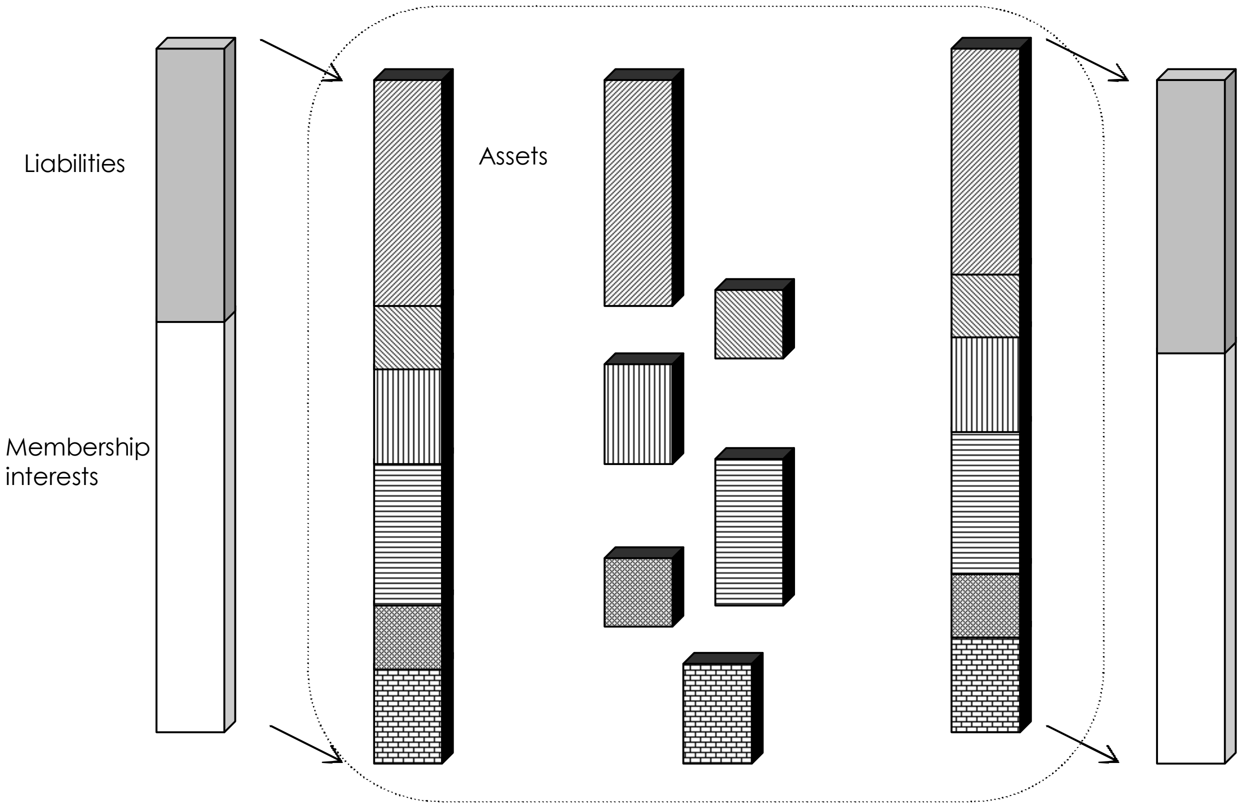
The head company will always enter consolidation with existing asset values. When a consolidated group is formed, no changes are made in relation to the head company's assets, other than to the intragroup debt and intragroup membership interests it holds, which are not recognised for income tax purposes after consolidation.

Pre-CGT assets

The pre-CGT status of assets and membership interests in the joining entity is preserved. → 'Treatment of assets', C2-1

Figure 1: Treatment of assets in consolidation

1. **On entry to a consolidated group**, the tax costs of the subsidiary's membership interests and liabilities become the tax costs of its assets for the head company
2. **While a subsidiary is a consolidated group member**, its assets are effectively treated as assets of the head company for income tax purposes and can be transferred between group members without any income tax consequences



3. **On exit from a consolidated group**, the process is reversed – the tax costs of the assets that a subsidiary takes with it, less its liabilities, become the tax costs of the membership interests in the subsidiary

Transitional concessions

Transitional concessions provide compliance cost savings for groups consolidating during the transitional period (1 July 2002 to 30 June 2004).

In particular, the head company can choose on formation to retain the existing tax values for a subsidiary's assets instead of applying the cost setting rules, provided that the subsidiary is wholly owned on or before 30 June 2003 (and once wholly owned after 1 July 2002 it must remain so until the group consolidates). → 'Treatment of assets', C2-1

Cost setting on formation and entry

On formation or entry the tax cost of each asset of a joining subsidiary is based on a share of the allocable cost amount (ACA) of that subsidiary. The ACA consists of the cost of the membership interests in the entity together with its liabilities, which become liabilities of the group. Adjustments are made to reflect certain undistributed profits, distributions and losses of the joining entity and certain deductions to which the head company becomes entitled.

Part of the ACA is allocated to the subsidiary's *retained* cost base assets (i.e. assets such as cash that retain their cost bases at the joining time). The remainder of the ACA is then apportioned to the subsidiary's *reset* cost base assets in proportion to their market values, subject to further adjustments for revenue-like assets and over-depreciated assets. → figure 2, p. 4

Note

Treatment of goodwill

Goodwill owned by the joining entity is treated as a reset cost base asset of the joining entity, whether or not an amount has been recognised in its accounting statements.

Goodwill is determined as the sum of the differences between (a) the market value of each business of the joining entity and (b) the market value of the net identifiable assets of each business of the joining entity.

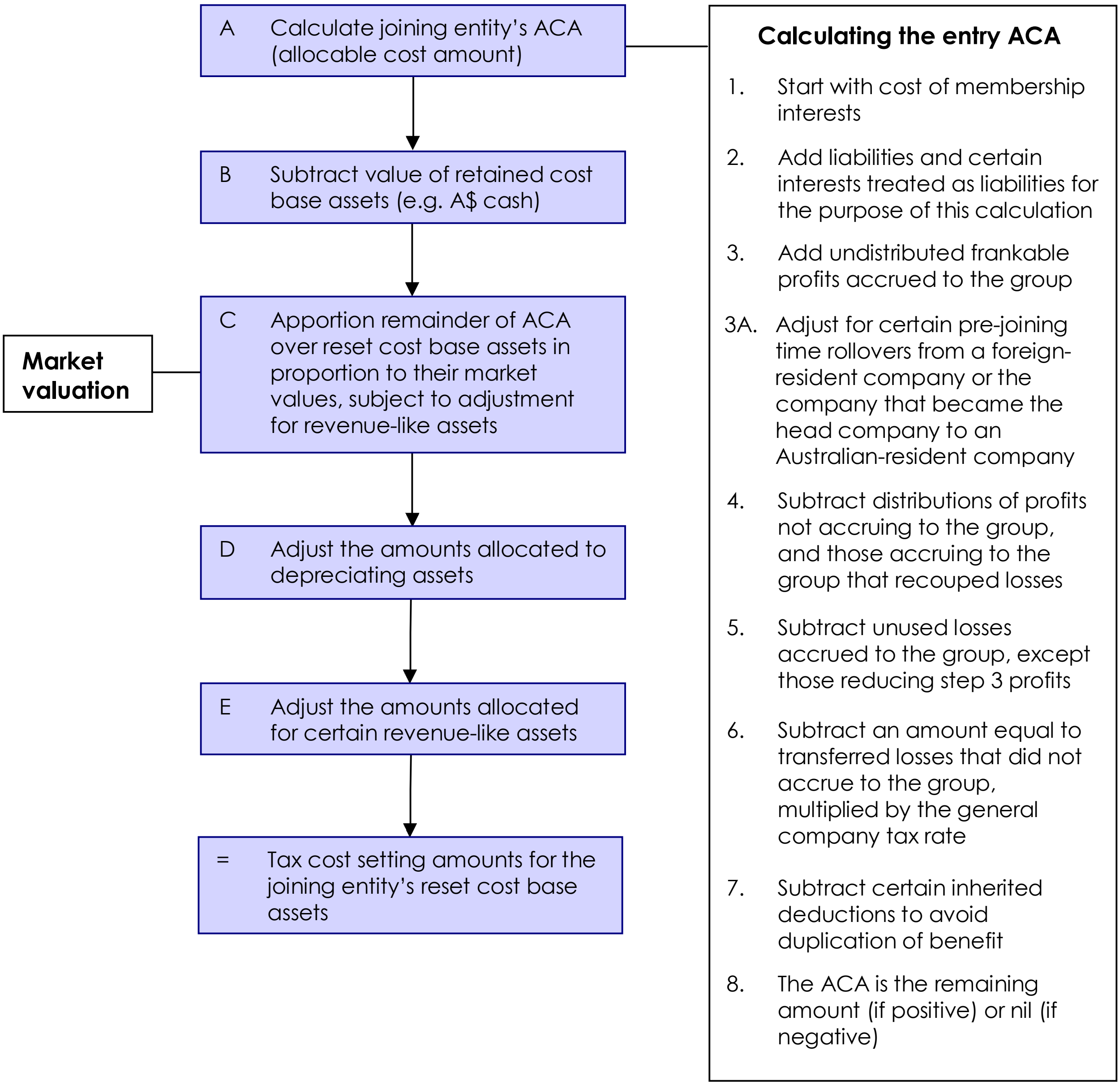
In addition, any goodwill arising from any increase in the value of the businesses of the other group entities due to the entity joining the group (synergistic goodwill) is treated as an asset of the joining entity. If this goodwill has a market value, a portion of the joining entity's ACA is allocated to it like any other reset cost base asset.

→ 'Goodwill' in 'Treatment of assets', C2-1; Taxation Ruling TR 2005/17

Exception for demutualised general insurance company

Where a general insurance company that has demutualised joins a consolidated group and was wholly owned by the same group during the period from demutualisation to the joining time, a goodwill asset of the company just before the joining time is treated as a retained cost base asset. → section 713-705, ITAA 1997

Figure 2: Cost setting process on formation and entry



Example

Assume a joining entity has the following assets and there was no distribution of profits:

	Tax value	Market value
Cash	$100	$100
Land	$100	$320
Machine	$100	$80

Assume that the ACA is $300. Cash, as a retained cost base asset, retains its tax value: $100.

The remaining $200 is then allocated to Land and the Machine based on their proportion of the total market value of reset cost base assets.

	Market value	ACA apportioned according to market value	New cost base
Land	$320	$200 x ($320 / $400) =	$160
Machine	$80	$200 x ($80 / $400) =	$40
	$400		

→ 'Assets', C2-0, includes detailed examples of these calculations

Market valuation

The cost setting process requires market valuing of a joining subsidiary's assets at the joining time. → Step C in figure 2, p. 4

However, to reduce compliance costs, valuation short cut options allow existing tax values to be used for:

- a depreciating asset (not including intangible assets) whose adjustable value is 1% or less of the joining subsidiary's ACA
- trading stock (other than livestock or growing crops) that is not a retained cost base asset, and
- employee share acquisition scheme (ESAS) shares or unlisted shares that have previously been market valued.

→ *Market valuation for tax purposes* at **www.ato.gov.au**

Note

Market valuations for loss calculations

Market valuations may also be required to calculate the amount of a loss transferred from a joining subsidiary that can be utilised by a head company.
→ 'Transferring and using losses', B2-3

Cost setting on exit

An entity leaves a consolidated group when one or more membership interests are sold outside the group or the entity becomes otherwise ineligible to be a member.

Where a subsidiary member leaves a consolidated group, the head company recognises, just before the leaving time, the membership interests in the leaving entity. These membership interests are not recognised while the entity is a member of the group.

The process at the joining time is now reversed and the group's cost base of membership interests is derived from the net assets of the leaving entity at the leaving time, as this is what is actually being taken out of the consolidated group. This preserves the alignment between the costs for membership interests in the entity and its assets.

The tax cost setting amount for membership interests is based on a share of the ACA on exit, which consists of the terminating values of the assets that the leaving entity takes with it, less its liabilities. Adjustments are made to reflect the value of certain inherited deductions and intragroup liabilities.
→ figure 3, p. 7

If the head company ceases to be eligible to be a head company of a consolidated group, the group ceases to exist. → 'Changing group membership', B3-5

Special rules apply when a consolidated group joins another consolidated group. → 'Treatment of assets', C2-1

Figure 3: Cost setting process on exit

A Calculate leaving entity's ACA (allocable cost amount)

↓

B Allocate the result to each of the membership interests by dividing the result by the number of those membership interests

↓

C If there is more than one class of membership interest in the leaving entity, allocate the ACA to each class in proportion to the market value of all of the membership interests in the class

Market valuation

↓

D Allocate the result to each of the membership interests in the class by dividing the result by the number of those membership interests in the class

↓

= Tax cost setting amount for the leaving entity's membership interests

Calculating the exit ACA

1. Start with terminating values of assets that the leaving entity takes with it
2. Add certain inherited deductions not reflected in the terminating value of the assets leaving the group
3. Add intragroup liabilities owed to the leaving entity at the leaving time
4. Subtract liabilities and certain interests treated as liabilities for the purpose of this calculation
5. The ACA is the remaining amount (if positive) or nil (if negative)

More information

More detailed technical information on the treatment of assets under consolidation is provided in Part C of this manual. → 'Treatment of assets', C2-1

References

Income Tax Assessment Act 1997, subsection 701-10(2); as amended by *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (No. 83 of 2004), Schedule 2, Part 4

Income Tax Assessment Act 1997, section 701-58; as inserted by *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (No. 83 of 2004), Schedule 2, Part 4

Income Tax Assessment Act 1997, section 713-705; as inserted by *Tax Laws Amendment (2004 Measures No. 7) Act 2005* (No. 41 of 2005), Schedule 6, Part 5

Income Tax Assessment Act 1997, subsection 705-90(6); as amended by *Tax Laws Amendment (2004 Measures No. 7) Act 2005* (No. 41 of 2005), Schedule 6, Part 3

Income Tax Assessment Act 1997, sections 705-93, 705-147, and 705-227, as amended by *Tax Laws Amendment (2010 Measures) Act 2010* (No. 56 of 2010) Schedule 5, Part 5

Income Tax Assessment Act 1997, subsection 711-45(6B); as inserted by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 20

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 2) Bill 2004, paragraphs 2.54 – 2.60

TR 2005/17 – Income tax: goodwill: identification and tax cost setting for the purposes of Part 3-90 of the *Income Tax Assessment Act 1997*

Revision history

Section B2-2 first published (excluding drafts) 2 December 2002 and updated 28 May 2003. Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on proposed changes to consolidation rules.	Proposed legislative amendments.
26.10.05	Reference to insurance companies, p. 3, change to note on goodwill, p. 3 and figure 2, step 3, p. 4.	Legislative amendments.
6.5.11	Changes to steps 2 and 3A in entry ACA (figure 2) and step 4 in exit ACA (figure 3).	Legislative amendments.

Transferring and using losses

Key points

In general:

- Unused carry-forward losses of a joining entity can be transferred to the head company of a consolidated group if the losses could have been used by the joining entity.
- Transferred losses can be utilised by the head company at approximately the same rate that would have been available to the joining entity had it remained outside the group.
- A concessional method is available that allows for certain transferred losses to be utilised over three years.

Transferring losses

When an entity joins a consolidated group, it calculates its taxable income or loss for the period up to the time it joins the group. Generally, any unused carry-forward losses are transferred to the head company if the losses *could* have been used by the joining entity in the 12 months prior to joining the consolidated group. This is known as the 'trial year' and extends to just after the joining time.

Whether the losses could have been used by the joining entity in the trial year is determined by applying modified versions of the usual tests for deducting and applying losses:

- **continuity of ownership test:** requires that the joining entity maintained a majority of the same ownership for the period between incurring the loss and just after the joining time (the joining entity must also satisfy the control test)

  or, if the continuity of ownership or control test is not met:

- **same business test:** requires that the joining entity carry on the same business for at least the 12 months prior to the joining time.

If the joining entity subsequently ceases to be a member of the consolidated group, all losses remain with the head company.

→ 'Treatment of losses', C3-1

Note

Removal of existing grouping provisions

After 30 June 2003 (this date varies if the head company has a substituted accounting period), an unconsolidated group will not be able to offset losses in subsidiaries with other wholly-owned group members. These losses would need to be offset against the income or gains generated by the individual group member. By choosing to consolidate, these tax attributes will be able to be used by the group (subject to the transfer rules, recoupment rules and the prescribed utilisation rate).

→ 'Choosing', B1-1

Using losses

Losses utilised by the head company can be either:

- losses generated by the group (group losses), and/or
- transferred losses that were generated by an entity before it became a member of the group.

Group losses must be utilised before transferred losses. Before utilising either a group loss or transferred loss, the head company must apply the general loss recoupment provisions – that is, it must pass either the continuity of ownership and control tests or the same business test. For transferred losses, these tests are modified for the purposes of determining whether the company has maintained the same ownership:

- the loss year is modified so that it starts from when the loss was transferred to the head company (this ensures that things that happened to the head company before the transfer time are not taken into account in applying the continuity of ownership test)
- for a loss transferred to the head company from a company as a result of passing the continuity of ownership and control tests, pre-consolidation ownership changes in the loss company are recognised.

Determining the amount of transferred losses that can be utilised

There are two methods of determining the amount of transferred losses that can be utilised:

- available fraction method
- concessional method.

Available fraction method

The use of transferred losses is limited by their available fraction. The available fraction is a proxy for determining the proportion of the group's income or gains generated by the loss entity against which the losses may be utilised.

The available fraction is calculated for a 'loss bundle'. A loss bundle is a set of losses transferred to the head company from the same joining entity at the same time. Losses within a loss bundle are categorised by sort (such as film losses and net capital losses).

The available fraction for each bundle of losses is calculated as follows:

$$\frac{\text{Modified market value of the loss entity}}{\text{Adjusted market value of the consolidated group}}$$

To use this method, market valuations for both the loss entity and the consolidated group are necessary.

There is a limit on the amount of losses of each sort within a bundle of losses that can be utilised by the head company. Broadly, the limit is set by multiplying the head company's income or gains of that type by the available fraction for the bundle of transferred losses.

Transferred losses that cannot be used in a given year can be carried forward.

As a concession for groups that consolidate during the transitional period – that is, between 1 July 2002 and 30 June 2004 – the head company, in certain circumstances, can increase the available fraction for a bundle of losses transferred from a member company (essentially by transferring part of the modified market value of another group company to the loss company).

Concessional method

The head company has the option of using losses over the three years following consolidation, subject to some limits. This method is only available:

- for losses that were transferred as a result of passing the continuity of ownership and control tests, and were actually incurred in an income year ending on or before 21 September 1999
- if the group consolidates during the transitional period – that is, between 1 July 2002 and 30 June 2004 – and the member (that is a company) transfers its losses at that consolidation date.

When determining the amount of losses utilised in an income year, losses claimed on a concessional basis are generally utilised before other transferred losses of the same sort.

More information

→ 'Treatment of losses', C3-1

Revision history

Section B2-3 first published (excluding drafts) 2 December 2002.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Transferring franking credits

Key points

On consolidation:

- the franking surpluses of subsidiary members are transferred to the head company, and
- the head company operates a single franking account for the group.

At consolidation

If the subsidiary member's franking account is in:

- surplus – the balance is transferred to the head company, setting the subsidiary member's franking account balance to zero
- deficit – the subsidiary member becomes liable for franking deficit tax, with a corresponding credit in the franking account setting its franking account balance to zero.

While it is part of a consolidated group, the subsidiary member's franking account continues to exist but is inoperative.

After consolidation

After consolidation, the head company operates a single franking account for the group. Activities that would otherwise have caused a franking credit or debit to arise in the franking account of a subsidiary member will instead give rise to a franking credit or debit in the franking account of the head company.

Distributions by a subsidiary member

Generally, a subsidiary member cannot frank frankable distributions to entities outside the group – only the head company can.

However, a subsidiary member can make frankable distributions in relation to disregarded employee shareholdings and non-share equity interests as well as membership interests held in it by a non-resident. Such distributions are treated as having been made by the head company – this gives rise to a franking debit in the head company's franking account.

Note

MEC groups

Special rules apply in relation to frankable distributions made by certain subsidiary members in a multiple entry consolidated (MEC) group.
→ 'Multiple entry consolidated (MEC) groups', C10-1

More information

More detailed technical information on the treatment of franking credits under consolidation is provided in Part C of this manual. → 'Treatment of franking credits', C5-1

Revision history

Section B2-4 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Treatment of foreign income tax offsets, excess foreign tax credits, attribution surpluses, conduit foreign income and irrevocable elections

Key points

On consolidation:

- the head company can claim a foreign income tax offset for foreign income tax paid by joining entities in relation to amounts included in the head company's assessable income
- excess foreign tax credits of joining entities accumulated before 1 July 2008 are transferred to the head company under special transitional rules
- the attribution account surpluses in respect of a controlled foreign company (CFC) are transferred to the head company
- from the 2010-11 income year onwards, the post-FIF (foreign investment fund) abolition surpluses in respect of a FIF or foreign life assurance policy (FLP) are transferred to the head company
- conduit foreign income received by an entity before it joins a consolidated group can be treated by the head company as its conduit foreign income
- irrevocable elections or choices made by a joining entity or head company in relation to interests in CFCs are not inherited by the head company or a leaving entity respectively.

Foreign income tax offset rules

The foreign income tax offset rules replace the foreign tax credit rules from an entity's first income year starting on or after 1 July 2008. Transitional rules provide for the utilisation of an entity's existing excess foreign tax credits (FTCs).

The application of the FTC rules to consolidated groups is dealt with in this section from p. 2.

Under the foreign income tax offset rules a taxpayer is entitled to a non-refundable tax offset for foreign income tax paid on an amount included in its assessable income. The taxpayer becomes entitled to a foreign income tax offset in the income year the amount is included in its assessable income. This may not be in the same year in which the foreign income tax is paid. There is no mechanism for allowing the carry-forward of excess foreign income tax.

Under the single entity rule, the income of a consolidated group or multiple entry consolidated (MEC) group is included in the head company's assessable income. Where a subsidiary member has paid foreign income tax on an amount included in the head company's assessable income, the head company is treated as having paid the tax. Once consolidated, only the head company is entitled to a foreign income tax offset for foreign income tax paid on an amount included in the head company's assessable income.

Where an entity joins a consolidated or MEC group part way through an income year, the joining entity is entitled to a foreign income tax offset for foreign income tax paid on an amount included in its assessable income for its non-membership period.

Transitional rules for excess foreign tax credits

Transitional rules allow the joining entity to transfer pre-commencement excess foreign income tax to the head company at the joining time. These transitional rules reflect the previous FTC rules on the transfer of excess FTCs to the head company at the joining time.

The pre-commencement excess foreign income tax transferred from the joining entity is pooled with any pre-commencement excess foreign income tax of the head company (and any other transferred pre-commencement excess foreign income tax from other subsidiary members). As there is a five year limit on the utilisation of pre-commencement excess foreign income tax by the head company, the pre-commencement excess foreign tax in the pool must be separately identified according to the income years in which it arose. The head company can apply pre-commencement excess foreign tax transferred from a joining entity in an income year starting on or after the joining time.

Leaving a consolidated group

Where an entity leaves a consolidated or MEC group, it is only required to include foreign income in its assessable income for the period it is not a member of any consolidated or MEC group. The leaving entity does not have access to any pre-commencement excess foreign income tax that it had before it joined the consolidated or MEC group, or that arose in the group while it was a subsidiary member.

→ 'Treatment of foreign income tax offsets, attribution surpluses and conduit foreign income', C6-1

Excess foreign tax credits (pre 1 July 2008)

For income years starting before 1 July 2008, the former FTC rules applied, with modifications for tax consolidation set out in Subdivision 717-A of the *Income Tax Assessment Act 1997* (ITAA 1997). Under the former provisions, the head company was deemed to have paid and been personally liable for the foreign tax paid by the members of the group. This means the head company could claim an FTC against Australian tax payable on the foreign income of all the members of the consolidated group included in the head company's assessable income – using not only the head company's own FTCs, but also the FTCs of subsidiary members and excess FTCs transferred into the group from joining entities.

On consolidation, the excess FTCs of companies joining or forming a consolidated or MEC group were transferred to the head company. The excess FTCs were then pooled by the head company according to the class and income year in which they arose.

The head company generally could not use the excess FTCs of a subsidiary member until the end of the head company's income year following the one in which the member joined the group, unless the member joined at the start of the head company's income year.

Where an entity was not a member of a consolidated or MEC group for part of an income year, it was entitled to excess FTCs that arose in a non-membership period before it joined the MEC group. However, where the excess FTCs had been transferred to the head company of a consolidated group because the entity became a subsidiary member of that group, the entity relinquished any future entitlement to those excess FTCs in later income years and non-membership periods, or if it joined another group.

→ 'Treatment of foreign income tax offsets, attribution surpluses and conduit foreign income', C6-1

Attribution surpluses

Part X and former Part XI of the ITAA 1936 provide rules for maintaining attribution accounts in order to prevent double taxation of the profits of controlled foreign companies (CFCs), foreign investment funds (FIFs) and foreign life assurance policies (FLPs). A surplus in the attribution account at any point in time occurs when the credits in the account exceed the debits.

A company that becomes a subsidiary member of a consolidated group may hold interests in a CFC, FIF or FLP. If the balance of any relevant attribution account kept by that company is in surplus immediately before the joining time, the surplus is transferred to the head company of that group.
→ Subdivision 717-D, ITAA 1997

This ensures that distributions from CFCs, FIFs and FLPs are not taxed to the head company where the joining company has already been taxed on the attributed income.

After the transfer of surpluses, the attribution accounts of the joining company become inoperative. Any attribution account debits or credits that would have arisen in the attribution accounts kept by the joining company during the time it is a member of the consolidated group will now arise in the attribution accounts kept by the head company.

When a company leaves a consolidated group it may take with it interests in a CFC, FIF or FLP. Where this happens, the head company transfers to the leaving company a proportion of the attribution account surplus that the head company has in relation to these interests. The proportion is based on the percentage of the group's interest in the CFC, FIF or FLP held by the leaving company. → Subdivision 717-E, ITAA 1997

The FIF rules were repealed with effect from the 2010-11 income year. Companies with interests in a FIF or FLP will no longer be subject to the requirements of the attribution rules.

FIF income (pre-2010-11)

For income years prior to 2010-11, before the repeal of the FIF rules, special rules applied to ensure that the correct amount of FIF income was assessed to the correct taxpayer where a company joined or left a consolidated group during the notional accounting period of a FIF. To achieve this, where the FIF's notional accounting period did not actually end at the joining time, the FIF income was allocated to the joining company for the period from the beginning of the FIF's notional accounting period until the joining time, and the head company was allocated FIF income from the joining time onwards. Similarly, when a company left the group the FIF income was allocated between the head company and the leaving company.

FIF income (2010-11 onwards)

From the 2010-11 income year onwards, any FIF attribution surpluses that previously arose for the head company of a consolidated group, including those transferred to it and those of its own, will become part of its post-FIF abolition surplus.

When a company becomes a subsidiary member of a consolidated group and it has a post-FIF abolition surplus, the surplus is transferred to the head company of that group. → section 717-220, ITAA 1997

When a company leaves a consolidated group and takes with it interests in a FIF or FLP, the head company transfers to the leaving company a proportion of the post-FIF abolition surplus that it has in relation to those interests. The proportion is based on the percentage of the group's interest in the FIF or FLP held by the leaving company. → section 717-255, ITAA 1997

Under section 23AK of the ITAA 1936, when the head company or the leaving company receives a distribution paid out of previously attributed FIF income, it will continue to be exempt from tax.

Under section 23B of the ITAA 1936 (which was introduced to preserve the effect of former section 613 of the ITAA 1936), when the head company or the leaving company disposes of an interest in a FIF or FLP where the FIF income has been attributed but not distributed before disposal, the head company or the leaving company may reduce its capital proceeds. The capital proceeds may be reduced by so much of the post-FIF abolition surplus that it has in relation to those interests not exceeding the capital proceeds.

Therefore, on disposal of an interest in a FIF or a FLP, the head company or the leaving company can continue to take advantage of the section 23AK exemption or the former section 613 reduction of capital proceeds.

→ 'Treatment of foreign income tax offsets, attribution surpluses and conduit foreign income', C6-1

Elections relating to CFCs, FIFs and FLPs

An entity can make irrevocable elections in relation to calculating the attributable income of CFCs, or FIF income for FIFs or FLPs. If a subsidiary member makes irrevocable elections before the joining time, the elections are not taken to have been made by the head company for the head company core purposes. Any irrevocable elections made by a head company before consolidation continue to apply to interests in CFCs, FIFs and FLPs that the head company holds under the single entity principle. → section 715-660, ITAA 1997

Due to the repeal of the FIF rules, a consequential amendment was made to section 715-660 of the ITAA 1997. This is because from the 2010-11 income year onwards, taxpayers with interests in FIFs or FLPs are no longer subject to the attribution rules and are not required to make any elections in relation to calculating FIF income.

→ 'Treatment of foreign income tax offsets, attribution surpluses and conduit foreign income', C6-1

Conduit foreign income

The conduit foreign income rules replace the foreign dividend account rules from an entity's first income year commencing on or after 1 July 2005. Transitional rules apply to this first income year.

The operation of the foreign dividend account rules is dealt with under 'Foreign dividend accounts' on p. 6.

The conduit foreign income rules provide an exemption from withholding tax on unfranked (but frankable) distributions declared to be conduit foreign income received by non-resident members of an Australian corporate tax entity.

Without limiting the effect of the single entity and the entry history rules, both have effect for all purposes of the conduit foreign income rules.
→ section 715-875, ITAA 1997

The single entity rule treats conduit foreign income derived by any member of a consolidated group to be conduit foreign income derived by the head company.

On an entity joining a consolidated group, the entry history rule applies so that any conduit foreign income of the joining entity becomes conduit foreign income of the head company.

Where an entity leaves a consolidated group, it does not take any conduit foreign income with it. The conduit foreign income remains with the head company.

The conduit foreign income rules also provide that conduit foreign income can be distributed through a chain of Australian corporate tax entities and retain its character as conduit foreign income provided the income is distributed within the required time. This rule has no application for distributions between members of the same consolidated group while they are members of the group. The head company can distribute conduit foreign income within the required time.

The conduit foreign income rules apply in the same way to MEC groups.

→ 'Treatment of foreign income tax offsets, attribution surpluses and conduit foreign income', C6-1

Foreign dividend accounts

Before the introduction of the conduit foreign income rules, a foreign dividend account (FDA) was kept by a company so that it could pay dividends to non-resident shareholders free from dividend withholding tax where those dividends were paid out of certain non-portfolio dividends received by the company.

The head company of a consolidated group operated a single FDA by pooling any FDA surpluses and deficits transferred to it by subsidiary members at the joining time. The foreign investments of all the subsidiary members were aggregated so that the head company could credit the FDA for the total non-portfolio dividends received and debit the account for the total foreign tax paid. The head company was then taken to have made the FDA declarations for dividends paid to its shareholders and the shareholders of its subsidiary members.

Special rules applied in relation to MEC groups.

When a company ceased to be a subsidiary member of a group it could not take an FDA balance with it on exit.

→ 'Treatment of foreign income tax offsets, attribution surpluses and conduit foreign income', C6-1

Offshore banking units

If a member of a consolidated group is a gazetted offshore banking unit, the consolidation rules deem the head company of the consolidated group to be an offshore banking unit for the period in which the subsidiary member has this status. → 'Treatment of foreign income tax offsets, attribution surpluses and conduit foreign income', C6-1

References

Income Tax Assessment Act 1997, Subdivision 717-A; as amended by *Tax Laws Amendment (2007 Measures No. 4) Act 2007* (No. 143 of 2007), Schedule 1

Income Tax (Transitional Provisions) Act 1997, Division 770; as amended by *Tax Laws Amendment (2007 Measures No. 4) Act 2007* (No. 143 of 2007), Schedule 1

Explanatory Memorandum to Tax Laws Amendment (2007 Measures No. 4) Bill 2007

Income Tax Assessment Act 1997, former Division 717-A; as amended by

- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 6
- *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 7
- Tax *Laws Amendment (2004 Measures No. 2) Act 2004* (No. 83 of 2004), Schedule 2

Income Tax Assessment Act 1997, Subdivisions 717-D and 717-E; as amended by

- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 6
- *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 8
- *Tax Laws Amendment (2007 Measures No. 4) Act 2007* (No. 143 of 2007), Schedule 1
- *Tax Laws Amendment (Foreign Source Income Deferral) Act (No. 1) 2010* (No. 114 of 2010), Schedule 1

Explanatory Memorandum to Tax Laws Amendment (Foreign Source Income Deferral) Bill (No. 1) 2010

Income Tax Assessment Act 1997, Subdivisions 715-J and 715-K; as amended by *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004

Income Tax Assessment Act 1997, Subdivision 715-U and Division 802; as amended by *Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Act 2005* (No. 147 of 2005), Schedule 2

Explanatory Memorandum to Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Bill 2005

Income Tax Assessment Act 1997, Subdivision 717-J; as amended by:

- *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 9

- *Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Act 2005* (No. 147 of 2005), Schedule 2

Income Tax Assessment Act 1997, Subdivision 717-O; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 10

Revision history

Section B2-5 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on recent changes to consolidation rules.	Legislative amendments.
3.11.04	Certain irrevocable elections are not inherited by head company or leaving entity.	Reflect amendments in *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (83 of 2004).
	Remove 14.7.04 notes on recent changes to consolidation rules.	Text amended to reflect the changed rules.
30.6.09	Extensively revised to take account of new rules for foreign income tax offsets and conduit foreign income.	Amendments in *Tax Laws Amendment (2007 Measures No. 4) Act 2007* and *Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Act 2005.*
6.5.11	Revised to take into account the repeal of Part XI of the ITAA 1936 in relation to the FIF and FLP rules.	Legislative amendments.

Consolidation and the thin capitalisation rules

Note

MEC groups and the thin capitalisation rules

The thin capitalisation rules for consolidated groups also apply to multiple entry consolidated (MEC) groups. For the purposes of this section, 'consolidated groups' includes MEC groups.

The thin capitalisation grouping rules are effectively replaced by the consolidation rules. The thin capitalisation grouping rules generally cease to operate for a company from the time it becomes a member of a consolidated group or from 1 July 2003, whichever is earlier. However, these rules continue to operate until the consolidation day (joining time) for companies that become members of a consolidated group that forms on the first day of the head company's income year beginning before 1 July 2004.

The thin capitalisation rules apply to a consolidated group in accordance with the single entity principle.

The rules characterise the head company of the consolidated group as either an inward or outward investor, and as an ADI (authorised deposit-taking institution) or non-ADI depending on the characteristics of its member entities. Subject to certain modifications to the rules, the group's thin capitalisation position is then determined in accordance with the thin capitalisation rules applicable to that classification.

Any denial of debt deduction is accounted for in the tax return lodged by the consolidated group.

The thin capitalisation regime also continues to permit foreign bank branches to group with a consolidated group for thin capitalisation purposes only, in order to determine the relevant funding levels on a group basis. In these cases, any denial of debt deduction will be apportioned between the foreign bank branch and the consolidated group on a similar basis to that which currently applies under the existing thin capitalisation grouping provisions.

Note

Recent changes to consolidation rules

Recent changes to the *Financial Corporations (Transfer of Assets and Liabilities) Act 1993* ensure that the income tax relief provided by that Act applies appropriately to financial corporations that are members of consolidated groups – see *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (83 of 2004), Schedule 2, Part 12, 'Financial corporations (Transfer of Assets and Liabilities) Act 1993'.

More information

→ 'Thin capitalisation and consolidated groups', C6-1-110

Revision history

Section B2-6 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on recent changes to consolidation rules, p. 1.	Legislative amendments.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

B3: Operating

Operating

About this section

A consolidated group is treated as a single entity for income tax purposes. The head company becomes the contact point with the ATO.

This section deals with:

- **Making a choice to consolidate and notifying:** the head company chooses the date of effect of consolidation, makes the choice in writing and notifies the ATO.
  → B3-1
- **Paying PAYG instalments:** When the head company lodges the first consolidated income tax return, the ATO calculates an instalment rate for the head company using information on the return. The head company then pays PAYG instalments on a consolidated basis.
  → B3-2
- **Determining annual liability:** The head company self-assesses the annual income tax liability of the consolidated group, lodges a single income tax return for the group and makes a balancing payment or receives a balancing credit.
  → B3-3
- **Managing obligations:** The head company is responsible for the income tax-related liabilities of the entire group from the date of consolidation. Subsidiary members could be made liable to pay all or some of the unpaid income tax-related liabilities of the group.
  → B3-4
- **Changing group membership:** The head company needs to notify the ATO, and may also need to recalculate the group's income tax position, when a member joins or leaves the group, or the consolidated group ceases to exist.
  → B3-5

Revision history

Section B3-0 first published (excluding drafts) 2 December 2002. Further revisions are described below.

Date	Amendment	Reason
6.5.11	Minor revisions to reflect changes to choice to consolidate rules.	Legislative amendments.

Making a choice to consolidate and notifying

Key points

The choice to consolidate is irrevocable and must:

- include all eligible members of a group, and
- be made in writing.

The head company can make the choice in writing up until the day it lodges its income tax return for the income year in which the day specified in the choice occurs (or if a return is not required, the date it would otherwise be due).

The head company must notify the ATO using the approved notification form within the same time period as applies for making the choice in writing.

Notification can be submitted online or on paper.

Changes to group membership and cessation of the consolidated group must also be notified.

Effects of choice to consolidate

A consolidated group is created when a head company of a consolidatable group makes a choice in writing that it is forming a consolidated group from a particular date and notifies the Commissioner of the choice in the approved form. → 'Choice in writing', C7-1-110

One in, all in

Consolidation works on a 'one in, all in' basis – that is, it is binding on all eligible members of the group. When a choice is made to consolidate, all eligible members of the consolidatable group will become members of the consolidated group. There are special rules for MEC groups.

Consolidation cannot be revoked

The choice to consolidate cannot be revoked and the date specified in the written choice cannot be amended.

In general, a consolidated group will continue to exist as long as the head company remains eligible to be the head company. It is not affected by changes in the membership of the group. A consolidated group may at times consist solely of a head company.

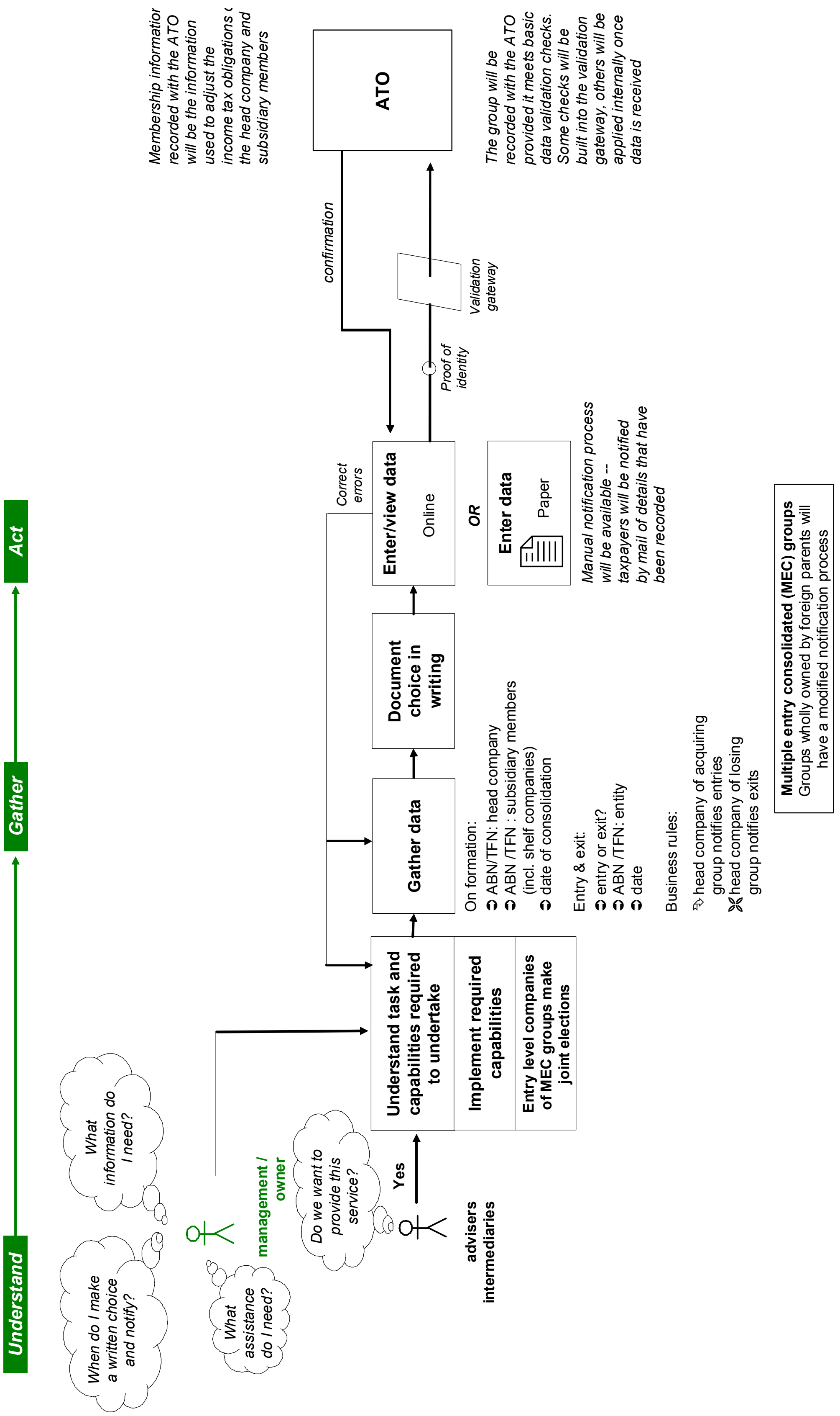
A consolidated group will cease to exist if the head company ceases to be a head company; for example, by becoming a subsidiary member of another consolidated group.

Note

Income tax liability of members

Each member of a consolidated group remains liable for income tax for periods in the income year in which it is not a subsidiary member of a consolidated group. If the date of consolidation is not the start of the subsidiary member's income year (usually 1 July), the subsidiary members of the group may need to lodge their own income tax returns to report the tax liability relating to periods that were not covered by the consolidation arrangements.

Figure 1: Consolidation pathway – making a choice and notifying status



Head company to notify ATO

The head company must notify the ATO of its choice to consolidate on the approved notification form. This enables the ATO to adjust its records of liability and reporting obligations for the entities in the consolidated group.

→ 'Consolidated groups – notices to be given to the Commissioner', C7-1-120

MEC groups

In the case of a foreign-owned MEC group, the eligible tier-1 companies forming the group are required to jointly make a choice in writing and to choose the date on which the MEC group is to form. The head company of the MEC group is responsible for notifying the ATO of this choice.

→ 'Multiple entry consolidated (MEC) groups', C10-1; 'MEC groups – notices to be given to the Commissioner', C10-1-110

Note

Transitional rules: setting asset values

If a group consolidates before 30 June 2004 and qualifies as a transitional group, it can take advantage of the transitional rules for determining asset values. Transitional rules provide that assets may retain their existing costs for tax purposes on a subsidiary-by-subsidiary basis, rather than needing to use cost setting rules across the group.

To qualify as a transitional group, the group must have at least one transitional entity.

→ 'Transitional entities and chosen transitional entities', C2-4-105; 'Treatment of assets', C2-1

Make a choice and notify by lodgment date of income tax return

The head company can make the choice to consolidate at any time up to the date of lodgment of its income tax return for the income year in which the choice is to have effect – or, if a return is not required, the date it would have otherwise been due.

The ATO must be notified of the choice to consolidate within the same time period as applies to making the choice. Note that, while there is no legal requirement to do so, making the notification two to three weeks before the head company lodges its return will allow the ATO to update the group's tax records and ensure the return is correctly processed.

Example

Making the choice to consolidate and notifying the ATO

A consolidatable group exists consisting of a head company, Head Company Pty Ltd, and three wholly-owned subsidiary members. On 15 August 2010, Head Company makes a written choice to consolidate, effective from 1 July 2009. In September 2010, Head Company notifies the ATO of the formation of the group. Head Company lodges a consolidated income tax return for the income year ending 30 June 2010 on 15 December 2010 and begins reporting and paying consolidated PAYG instalments from the March quarter due 21 April 2011.

The consolidated group is treated as a single entity for income tax purposes for the 2009-10 income year.

Notifying changes to group membership

The head company or the head company's former public officer (if the company no longer exists) is required to notify the ATO of the following events:

- an entity becoming a subsidiary member of the consolidated group
- an entity ceasing to be a subsidiary member of the consolidated group, or
- a consolidated group ceasing to exist.

Generally, the event must be notified within 28 days; however, if an entity joins or leaves the group before the choice to consolidate is notified to the ATO, the information about the change in membership must be included in the choice notification.→ 'Changing group membership', B3-5

How to notify

Notifications must be made on the approved ATO forms.

→ 'Consolidated groups – notices to be given to the Commissioner', C7-1-120;
'MEC groups – notices to be given to the Commissioner', C10-1-110

When the notification has been processed, a letter will be sent to the head company at its postal address confirming receipt of the notification and the date of consolidation, and listing the subsidiary members as included in the notification.

Revision history

Section B3-1 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on recent changes to the consolidation rules.	Legislative amendments.
6.5.11	Extensively revised to reflect changes to the choice and notification provisions.	Legislative amendments.

Paying PAYG instalments

Key points

Until the head company of a group is given an instalment rate worked out from its first consolidated income tax return, member entities continue to pay PAYG instalments as if they were not consolidated.

- Member entities can vary their instalments – however, this could have consequences for the head company of the group, and both the head company and subsidiary member should carefully consider the basis on which any variation is made.

When the head company lodges the first consolidated income tax return, the ATO calculates an instalment rate for the head company using information on the return.

- Head companies with a base assessment instalment income of $1 million or less retain the option to pay an instalment amount calculated by the ATO.
- The right to vary PAYG instalments on the basis of projected outcomes continues to be available.

The pay as you go (PAYG) system for paying income tax instalments is modified to ensure the benefits of single entity tax treatment extend to income tax instalments payable by head companies of consolidated groups.

Formation arrangements

Until the first consolidated income tax return is lodged and the head company receives its consolidated instalment rate, member entities continue to pay PAYG instalments as if they were not consolidated.

During the formation period, the head company is entitled to a credit for PAYG instalments payable by a subsidiary member of the group after the joining time of that member. The amount of the credit takes account of the period in which a subsidiary member is actually a member of the group and the extent to which the instalment period falls within the head company's income year.

Any unpaid instalments of members remain the liability of those members.

Note

Instalment income

During the period that member entities continue to pay PAYG instalments, they calculate their instalment income as though they were not members of a consolidated group.

For example, they continue to include income derived from intragroup transactions, even though such income is not assessable to the member entity or the head company. This is because the entity's instalment rate, which was worked out from an assessment for an income year when the entity was not a member of a consolidated group, takes into account intragroup transactions in that income year.

Varying

Entities retain their existing right to vary their instalments. However, this could have consequences for the head company of the group, and both the head company and subsidiary member should carefully consider the basis on which any variation is made.

If any member varies an instalment, the instalments of all members will be considered on a group basis. The head company of the group may be subject to a general interest charge in relation to the instalments payable by the group's members for a particular instalment quarter if the group's instalments for that quarter are less than 85% of one-quarter of the head company's benchmark tax. (Generally, the head company's benchmark tax is its assessed tax reduced by any tax attributable to any net capital gains that are included in its assessable income.)

This means that if any entity varies an instalment, the 'protection' of using the ATO instalment rate or amount is effectively removed for the head company of the group.

Ongoing arrangements

After the head company lodges the group's first consolidated income tax return, the ATO calculates an instalment rate for the group based on the head company's return. The group is then a 'mature group' and the head company pays PAYG instalments on a consolidated basis from the beginning of the instalment quarter in which the ATO issues the rate. The head company receives a separate activity statement to pay these instalments. (For an example of the new *Consolidated activity statement* → C8-2-110.)

The instalment rate is calculated on the same basis as for an unconsolidated company, with one exception: when the adjusted taxable income of the head company is calculated, instead of automatically taking account of the amount of any carry-forward tax loss, the lesser of the following amounts is taken into account:

- the amount of any carry-forward tax loss, and
- the amount of any tax loss deducted in the base year.

If the group's base assessment instalment income is $1 million or less, the ATO also calculates the group's GDP-adjusted notional tax. The head company would have the option of paying an instalment, calculated by the ATO, based on this amount. (Generally, the head company's base assessment instalment income is the gross business and investment income shown in its latest income tax return.)

Note

Availability of options

The *Consolidated activity statement* for the first quarter of an income year shows the payment option or options available to the head company. The head company can use only one option in an income year. Therefore, if the first *Consolidated activity statement* is for a quarter other than the first quarter of the head company's income year, only one option will be available – the option that was used by the head company in previous quarters of that income year.

→ 'Completing the *Consolidated activity statement*', C8-2-110

A head company is able to vary its consolidated instalment based on its estimate of the expected consolidation outcomes for the year. It is liable for a penalty if:

- it uses the *instalment rate x instalment income* method and the varied instalment rate is less than 85% of the head company's benchmark instalment rate for that income year, or
- it uses the GDP-adjusted instalment amount method and the varied amount is based on an estimate that is less than 85% of the head company's benchmark tax.

A head company of a mature group must pay quarterly instalments. These instalments are due on or before 21 days after the end of the instalment quarter.

If there has been a change to the membership of a mature group, the ATO may give the group a new instalment rate or GDP-adjusted instalment amount to reflect the change in membership. The new rate or amount may be lower or higher. The ATO may give a new rate or amount if applying the head company's existing rate to the instalment income of the changed group or paying the existing instalment amount would result in the head company paying instalments that significantly exceed or fall short of its expected tax liability.

Members entering a mature group part-way through a quarter are required to pay an instalment for that quarter. If they are paying using the *instalment rate x instalment income* method, they include only the income prior to entry to the group (income derived from the date of entry onwards is income of the head company).

Members leaving a mature group part-way through a quarter are required to pay an instalment for that quarter. They leave with the instalment rate of the head company and pay an instalment based on their instalment income from the date of exit to the end of the quarter. The leaving member is given its own rate, and if eligible an instalment amount, after it lodges a tax return that covers the period after it exited.

Deregistered companies

Under section 9 of the *Corporations Act 2001* a company is defined as a company registered under that Act. When a company is deregistered by the Australian Securities Investments Commission (ASIC), it ceases to exist as a Corporations Act company and therefore no longer meets the definition of an entity as detailed in the tax law. Accordingly, when a subsidiary member of a consolidated group is deregistered, it can no longer form part of a consolidated group, and the head company is required to notify the ATO that the subsidiary member has left the group on the date it was deregistered. Where an entity leaves a consolidated group because it has been deregistered, the ATO withdraws it from the PAYG instalment system.

More information

→ 'Treatment of PAYG instalments', C8-1

Revision history

Section B3-2 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
15.4.10	New section on deregistered companies, p. 3.	For clarification.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Determining annual liability

Key points

The **head company** self-assesses the annual income tax liability of the consolidated group, lodges a single income tax return for the group and makes a balancing payment or receives a balancing credit.

Subsidiary members that are part of a consolidated group for only part of a financial year separately self-assess their income tax liability and lodge an income tax return for the periods in which they were not part of a group.

Self-assess income tax liability

The head company needs to consolidate income tax information from all members of the group to prepare a single consolidated income tax return.

Entities that are part of a consolidated group for only part of an income year separately self-assess their income tax liability and entitlement to pay as you go (PAYG) instalment credits for the periods in which they were not part of the group.

Reconcile, lodge and make payment

Head company

The head company:

- lodges a single income tax return for the group
- reconciles available PAYG instalment credits with its income tax liability, and
- makes any balancing payment or receives a refund.

During the formation period, the head company is entitled to a credit for PAYG instalments payable by the group's subsidiary members. Where a subsidiary member's instalment liability spans both pre- and post-consolidation periods, the head company needs to make a reasonable apportionment of the liability between the two periods.

The credit available to the head company takes into account the period in which the member was actually in the group. The remainder of the credit is available to the subsidiary member. Where the subsidiary member and the head company have different accounting periods, the amount of the credit available to the head company takes account of how much of the instalment period fell within the head company's income year. The balance of the credit is available to the head company in the subsequent income year. Where necessary, the ATO will assist by providing information on instalment obligations to those authorised to receive it.

Note

Access to income tax information

A head company may access ATO income tax information on a subsidiary member once it has notified the ATO of the consolidated group's formation.

Where a head company requires information but has yet to notify the ATO of the group's formation, the information may be provided where one of the following conditions is met:

- The tax agent reference number for the head company and subsidiary member is identical and the subsidiary member authorises the tax agent to pass the information to the head company (that is, the head company would access the information via the tax agent).
- The subsidiary member's public officer nominates an officer of the head company as the subsidiary member's representative using the approved form (so that the nominated person is entitled to receive protected information).

When preparing the income tax return, the head company should complete label Z1 at item 3 'Status of company' on page 2 of the return to indicate the return has been prepared on the basis that it is the head company of a consolidated or MEC group. → *Company tax return instructions*, NAT 0669-6

Subsidiary members

An entity that is a subsidiary member of a consolidated group for the entire income year does not lodge an income tax return or complete any schedules. But if the entity is not part of a consolidated group for any period of the income year, it needs to lodge a single income tax return (at the normal lodgment time) covering the period(s) it was outside a group. Therefore, an entity that joins a consolidated group during an income year should wait until the end of the year before it lodges a return covering the period(s) it was not a member of a consolidated group.

When a entity that has been a subsidiary member of a consolidated group for any period of the year is preparing a return, it should complete label Z2 at item 3 'Status of company' on page 2 of the return to indicate that it has been a subsidiary member of a group. → '*Company tax return instructions*, NAT 0669-6

Note

A subsidiary member of a consolidated group should *not* indicate this is a final return if membership of the consolidated group is the only basis on which the company will not be required to lodge future returns.

Tax consequences arise for the joining entity as a consequence of it ceasing to hold its trading stock, and this must be taken into account in calculating the entity's income tax liability for the period up to the joining time. → section 701-35, ITAA 1997; 'Treatment of trading stock brought into the group', C9-5-320

Where a subsidiary member has operated outside the group for more than one period during a particular income year, the income tax payable for that year is worked out by calculating the taxable income for each non-membership period as if each period were a separate income year. The subsidiary member's income tax liability for the whole year is the total of each of these amounts. Note that if this entity has a loss or entitlement to other credits for the non-membership period that ends on the last day of the income year, that loss or credit cannot be applied in calculating the tax payable for any prior non-membership period. Such a loss or credit is carried forward. → 'Calculating taxable income, income tax and losses for non-membership periods', C9-5-110

Where a return is required because the subsidiary member was not a member of a consolidated group for part of the income year, the subsidiary member should complete any schedules relevant to the non-membership periods.

The subsidiary is required to self-assess its entitlement to a PAYG instalment credit. The basis for this calculation is described under 'Head company', p. 1.

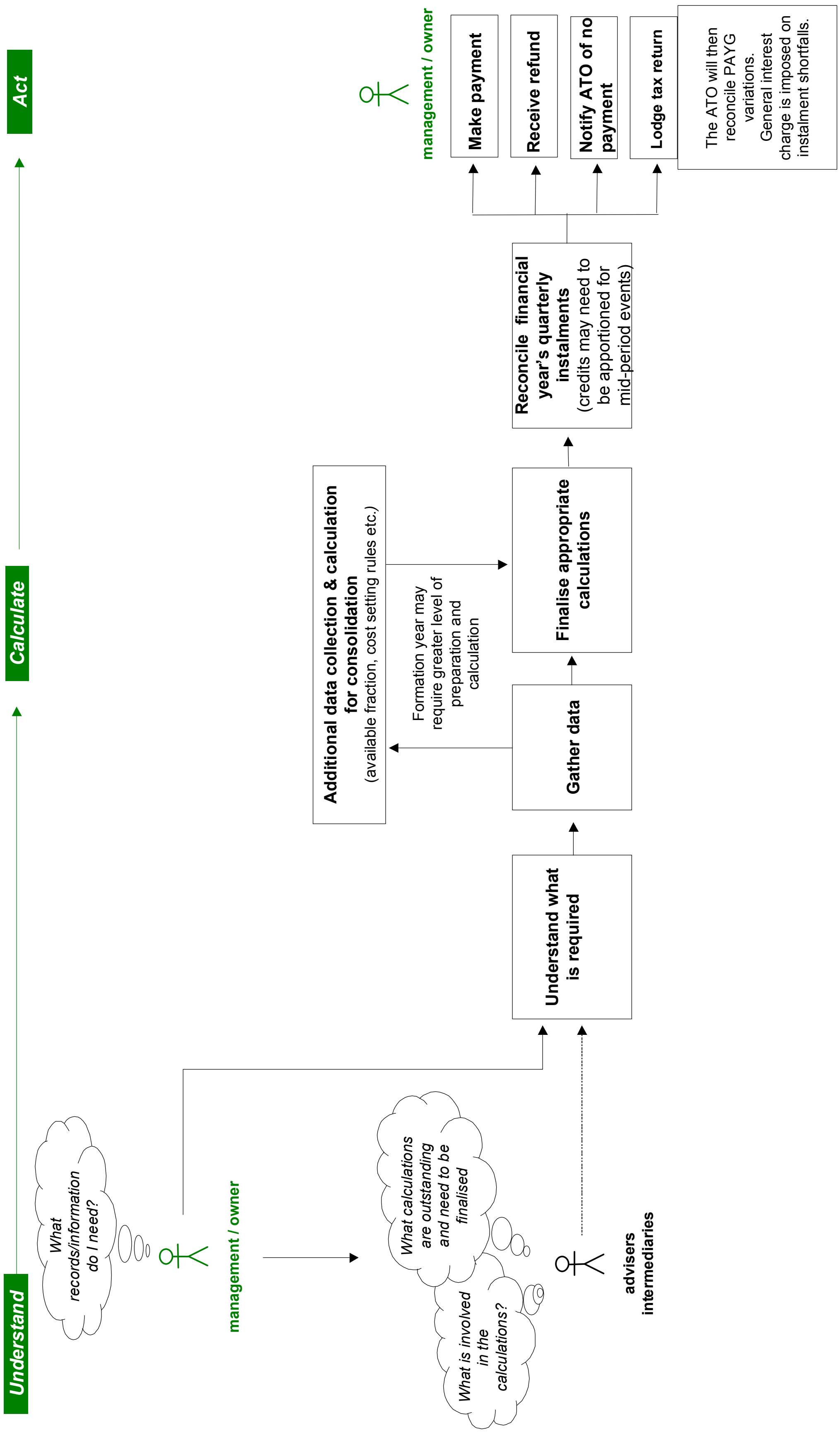
Revision history

Section B3-3 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Changes to text on the tax return obligations of a subsidiary member and on the tax consequences for a joining entity of it bringing trading stock into the group, p. 2.	For clarification.
6.5.11	Revisions to reflect changes introduced by the *Tax Laws Amendment (Confidentiality of Taxpayer Information) Act 2010* (No. 145 of 2010).	Legislative amendments.

Figure 1: Consolidation pathway – Determining annual liability



Managing obligations

Key points

The **head company** is responsible for the income tax liabilities of the entire group from the date of consolidation, and the group's PAYG instalment liabilities after a group PAYG instalment rate has been issued.

Subsidiary members could be made liable to pay all or some of the unpaid income tax related liabilities of the group.

The head company is also responsible for supply of income tax related information for the consolidated group.

In accordance with the single entity rule, the head company is responsible for a consolidated group's income tax liabilities (group liabilities) from the date of effect of consolidation.

After the head company lodges the group's first consolidated income tax return, the Tax Office issues a consolidated group pay as you go (PAYG) instalment rate. When this occurs the group will be known as a 'mature group'. From this point the head company is responsible for the group's PAYG instalment liabilities.

The head company is not responsible for the income tax related liabilities incurred by subsidiary members before they join the group. Nor is the head company responsible for unpaid PAYG instalments that are payable by subsidiaries before it receives the group's consolidated PAYG instalment rate. These liabilities remain with the subsidiary member.

The group needs to ensure that the head company is in a position to meet its obligations. This might involve:

- ensuring arrangements are in place with subsidiary members to fund the head company's payment to the Tax Office, and
- ensuring the information required from subsidiary members is available in time for the head company to lodge the group's activity statement or income tax return and calculate the amount that needs to be paid.

The Tax Office will create a separate PAYG instalment account for the group to record liabilities and head company payments of consolidated PAYG instalments.

Payment not made

It is expected that a head company will pay its group liabilities by the relevant due date. If, for whatever reason, the head company cannot make payment by the due date the onus will remain with the head company to contact the Tax Office to explain its situation and seek to come to an arrangement to pay.

The Tax Office will initially seek to recover any unpaid group liabilities from the head company. Where this is unsuccessful or is likely to be unsuccessful, the Tax Office may seek recovery from subsidiary members of the group.

A subsidiary member could be made liable for a group liability that accrued during a period it was a member of a group if the head company fails to pay, whether or not the subsidiary member has ceased to be a member of the group. Such a subsidiary member is known as a 'contributing member'.

Tax sharing agreement may limit liability

A contributing member's exposure to a group liability could be limited to an amount determined by a tax sharing agreement (TSA), providing it is a party to the agreement and the agreement:

- is in place before the head company's due time (i.e. the due date for payment of the liability)
- allows an amount to be determined for each TSA contributing member in respect of the group liability
- provides a reasonable allocation of the total amount of the group liability (or alternatively, where the liability is for income tax, the total amount less the head company's PAYG instalment credits on assessment) between the head company and the contributing members, and
- has not been entered into as part of an arrangement, a purpose of which was to prejudice recovery by the Tax Office.

Note that each group liability must be covered by no more than one TSA.

Provided it still represents a reasonable allocation, not all contributing members are required to be party to the TSA. However, it may be prudent that all contributing members elect to do so for due diligence and other commercial reasons.

For a TSA to have effect, the head company must provide a copy in the approved form to the Tax Office within 14 days of a request to the head company.

If an unpaid group liability is not covered by a TSA or if the TSA is not provided to the Tax Office when required, contributing members are jointly and severally liable for the liability.

Payment by a subsidiary to head company

A payment made by a subsidiary member to the head company does *not* extinguish the subsidiary member's liability – i.e. the subsidiary member could still be required to make a payment to the Commissioner of their TSA contribution amount or of a joint and several liability. This applies even if the amount paid to the head company equals what would be required under the TSA.

Clear exit

A contributing member that has left the group can leave the group clear of the group liability if:

- the group liability is covered by a TSA to which it is a party and which satisfies the conditions set out above
- the member had left the group before the group liability had become due and payable by the head company[3]
- the member had paid to the head company the allocated amount under the TSA (or a reasonable estimate of the amount) before it left the group, and
- the exit from the group did not take place as part of an arrangement, a purpose of which was to prejudice the recovery of some or all of the group liability.

As noted earlier, a group liability will be held not to be covered by a TSA if the head company fails to give the Commissioner a copy of the TSA within 14 days of a written request. However, a member that has left the group in such a case may avoid joint and several liability by providing the Commissioner with a copy of the TSA within 14 days of being given written notice of the group liability by the Commissioner.

Note that a further liability may arise for a leaving entity that has made a clear exit if the group liability is subsequently altered (for example, an income tax assessment is amended).

Group liabilities

Group liabilities include:

- PAYG instalments once the group is a mature group
- income tax (including any liability taken to be income tax for the purposes of section 204 of the *Income Tax Assessment Act 1936*)
- franking deficit tax
- general interest charge (GIC) in respect of the unpaid amount of any of the above liabilities, and
- certain administrative penalties incurred by the head company.

[3] Note that amended assessments relating to the 2003-04 and earlier income tax years are due and payable on the same date as the original assessment. However, for amended assessments relating to the 2004-05 and later years, the due and payable date is 21 days from when the taxpayer is given notification of the amendment.

References

More detailed technical information on TSAs is provided in part C of the manual. → 'Tax sharing agreements', C9-7-110

The law dealing with income tax related liabilities when a head company fails to pay is in Division 721 of the *Income Tax Assessment Act 1997*, as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1, the *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 14, and *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (No. 83 of 2004), Schedule 2, Part 10.

Revision history

Section B3-4 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

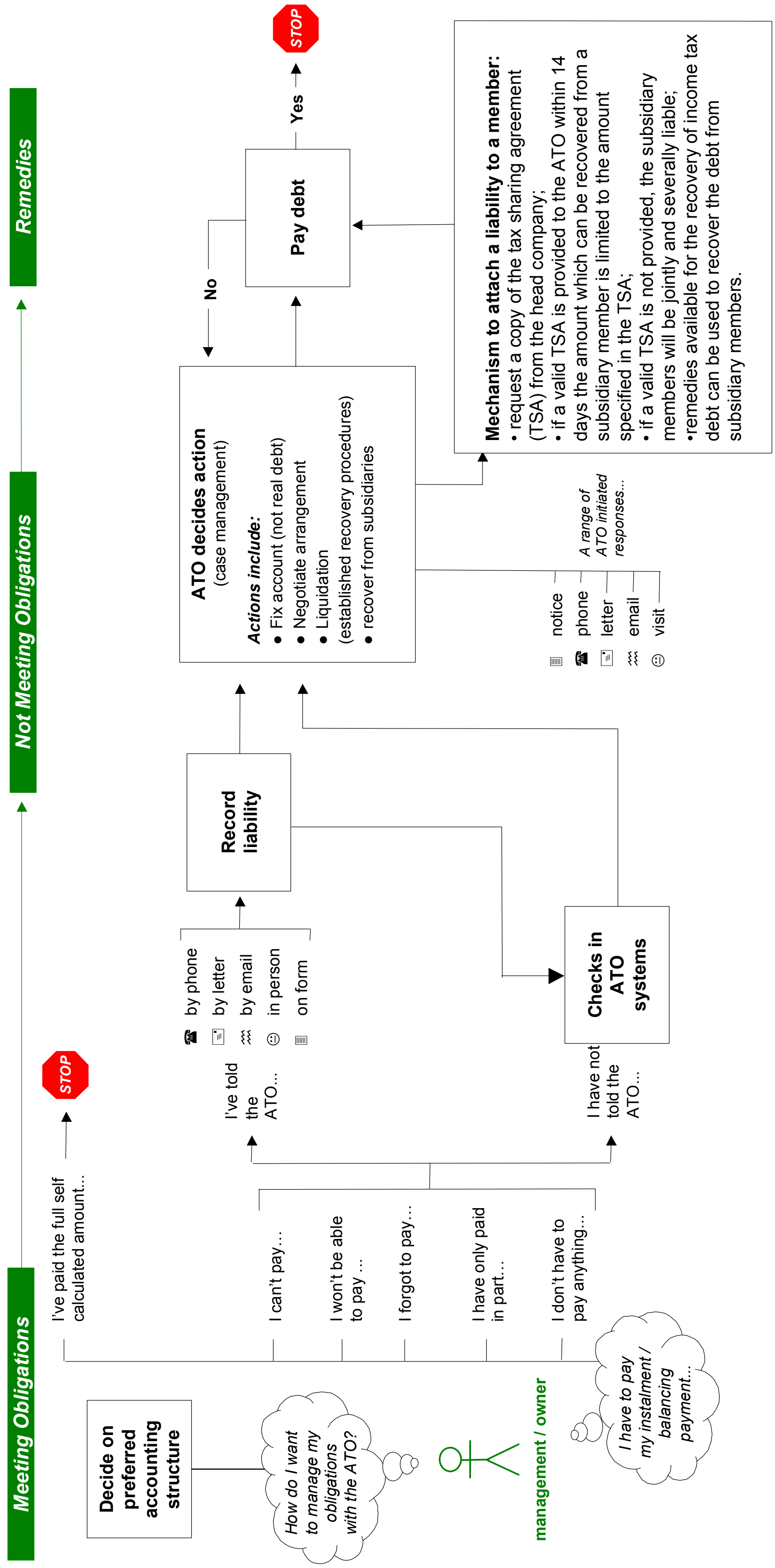
Date	Amendment	Reason
23.4.04	New paragraph under 'Tax sharing agreement may limit liability' (p. 2) clarifying that not all contributing members are required to be a party to a TSA.	For clarification.
	Section on 'Transitional year' deleted.	No longer relevant.
14.7.04	Note on recent changes to consolidation rules.	Legislative amendments.
26.10.05	Minor changes to pp. 2, 3.	Legislative amendments.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Figure 1: Consolidation pathway – Managing obligations



Changing group membership

Key points

The head company must notify the ATO, generally within 28 days, and may also need to recalculate the group's income tax position, when:

- a new member joins the group
- an existing member leaves the group
- the consolidated group ceases to exist.

In some circumstances, a shelf company may be interposed as a new head company without causing the group to cease.

Joining member

In general, an entity that meets the membership criteria becomes a subsidiary member when it is 100% beneficially owned by the head company or other group members. A subsidiary member joins the group by:

- being acquired
- being formed
- becoming eligible for membership.

When a new member joins the group, the head company needs to:

- set the tax cost of assets that the joining member brings into the group → 'Determining asset values', B2-2
- recalculate available fractions for the entire group (in certain circumstances) → 'Transferring and using losses', B2-3
- transfer franking credits, excess foreign tax credits, attribution account surpluses and attributed tax account surpluses to the head company → 'Transferring franking credits', B2-4; 'Treatment of foreign income tax offsets, excess foreign tax credits, attribution surpluses, conduit foreign income and irrevocable elections', B2-5
- notify the ATO within 28 days of the entity joining the group, except where the entity joins before the notification of formation of a consolidated group has been lodged, in which case the notification of the entity joining the group must be included on the formation notice. → 'Consolidated groups – notices to be given to the Commissioner', C7-1-120

Leaving member

Generally, a subsidiary member is no longer a member of the group when it ceases to be 100% beneficially owned by the head company or other group members. A subsidiary member leaves the group when:

- all or part of it is sold
- it is deregistered
- it becomes ineligible for membership for any other reason.

Note

An entity does not cease being the beneficial owner of a membership interest in another entity merely because the first entity is in the process of being **wound up**, is in **receivership** or is under **administration**. → 'Wholly-owned subsidiary – the general test' in 'Eligibility tests and rules', C1-1

When an existing member leaves the group the head company needs to:

- determine the terminating values of the assets in the leaving entity just before the leaving time → 'Determining asset values', B2-2
- set the tax cost of the membership interests in the leaving entity
  → 'Adjustment for intra group liabilities owed to a leaving entity on exit', C2-5-260
- work out the pre-CGT proportion of membership interests in the entity leaving the group → 'Pre-CGT membership interests in a leaving entity (with pre-CGT factor attached to assets)', C2-5-710; 'Pre-CGT membership interests in a leaving entity – pre-CGT proportion rules', C2-5-713
- notify the ATO within 28 days of the entity joining the group, except where the entity joins before the notification of formation of a consolidated group has been lodged, in which case the notification of the entity joining the group must be included on the formation notice.
  → 'Consolidated groups – notices to be given to the Commissioner', C7-1-120

A consolidated group continues to exist even though a subsidiary member (or members) leaves the group. The tax attributes that the subsidiary member had when it joined the consolidated group, such as losses and franking credits, remain with the head company of the group.

Subsidiary members that leave the group are treated as separate entities for income tax purposes unless, on leaving, they immediately become subsidiary members of another consolidated group.

Consolidated group ceases to exist

A decision to consolidate cannot be revoked and continues to have effect until the consolidated group ceases to exist. A consolidated group ceases to exist if:

- the head company becomes a subsidiary member of another consolidated group or of a consolidatable group
- the head company ceases to be eligible to be a head company because, for example, the head company ceases to exist or becomes a foreign-resident
- the head company joins a MEC group.

Note

A consolidated group does *not* cease to exist if...

- one or all subsidiary members leave the group (the group can exist with the head company as the sole member)
- ownership of the head company changes (unless it is a change that makes the head company ineligible to be a head company)
- an interposed shelf head company replaces the former head company → 'Interposed shelf head company' below

Head company becomes a subsidiary member of another consolidated group

In this situation the head company and its subsidiary members are effectively treated as a single entity joining a consolidated group. The former head company:

- lodges a tax return for the income year in which it ceased to be a head company. The tax return takes into account all the periods in that income year in which it was not a subsidiary member. The income tax obligations for the period up to the time the former head company joins the new group remain with it
- notifies the ATO that the head company is no longer eligible → 'Consolidated groups – notices to be given to the Commissioner', C7-1-120
- may be permitted to transfer tax attributes (such as losses and franking credits) to the new head company.

The acquiring head company:

- resets the cost of assets using the cost setting rules (with certain modifications) → 'Determining asset values', B2-2
- notifies the ATO of new members joining its group → 'Consolidated groups – notices to be given to the Commissioner', C7-1-120.

Head company ceases to be eligible and the first situation does not occur

This situation may arise where, for example, the head company is purchased by another unconsolidated group and becomes part of a larger consolidatable group. Alternatively, the head company could become a foreign-resident, or there could be a change in its status as a company that pays tax at the general company tax rate.

- Each of the subsidiary members is regarded as having left the group immediately before the head company ceased to be eligible.
- The general cost setting rules (→ 'Determining asset values', B2-2) for entities leaving a consolidated group apply.
- Tax attributes, such as losses and franking credits, remain with the former head company.

- The head company notifies the ATO that it is no longer eligible to be a head company. → 'Consolidated groups – notices to be given to the Commissioner', C7-1-120

Head company joins a MEC group

A consolidated group ceases to exist in this situation, even if the head company continues to satisfy the conditions for being a head company of a consolidated group.

If the head company joins an existing MEC group, the head company and its subsidiary members are treated as a single entity joining a MEC group. The former head company notifies the ATO that it is no longer a head company.

Special rules apply for the head company of the MEC group.

Note

MEC group ceases to exist

The circumstances that cause a MEC group to cease to exist are different to those for a consolidated group. → 'Multiple entry consolidated (MEC) groups', C10-1

Interposed shelf head company

Normally a consolidated group ceases to exist when the head company becomes ineligible to be a head company. However, there is an exception to this rule.

Where a non-operating holding company (in effect, a 'shelf' company with no significant assets) is interposed between a former head company and its shareholders as a result of a share exchange, the consolidated group may continue to exist. The shelf company must be eligible to be a head company and the restructure must comply with existing conditions for the granting of CGT rollover relief (under subdivision 124-G of the *Income Tax Assessment Act 1997*).

For the exception to apply, the shelf company must make an irrevocable choice, within 28 days of the share exchange being completed, that the consolidated group will continue to exist. The consequences of this choice are:

- The shelf company becomes the head company from the date that the share exchange is completed.
- The former head company becomes a subsidiary member from that date.
- None of the subsidiary members are taken to have left the group.
- The general cost setting rules do not apply – assets retain the same tax costs as under the former head company.
- Consolidation provisions that ordinarily apply when an entity becomes a subsidiary member do not apply to the former head company (subject to specific exceptions).
- Everything that happened to the former head company is taken to have happened to the new head company (the 'substitution rule').

- The tax attributes of the former head company are transferred to the new head company.
- The new head company lodges the group's income tax return for that income year and assumes all the income tax related obligations of the former head company (the former head company does not lodge a return if it remains in the group for the remainder of the income year).

The ATO should be notified of the choice being made to continue as a consolidated group with a new interposed head company so that the ATO can update its income tax, PAYG instalments and franking accounts details for the group. → 'Consolidated groups – notices to be given to the Commissioner', C7-1-120

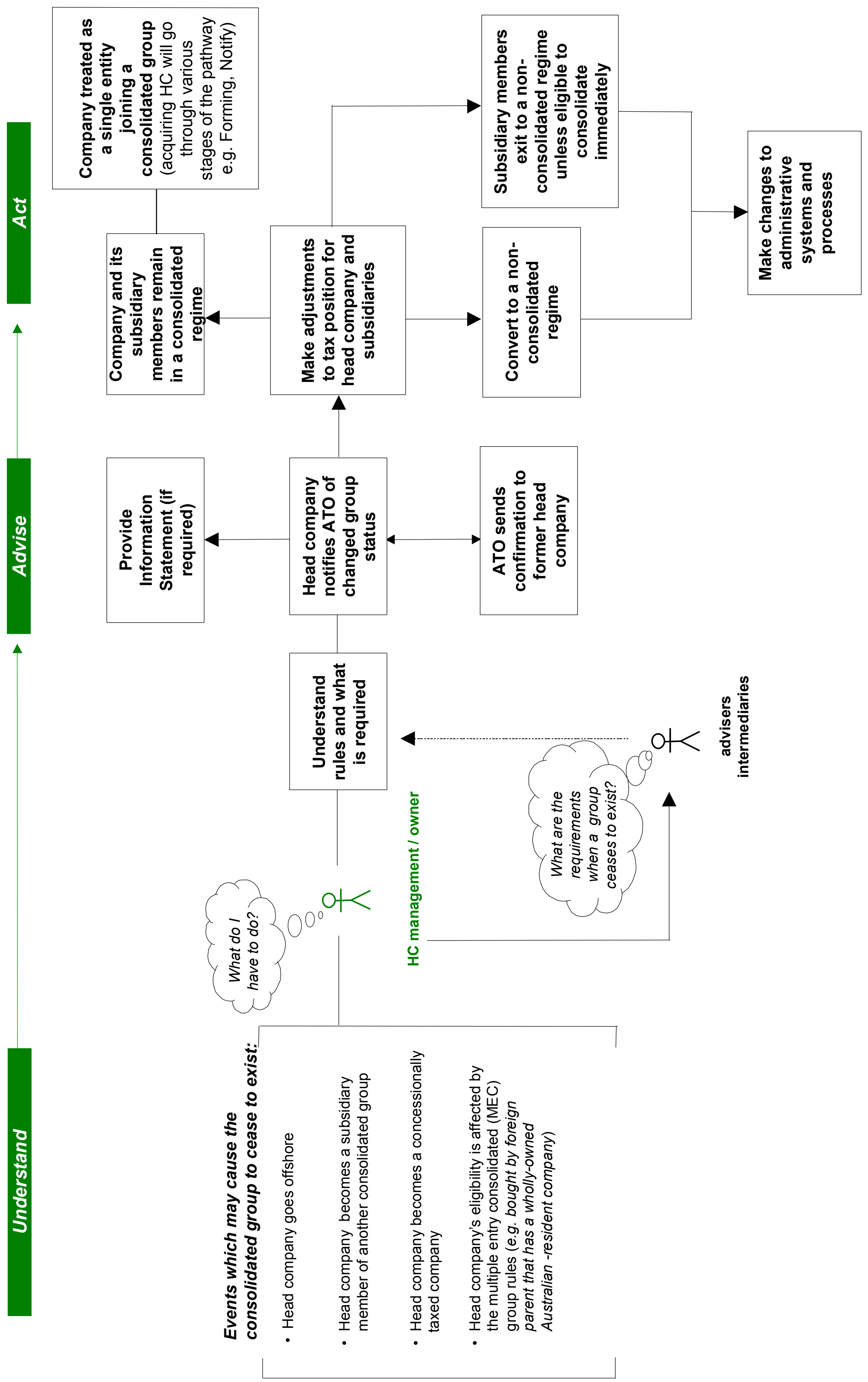
Revision history

Section B3-5 first published (excluding drafts) 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Notes on proposed changes to consolidation rules.	Proposed legislative amendments.
	Change in notification time from two months to 28 days, p. 4.	Legislative amendment.
26.10.05	Update of note on proposed change to consolidation rules, p. 2.	Legislative amendment.
6.5.11	Extensively revised to reflect changes to the choice and notification provisions.	Legislative amendments.

Figure 1: Consolidation pathway – consolidated group ceases to exist



C: Detailed information

C1: **Eligibility**

Eligibility

About this section

This section contains a series of flowcharts, reference material and examples that will help you determine whether your business structure contains one or more consolidatable groups.

It is designed to enable you to test each entity in your business structure to determine whether it qualifies as a head company, a subsidiary member or an entity that cannot be part of a consolidatable group.

Contents

Revision history

Section C1-0 first published 2 December 2002.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Eligibility tests and rules

Contents

The consolidatable group

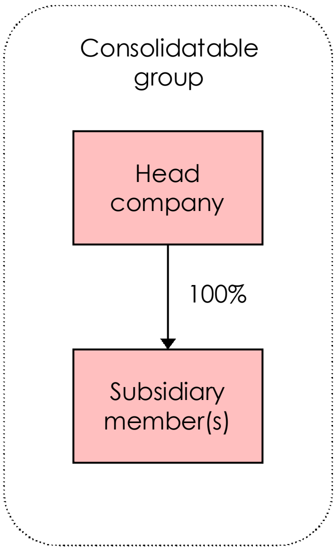
To consolidate, a group must consist of an Australian-resident head company and at least one wholly-owned resident subsidiary (which may be a company, trust or partnership). Certain types of company cannot be a head company or subsidiary member and certain types of trust cannot be a subsidiary member → 'Excluded entities', p. 8.

If a group consolidates, all of the head company's eligible wholly-owned subsidiaries must be included in the consolidated group.

A foreign-owned group of Australian-resident subsidiaries that do not have a single resident head company may instead choose to consolidate by forming a multiple entry consolidated (MEC) group. → C10-1

Figure 1: Consolidatable group

To consolidate, a group must consist of a head company and at least one eligible wholly-owned subsidiary member



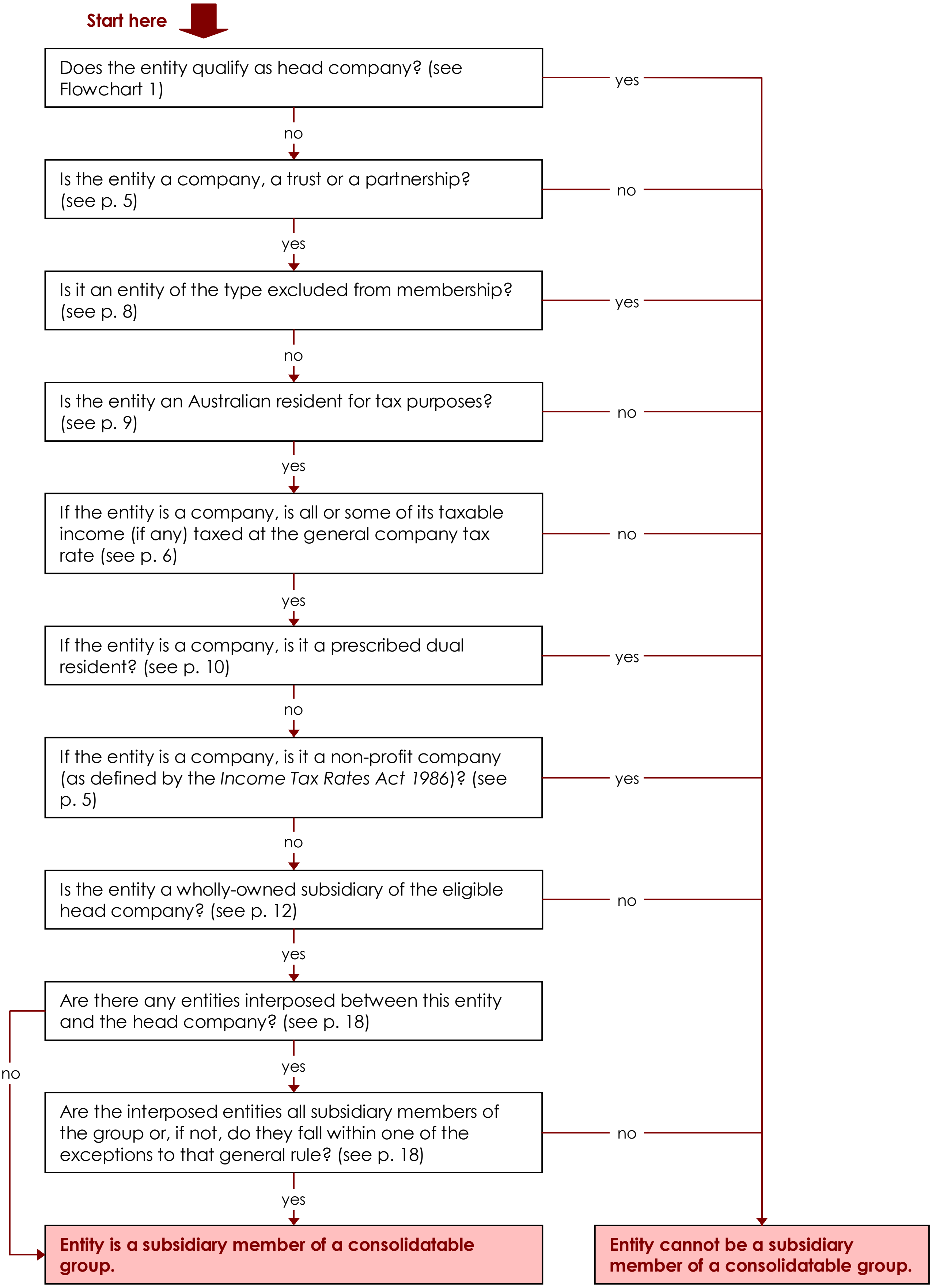
Flowchart 1 – Who can be a head company?

Start here

1. Is the entity a company* for the purposes of the ITAA 1997? (see p. 5)
   - no → **Entity cannot be a head company of a consolidatable group – but it may qualify as a subsidiary member (see flowchart 2).**
   - yes → 2
2. Is it a company of the type excluded from membership? (see p. 8)
   - yes → **Entity cannot be a head company or a member of a consolidatable group.**
   - no → 3
3. Is all or some of the company's taxable income (if any) taxed at the general company tax rate? (see p. 6)
   - no → **Entity cannot be a head company or a member of a consolidatable group.**
   - yes → 4
4. Is the company an Australian resident for tax purposes? (see p. 9)
   - no → **Entity cannot be a head company or a member of a consolidatable group.**
   - yes → 5
5. Is the company a prescribed dual resident? (see p. 10)
   - yes → **Entity cannot be a head company or a member of a consolidatable group.**
   - no → 6
6. Is the company a wholly-owned subsidiary of another company that is eligible to be a head company of a consolidatable or consolidated group? (see p. 12)
   - no → **Company can be a head company of a consolidatable or consolidated group.**
   - yes → 7
7. Are there any entities interposed between this entity and the eligible head company? (see p. 18)
   - no → **Entity cannot be a head company of a consolidatable group – but it may qualify as a subsidiary member (see flowchart 2).**
   - yes → 8
8. Are the interposed entities all subsidiary members of the group or, if not, do they fall within one of the exceptions to that general rule? (see p. 18)
   - yes → **Entity cannot be a head company of a consolidatable group – but it may qualify as a subsidiary member (see flowchart 2).**
   - no → **Company can be a head company of a consolidatable or consolidated group.**

* A corporate unit trust or a public trading trust that satisfies the eligibility criteria for being a head company (except that it is not a company) may choose to form a consolidated group as if the trust were a company. If it makes such an election, it will forever after be treated as a company for income tax purposes, even if the group later deconsolidates.
→ Subdivision 713-C, ITAA 1997

Flowchart 2 – Who can be a subsidiary member?



Included entities

A company

A 'company' for income tax purposes is defined in section 995-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) to mean:

- 'a body corporate; or
- any other unincorporated association or body of persons;

but does not include a partnership or a non-entity joint venture'.

As can be seen from this definition, a body does not necessarily have to be incorporated as a company for company law purposes to be a company for income tax purposes.

The terms 'company' and 'partnership' are mutually exclusive. A partnership is defined in section 995-1 of the ITAA 1997 to mean:

- an association of persons (other than a company or a limited partnership) carrying on business as partners or in receipt of ordinary income or statutory income jointly, or
- a limited partnership.

→ 'A partnership', p. 7

Most unincorporated clubs and associations would fall outside the definition of partnership, as they are not being conducted with a view to profit, and would therefore be companies for income tax purposes.

While a 'non-profit company' can be the head company of a consolidated group, it cannot be a subsidiary member. For an organisation such as a club, society or association to be a non-profit company:

- it must be a company that is not carried on for the purposes of profit or gain to its individual members, and
- its constituent documents must prohibit it from making any distribution, whether in money, property or otherwise, to its members.

→ section 3, *Income Tax Rates Act 1986*

Even though the terms company and partnership are mutually exclusive, a 'corporate limited partnership' is deemed to be a company and not a partnership for income tax purposes. → sections 94H – 94K of the *Income Tax Assessment Act 1936* (ITAA 1936).

A limited partnership is defined in section 995-1 of the ITAA 1997 to mean:

- an association of persons (other than a company) carrying on business as partners or in receipt of ordinary income or statutory income jointly, where the liability of at least one of those persons is limited, or
- one of certain types of venture capital partnership (see section 995-1 for more detail).

Under the various state partnership Acts, there are four basic requirements for a limited partnership:

- there must be one or more general partners liable for all the debts and obligations
- there must be one or more limited partners who must contribute capital and who cannot be required to provide funds in addition to their capital contribution
- the limited partner cannot draw out their capital during the continuance of the partnership, and
- the limited partner cannot take part in the management of the partnership.

With the exception of certain venture capital partnerships, a 'limited partnership' will be a 'corporate limited partnership' → section 94D, ITAA 1936. It will be treated as a company for income tax purposes other than in relation to the definitions of the terms 'dividend' and 'resident' or 'resident of Australia' → section 94J of ITAA 1936. This is reinforced by section 94K of the ITAA 1936 which states that a reference to a 'partnership' does not include a reference to a 'corporate limited partnership'.

Corporate limited partnerships are public companies for tax purposes.
→ section 94N, ITAA 1936.

General company tax rate

To be either a head company or a subsidiary member of a consolidated group, a company must have at least some of its taxable income (if it has any) taxed at the general company tax rate.

The term 'general company tax rate' is defined in section 995-1 of the ITAA 97 to mean 'the rate of tax imposed on taxable incomes of companies (except companies that are registered organisations, life insurance companies and companies that are PDFs throughout the last day of the year of income)'. For the 2002–03 income year the rate is 30%.

A trust

'A trust may be defined as an obligation enforceable in equity which rests on a person (the trustee) as owner of some specific property (the trust property) to deal with that property for the benefit of a certain person (the beneficiary) or persons, or for the advancement of certain purposes.'[4]

The trustee may be a natural person or a company and may also be a beneficiary of the trust, provided they are not the sole beneficiary. The trustee has a personal obligation, which is fiduciary in nature (duty of care owed), to deal with the trust property for the benefit of the beneficiaries.

A trust, unlike a company, is not a separate legal entity. However, the ITAA 1936 recognises a 'trust estate' for tax purposes and may treat it as a separate

[4] *Principles of the law of trusts*, HAJ Ford and WA Lee, Law Book Company, at paragraph 1000

entity for the purposes of performing certain calculations (such as calculating the trust estate's net income). The net income of the trust estate is then attributed to either the trustee or the beneficiaries in accordance with Division 6 of the ITAA 1936.

The members of fixed and discretionary trusts (other than corporate unit trusts and public trading trusts) are the beneficiaries, unitholders or objects of the trust. The members of corporate unit trusts and public trading trusts are the unitholders. → section 960-130: meaning of 'members of entities'

Discretionary trusts may be members of a consolidatable group, provided their objects are confined to members of the group. → 'Discretionary trusts', p. 14

A partnership

A partnership is defined in section 995-1 of the ITAA 1997 to mean:

- an association of persons (other than a company or a limited partnership) carrying on business as partners or in receipt of ordinary income or statutory income jointly; or
- a limited partnership.

Note that foreign hybrid companies are treated for income tax purposes as partnerships. → Division 830, ITAA 1997

The phrase 'carrying on business as partners' is based on common law principles concerning the mutual rights and obligations of the parties involved. These principles are also embedded in the state and territory partnership legislation which defines a partnership as the relationship that exists between persons carrying on business in common with a view to profit. The legislative definition in section 995-1 extends the meaning given to the word 'partnership' in common law and state and territory partnership law. An example of a partnership where the partners are not carrying on a business is joint ownership of a rental investment property.

Taxation Ruling TR 94/8 outlines factors taken into account in deciding whether persons are carrying on business as partners for income tax purposes.

Corporate limited partnerships are considered to be companies for tax law purposes. → 'Company', p. 5

Partnerships are not separate legal entities. The net income/loss of a partnership is calculated and the partners include their share of the net income/loss in their taxable income. Where the partner is an individual, they are assessed at individual marginal rates. Where the partner is a company it is assessed at the corporate tax rate.

Excluded entities

Companies that cannot be a head company or subsidiary member

The table below lists the companies that are specifically excluded from being a head company of a consolidatable or consolidated group. Essentially, these companies cannot be a head company because they receive some form of concessional tax treatment. Allowing them to be a head company would extend that concessional tax treatment to all members of the group.

This entity …	is excluded under …	because …
An entity that is exempt from income tax under Division 50 of the ITAA 1997	subsection 703-20(2) ITAA 1997, table item 1.	The total ordinary and statutory income of these companies is exempt from income tax.
A recognised medium credit union (as defined by section 6H of the ITAA 1936).	subsection 703-20(2), table item 2.	These credit unions have a threshold placed on the tax payable on their taxable income, even though they are subject to the corporate tax rate.
An approved credit union (as defined under section 23G of the ITAA 1936) that is not a recognised medium or large credit union (as defined under section 6H of the ITAA 1936).	subsection 703-20(2), table item 3.	These credit unions are entitled to an exemption under section 23G of the ITAA 1936 for interest received from non-corporate members.
An entity that is a pooled development fund (PDF) (as defined under section 995-1 of the ITAA 1997) at the end of the income year. → paragraph 3.40	subsection 703-20(2), table item 5.	These companies are subject to a concessional rate of tax compared to the general company tax rate.
A company that is a film licensed investment company (FLIC) (as defined in section 375-855 of the ITAA 1997).	subsection 703-20(2), table item 6.	Tax losses or net capital losses cannot be transferred to or from these companies. Further, section 375-880 of the ITAA 1997 prevents these companies from claiming deductions for expenditure on a film where the amount spent is FLIC concessional capital.

Other entities that cannot be a subsidiary member

In addition to all the companies listed in the table above, there are some entities listed in the table below that are also excluded from being subsidiary members of a consolidatable or consolidated group.

This entity …	is excluded under …	because …
A trust that is: • a complying superannuation entity • a non-complying ADF, or • a non-complying superannuation fund (as those terms are defined in section 267 of the ITAA 1936).	subsection 703-20(2), table item 7.	The taxable income of these entities is subject to tax at rates other than the general company tax rate.
A company that is a non-profit company (as defined in section 3 of the *Income Tax Rates Act 1986*).	subsection 703-15(2), table item 2.	The corporate tax rate is phased in on the taxable income of these companies.

Companies and trusts that appear in these tables are excluded from being a *subsidiary* member primarily to preserve the subsidiary's concessional tax treatment (that is, the concessions would be lost if the income were assessable to the head company). In some cases exclusions also act as an integrity measure to prevent certain entities from effectively gaining relative concessional treatment. For example, the income of a non-complying superannuation fund would be concessionally taxed if it were permitted to be a subsidiary member of a consolidated group, because the taxable income of a non-complying superannuation fund is taxed at a rate higher that the general company tax rate.

Australian residency

Resident company

The statutory definition of 'Australian resident' in section 995-1 of the ITAA 1997 points to the definition of 'resident' or 'resident of Australia' in subsection 6(1) of the ITAA 1936. A company is a resident of Australia if:

- it is incorporated in Australia, or
- although not incorporated in Australia it carries on business in Australia and has either
  - its central management and control in Australia, or
  - its voting power controlled by shareholders who are residents of Australia.

It is clear from this definition that if a company is incorporated in Australia it will, regardless of other aspects, be treated as a resident for Australian tax law purposes. This means that regardless of where the company is found to reside within the ordinary meaning of the word under common law, a company that was incorporated in Australia will automatically be a resident of Australia under the statutory definition. The second statutory test is only triggered where the company is not incorporated in Australia. It is considered that the residency test for a company not incorporated in Australia is a composite test which requires the company to carry on business in Australia as a prerequisite and, in addition, to have either its central management and control in Australia or its voting power controlled by Australian-resident shareholders. See ATO ID 2002/46 for further discussion of this test.

The following leading cases provide guidance as to what factors need to be considered in reaching the necessary conclusion of fact as to where the central management and control is exercised:

Koitaki Para Rubber Estates Ltd v FC of T (1941) 64 CLR 241; 6 ATD 82

John Hood and Co Ltd v Magee (1918) 7 TC 327

Malayan Shipping Co. Ltd v FC of T (1946) 71 CLR 156; 8 ATD 75

Esquire Nominees Ltd v FC of T (1973) 129 CLR 177; 73 ATC 4114

A corporate limited partnership will be considered a resident of Australia if and only if:

- the partnership was formed in Australia, or
- the partnership either carries on business in Australia, or has its central management and control in Australia. → section 94T, ITAA 1936

A company will not be eligible to be a member of a consolidatable or consolidated group unless it is an Australian resident (and it cannot be a 'prescribed dual resident'). → subsection 703-15(2), table column 3, ITAA 1997; Taxation Determination TD 2004/42

Prescribed dual resident company

Prescribed dual resident companies are precluded from being members of a consolidatable or consolidated group. → subsection 703-15(2), table items 1 and 2, column 3

A 'prescribed dual resident' is defined in subsection 6(1) of the ITAA 1936 and essentially means a company that qualifies as an Australian resident (as discussed above) but:

- is treated as being a resident solely of another country under tie-breaker rules in a double tax agreement, or
- qualifies as an Australian resident solely because its central management and control is in Australia and it carries on business here, but is also regarded as a resident of another country with its central management and control in another country.

Partnerships – no residency requirement

The consolidation legislation imposes no residency requirement on partnerships → column 3 of table in subsection 703-15(2). This is because, in a consolidation context, a partnership whose partners are subsidiary members (having satisfied the Australian residence requirements themselves) will be a resident partnership for most income tax purposes. It is therefore unnecessary to impose a further residency test on partnerships.

Resident trusts

A trust must comply with the Australian residency requirements of section 703-25 in order to be a subsidiary member → column 3 of table in subsection 703-15(2). The requirements for trusts (outlined in section 703-25 of the ITAA 1997) are as follows:

- A trust (except a unit trust) must be a 'resident trust estate' for the income year for the purposes of Division 6 of Part III of the ITAA 1936; that is, the trust will be taken to be an Australian resident in any given income year if it meets the following requirements of subsection 95(2) (ITAA 1936):

  (a) a trustee of the trust estate was a resident at any time during the year, or

  (b) the central management and control of the trust estate was in Australia at any time during the year.

- A unit trust (except a corporate unit trust, defined in section 102J ITAA 1936, or a public trading trust, defined in section 102R ITAA 1936) must be a resident trust estate for the income year for the purposes of Division 6 of Part III of the ITAA 1936 *and* a resident trust for CGT purposes for the income year. That is, the unit trust will be taken to be an Australian resident in any given income year if it meets the following requirements of subsection 95(2) (ITAA 1936):

  (a) a trustee of the trust estate was a resident at any time during the year, or

  (b) the central management and control of the trust estate was in Australia at any time during the year,

  and it also meets the additional requirements imposed by the definition of 'resident trust for CGT purposes' in section 995-1 of the ITAA 1997 – that is, one of the requirements in column 2 and one of the requirements in column 3 of the following table must be satisfied:

Item	One of these requirements is satisfied	And also one of these
1	Any property of the trust is situated in Australia.	The central management and control of the trust is in Australia.
2	The trust carries on a business in Australia.	Australian residents held more than 50% of the beneficial interests in the income or property of the trust.

- A corporate unit trust or a public trading trust must be a resident unit trust (defined in section 102H or section 102Q of the ITAA 1936 – whichever is relevant) for the income year.

Wholly-owned subsidiary

The term 'wholly-owned subsidiary' is a defined term. The general test to determine whether one entity is a wholly-owned subsidiary of another is in section 703-30 (ITAA 1997). There are also a number of other provisions that modify the operation of section 703-30 or deem an entity to be a wholly-owned subsidiary. These provisions are referred to here as 'special rules'.

The wholly-owned concept is used both in determining whether a company qualifies as a head company and whether an entity qualifies as a subsidiary member of a consolidatable group.

Wholly-owned subsidiary – the general test

The term wholly-owned subsidiary is defined in section 703-30.[5] Under subsection (1) of that provision, an entity (the subsidiary entity) will be a wholly-owned subsidiary of another entity (the holding entity) if all the membership interests in the subsidiary entity are beneficially owned by:

- the holding entity
- one or more wholly-owned subsidiaries of the holding entity, or
- a combination of the holding entity and one or more wholly-owned subsidiaries of the holding entity.

Subsection 703-30(2) then provides for that subsidiary entity to pass on its status as a wholly-owned subsidiary of the holding company to its own wholly-owned subsidiaries, and so on down the chain of companies. An entity other than the subsidiary entity is also a wholly-owned subsidiary of the holding entity if:

- it is a wholly-owned subsidiary of the holding entity, or
- it is a wholly-owned subsidiary of another entity that is held to be a wholly-owned subsidiary of the holding entity,

through the application of section 703-30.

Where cross-ownership exists between subsidiaries, they will not satisfy the requirements of section 703-30 and will be disqualified from being members of a consolidatable or consolidated group. This approach is consistent with the existing grouping rules.

Subsection 703-30(3) provides that, for the purposes of the consolidation membership rules only, the meaning of 'beneficial ownership' is extended so that an entity does not cease being the beneficial owner of a membership interest in another entity merely by becoming an externally-administered body

[5] The definition of wholly-owned subsidiary in section 703-30 derives from the definition of '100% subsidiary' in section 975-505 (ITAA 1997), which in turn is similar to the approach adopted in former subsections 80G(2) and 80G(3) of the ITAA 1936 dealing with the meaning of 'subsidiary company', discussed in IT 2465 (in particular, paragraphs 13-18).

corporate under domestic corporations law (or equivalent under a foreign law). For example, an entity would not cease to beneficially own a subsidiary for consolidation purposes merely because the first entity is in the process of being wound up, is in receivership or is under administration.

Membership interest

The term 'membership interest' is also a defined term and takes its meaning from section 960-135 (ITAA 1997). Essentially membership interest refers to each of the interests or rights that you have in a company, partnership or trust by virtue of which you are a member of that entity.

The table below sets out who is a member of the various types of entities that may be part of a consolidatable group. → section 960-130, ITAA 1997

Entity	**Member**
Company	A member of a company or a stockholder in the company
Partnership	A partner in the partnership
Trust (except a corporate unit trust or a public trading trust)	A beneficiary, unitholder or object of the trust
Corporate unit trust	A unitholder of the trust
Public trading trust	A unitholder of the trust

Note

Debt interests excluded

An important exception to who is a member of an entity relates to debt interests. An entity will not be a member of another entity if the only reason it would be a member is that it holds interests or rights in another entity that are debt interests → subsection 960-130(3). As a consequence, debt interests do not constitute membership interests and will be disregarded when determining whether an entity is a wholly-owned subsidiary of the holding entity. The term debt interest has the meaning given in the debt-equity rules → Subdivision 974-B, ITAA 1997. Finance shares may be debt interests for this purpose. An example of a finance share that is a debt interest is a compulsorily redeemable preference share.

'*Equity interest*' tests in Subdivision 974-C

Non-share equity interests (e.g. a convertible note that is not a debt interest) are rarely relevant in determining ownership of companies. Given this, for consolidation purposes the equity interest classification rules, contained in Division 974, are not used to determine whether an interest or right that is held by an entity in relation to another entity is a membership interest in that other entity.

Rights and options

Rights and options to acquire shares in a joining company are not membership interests and are disregarded in determining whether the company is a wholly-owned subsidiary of the head company under section 703-30 of the ITAA 1997.

Where a member of the joined group has a right or option to acquire shares in a joining company those interests are of no consequence for the purposes of section 703-30.

When the right or option in the joining company is held by an entity outside the joined group, this of itself will not prevent the company from becoming a member of the joined group. However, on exercise of the right or option, the acquirer will hold a membership interest in the company. Where the acquirer is still outside the group at this time, the company will cease to be a wholly-owned subsidiary of a holding entity under section 703-30 and will leave the group.

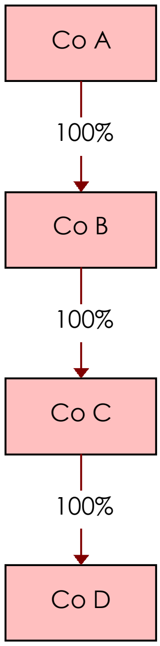
Discretionary trusts

Discretionary trusts may be members of consolidatable group. However, in many instances a discretionary trust will not be eligible for membership, either because individuals are included in the trust objects, or because the trust deed identifies a broad class of objects as potential beneficiaries, some of which are not members of the consolidatable group.

Example: Wholly-owned subsidiary – the operation of section 703-30

- Companies A, B, C and D are all Australian-resident companies that are eligible to be part of a consolidatable group.
- For an example of the operation of these rules in relation to trusts and partnerships see → 'Business structures and eligibility', C1-2 , example 4.

Figure 2



Company B is a wholly-owned subsidiary of head company A because all of its membership interests (shares) are beneficially owned by A. → paragraph 703-30(1)(a)

Company C is a wholly-owned subsidiary of head company A because all of its membership interests (shares) are beneficially owned by B, which is a wholly-owned subsidiary of A. → paragraph 703-30(1)(b)

Company D becomes a wholly-owned subsidiary of head company A under subsection 703-30(2), which extends the meaning of that term to every wholly-owned subsidiary of an entity that is a wholly-owned subsidiary through the application of subsection 703-30(1). In other words, the meaning of the term extends down through multiple ownership layers of a group structure.

Wholly-owned subsidiary – the special rules

It is possible for an entity to be a wholly-owned subsidiary of a holding company despite failing the general test contained in section 703-30, through the operation of special rules that cover the following situations:

- An exception to the general rule that all membership interests in a company must be beneficially owned by members of the group applies to certain ordinary shares that are issued under an arrangement for employee shareholdings, providing they account for 1% or less of the ordinary shares in the company. → section 703-35, ITAA 1997
- An entity that would otherwise be prevented from being a wholly-owned subsidiary because it is held through a non-fixed trust may qualify as a wholly-owned subsidiary. → section 703-40, ITAA 1997

Rule 1 – Disregarding employee shareholdings

Where certain ordinary shares issued under an arrangement for employee shareholdings represent 1% or less of the ordinary shares in the company, those shares can be disregarded in determining whether a company is a wholly-owned subsidiary of another. The employee share scheme under which shares have been issued is not restricted to Division 13A employee share schemes.

→ subsection 703-35(4)

The following requirements must be met:

- the share must have been acquired:
  - by the entity (e.g. an individual) in relation to the employment of the entity or an associate or services provided by the entity or an associate in the circumstances described in subsections 139C(1) and (2) of the ITAA 1936, or
  - as the result of the exercise of a right that the entity acquired from holding employee share scheme shares
- all of the shares available for acquisition under the scheme must be ordinary shares or rights in respect of ordinary shares
- at the time the share was acquired, the entity did not hold a legal or beneficial interest in more than 5% of the shares in the company, and was not in a position to cast or control the casting of more than 5% of the maximum number of votes at a general meeting, as required by subsections 139CD(6) and (7) of the ITAA 1936
- the company is not covered by section 139DF of Division 13A of the ITAA 1936 where the business of the company is the acquisition, sale or holding of shares, securities or other investments, and the entity is employed by both that company and another company in the same company group
- at the time at which the share was acquired, an offer to acquire shares or rights in the company or in a holding company must have been available to 75% of the permanent employees of the employing company (the employer).

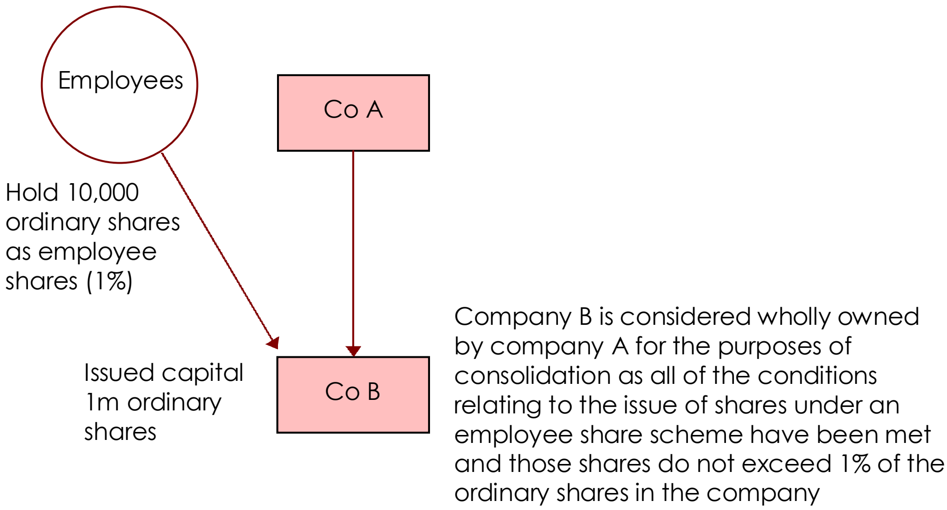
→ subsection 703-35(5)

If all of the conditions in the above dot points are satisfied except for the last, the share may still be disregarded in certain circumstances. → subsection 703-35(6)

Example: Wholly-owned subsidiary – disregarding employee shareholdings

- All entities are Australian residents and are eligible to be part of a consolidatable group.
- The 10,000 ordinary shares in company B that are not owned by company A were issued to employees in respect of their employment by company B. The share offer to employees was open to all permanent employees of company B. None of the employees of company B are also employed by company A.

Figure 3



Rule 2 – Entity held through non-fixed trust

Section 703-40 effectively allows an entity that is held through a non-fixed trust to be a wholly-owned subsidiary of the head company if it would have been a wholly-owned subsidiary had it been held by a fixed trust. This provision is needed to remove any concerns about the ability of the objects of a non-fixed trust to *beneficially own* the property of that trust.

Interposed entities

Generally, a company, trust or partnership will only be a subsidiary member of a consolidatable or consolidated group where all the entities interposed between it and the head company are also subsidiary members of the group. However, there are two exceptions to this rule:

Interposed nominees

Where an interposed entity holds membership interests in a subsidiary member only as a nominee of either the head company or one or more subsidiary members of the group, the nominee (which has legal but not beneficial ownership of the interests) *is not* a member of the group, but the entity in which the nominee holds membership interests *is* a member of the group.

→ subsection 703-45(2), ITAA 1997

→ 'Business structures and eligibility', C1-2 , example 6

Interposed foreign residents: transitional exception

In certain circumstances an Australian-resident entity may still qualify as a subsidiary member even where one or more non-member foreign-resident entities are interposed between it and the head company. These rules operate differently depending on whether the Australian-resident entity being tested is a company, trust or partnership. → Division 701C, *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A 1997)

Test entity is a company → section 701C-10, IT(TP)A 1997

If the test entity is a company, it may still qualify as a subsidiary member at a particular time (the test time) if all of the following requirements are met:

- At least one entity interposed between the test entity and the head company is either a non-resident company or non-resident trust.
- Each of the interposed entities is one of the following:
  - a subsidiary member of the group
  - a non-resident company
  - a non-resident trust
  - a nominee entity that holds membership interests in the test entity, or in an interposed entity, on behalf of another member of the group, a non-resident company or a non-resident trust, or
  - a partnership, where each partner is a non-resident company or a non-resident trust.
- The test entity would be a subsidiary member of the group if it was assumed that each of the following interposed entities was a subsidiary member of the group:
  - each interposed entity that is a non-resident company, and
  - each interposed entity that is a non-resident trust.

Additional requirements relating to timing of the test

This exception operates as a transitional measure. One reason for this is that it is not possible to reset the cost bases of assets of a transitional foreign-held subsidiary, because the cost setting rules cannot be applied to that subsidiary through an interposed non-resident entity. Any modifications that are made to apply the cost setting rules to a non-resident entity would be both complex and affect the integrity of the cost setting rules. → Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) (No. 2) Bill 2003, paragraphs 4.34 – 4.37

<u>Testing for membership of a *consolidatable* group</u>

If testing for membership of a consolidatable group, the test time must be before 1 July 2004.

<u>Testing for membership of a *consolidated group at formation time*</u>

If testing for membership of a consolidated group at the time it forms, the test time must be before 1 July 2004.

<u>Test for membership of a *consolidated group after formation*</u>

Where:

- a consolidated group is being tested after formation, and
- at the test time the test entity has one or more of its membership interests held by a non-resident company or non-resident trust (or a nominee of a non-resident company or non-resident trust), or by a partnership in which each of the partners is a non-resident company or non-resident trust,

both of the following conditions must be satisfied for the test entity to qualify at test time for membership of the group:

- The test entity must have been a subsidiary member of the group at formation time (which means formation time must have been before 1 July 2004) and not ceased to be a subsidiary member of the group since that time.
- At formation time, a non-resident company or non-resident trust (or a nominee of a non-resident company or non-resident trust), or a partnership in which each of the partners is a non-resident company or non-resident trust, must have held one or more membership interests in the test entity.

These rules for testing for membership after formation have two primary outcomes:

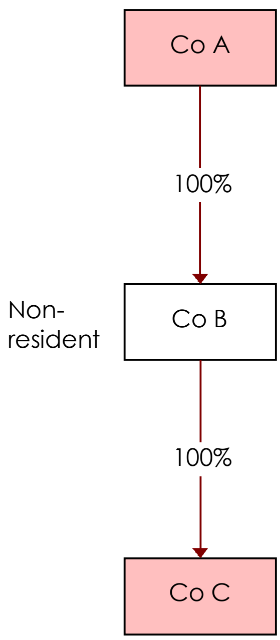
1. They ensure that a resident entity acquired after formation by a consolidated group that has an interposed foreign-resident entity (IFRE) will not qualify for membership of the group if one or more of the membership interests in the newly-acquired entity are held directly by the IFRE.

2. They ensure that an entity that qualified as a subsidiary member of a consolidated group at formation time becomes ineligible if a restructure of the consolidated group takes place after formation time which results in one or more membership interests in that subsidiary member being held directly by an IFRE, if no such interest was held directly by a non-resident at formation time.

Example: Interposed entities – application of section 703-45 of the ITAA 1997 and section 701C-10 of the IT(TP)A 1997 where test entity is a company

- All entities in the consolidated group below are Australian residents unless otherwise indicated. The Australian-resident companies are standard companies paying tax at the general company tax rate. None of the Australian-resident entities are 'excluded entities', as per section 703-20.
- Companies B and C are wholly-owned subsidiaries of company A.
- The consolidated group was formed on 1 July 2002 and the structure has remained unchanged since.
- The aim is to determine whether Co C is a subsidiary member of the group at 1 July 2004.

Figure 4



Item 2, column 4 of the table in subsection 703-15(2) of the ITAA 1997 directs us to section 703-45 of the ITAA 1997 and Division 701C of the IT(TP)A 1997.

Apply subsection 703-45(2) to test entity company C:
Fails (2)(a): Co B is not a member.
Fails (2)(b): Co B does not hold shares in Co C as a nominee.

Apply section 701C-10:
Meets (2): test entity Co C is a company.
Meets (3): the only interposed entity (B) is a non-resident company.
Meets (4): there is only one interposed entity (B) and that is a non-resident company.
Meets (5): the test entity company C would be a subsidiary member of the group if company B were a subsidiary member.
Meets the tests contained in (8)(a), (8)(b), (8)(c)(i), (8)(d) and (8)(e).

Outcome: At 1 July 2004, Company C is the sole subsidiary member of a consolidated group of which the head company is company A.

Test entity is a trust or partnership → section 701C-15, IT(TP)A 1997

If the test entity is a trust or partnership, it will only be a subsidiary member of the group at a particular time (the test time) where:

- at least one of the interposed entities is a company that is itself a subsidiary member through the application of section 701C-10 of the IT(TP)A 1997, and
- the trust or partnership being tested would be a subsidiary member if the membership interests beneficially owned by each of the interposed entities that is a company qualifying as a subsidiary member through the application of section 701C-10 were instead beneficially owned by the head company.

This effectively means that the interposed foreign resident test will not be satisfied where the test entity is a trust of which the membership interests are beneficially owned directly by a non-resident.

It also means that the interposed foreign resident test applying where the test entity is a trust is also transitional in nature, because the test will only be met where there is a company interposed between the test entity trust and the head company that has met all the requirements of section 701C-10.

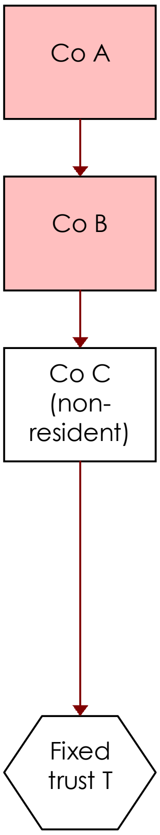
Example: Interposed entities – application of section 703-45 of the ITAA 1997 and section 701C-15 of the IT(TP)A 1997 where test entity is a trust

- All entities in the two groups illustrated in figures 5 and 6 (next page) are Australian residents except where otherwise indicated. The Australian-resident companies are standard companies paying tax at the general company tax rate. None of the Australian-resident entities are 'excluded entities', as identified by section 703-20. Companies B and C and fixed trust T are wholly-owned subsidiaries of company A.
- Co A chooses to form a consolidated group on 1 July 2002.
- The aim is to determine which entities will be subsidiary members of the groups in figures 5 and 6 respectively at formation time.

Figures 5 and 6 highlight the difference in the operation of the section where the membership interests in the trust are held by the interposed non-resident company, as against being held by a resident company.

The rationale for the different outcomes with regard to the eligibility of fixed trust T to be a group member is that, in figure 5, T distributes to a non-resident. When T makes a distribution to non-resident C in figure 5, the taxable income of C is calculated by reference to the net income of T. However, if T were a member of a consolidated group, all of T's income and expenditure would be attributed to head company A (single entity principle). Such a computation of trust net income is not possible. Hence in this situation the interposed entity rules must be designed to prevent T from being a member of a consolidatable or consolidated group. In figure 6, T distributes to another member of the consolidatable group, so the problem would not arise.

Figure 5



Step 1 – Apply section 703-15 to company B:
It meets all requirements set out in the table in subsection 703-15(2).

Outcome: B is a subsidiary member of the group.

Step 2 – Apply section 703-15 to company C:
Non-resident and therefore not a member: fails the residency requirement set out in the table in subsection 703 15(2).

Step 3 – Apply section 703-15 to fixed trust T:
Item 2, column 4 of the table in subsection 703-15(2) of the ITAA 1997 directs us to section 703-45 of the ITAA 1997 and Division 701C, IT(TP)A 1997:

Apply subsection 703-45(2) to test entity fixed trust T:

- Fails (2)(a): Co C is not a member.
- Fails (2)(b): Co C does not hold membership interests in trust T as a nominee.

Apply section 701C-15:

- Meets (2): test entity T is a trust.
- Fails (3): there are two interposed entities, Co B and Co C, neither of which qualifies as a subsidiary member of the consolidated group by meeting the set of requirements in section 701C-10 (i.e. Co B has no company interposed between it and head company A – and so no need to apply section 701C-10; and Co C is a non-resident so it fails the residency requirement in the table in section 703-15 – and so no need to apply section 701C-10.

Outcome: Fixed trust T is not a subsidiary member of the group. The consolidated group consists of A and B.

Figure 6

Step 1 – Apply section 703-15 to company B:
Non-resident and therefore not a member: fails the residency requirement set out in the table in subsection 703-15(2).

Step 2 – Apply section 703-15 to Co C:
Item 2, column 4 of the table in subsection 703-15(2) of the ITAA 1997 directs us to section 703-45 of the ITAA 1997 and Division 701C of the IT(TP)A 1997:

Apply subsection 703-45(2) to test entity company C:

- Fails (2)(a): Co B is not a member.
- Fails (2)(b): Co B does not hold shares in Co C as a nominee.

Apply section 701C-10

- Meets (2): it is a company.
- Meets (3): the only interposed entity (company B) is a non-resident company.
- Meets (4): there is only one interposed entity (B) and that is a non-resident company.
- Meets (5): the test entity C would be a subsidiary member of the group if B were a subsidiary member.
- Meets (7): formation date is before 1 July 2004.

Outcome: C is a subsidiary member of the group.

Step 3 – Apply section 703-15 to fixed trust T:

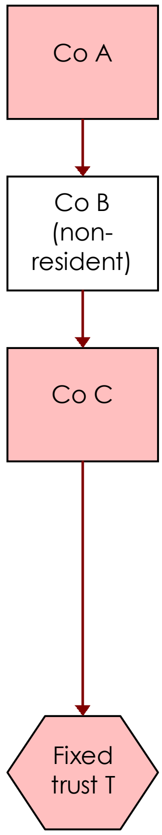
Apply subsection 703-45(2) to test entity fixed trust T:

- Fails (2)(a): Co B is not a member.
- Fails (2)(b): Co B does not hold membership interests in Co C as a nominee.

Apply section 701C-15:

- Meets (2): test entity T is a trust.
- Meets (3): there are two interposed entities, Co B and Co C, and Co C qualifies as a subsidiary member of the consolidated group by meeting the set of requirements in section 701C-10.
- Meets (4): test entity T would be a subsidiary member of the group if head company Co A beneficially owned all the membership interests in trust T (i.e. it was the sole beneficiary of T) in lieu of Co C.

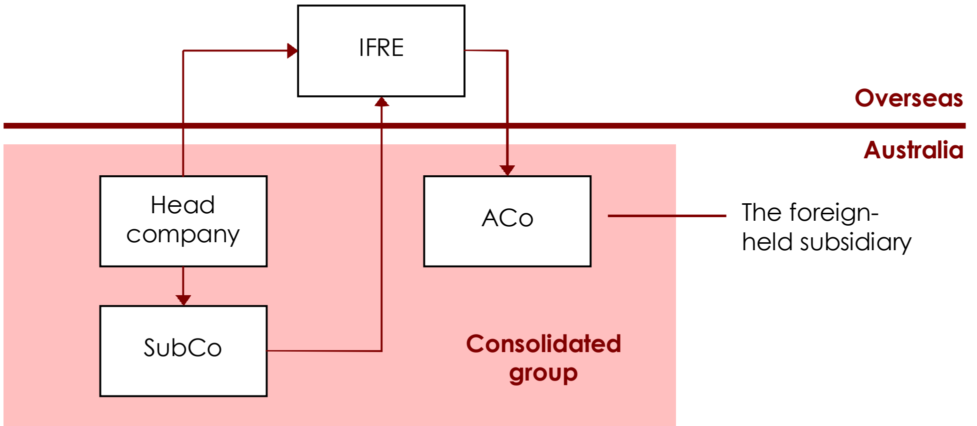
Outcome: Consolidated group consists of A, C and T.



Example: A company as a member under the IFRE tests – formation before 1 July 2004

In figure 7, an IFRE is interposed between the head company and its wholly-owned Australian-resident subsidiary company ACo. ACo follows the IFRE as the first Australian-resident company, so it can become a member of the consolidated group under the interposed foreign-resident entity tests. The head company must hold all the membership interests in the IFRE directly or through its wholly-owned subsidiaries who are also members of the consolidated group. In this example, the head company can own the IFRE directly or through SubCo or together with SubCo.

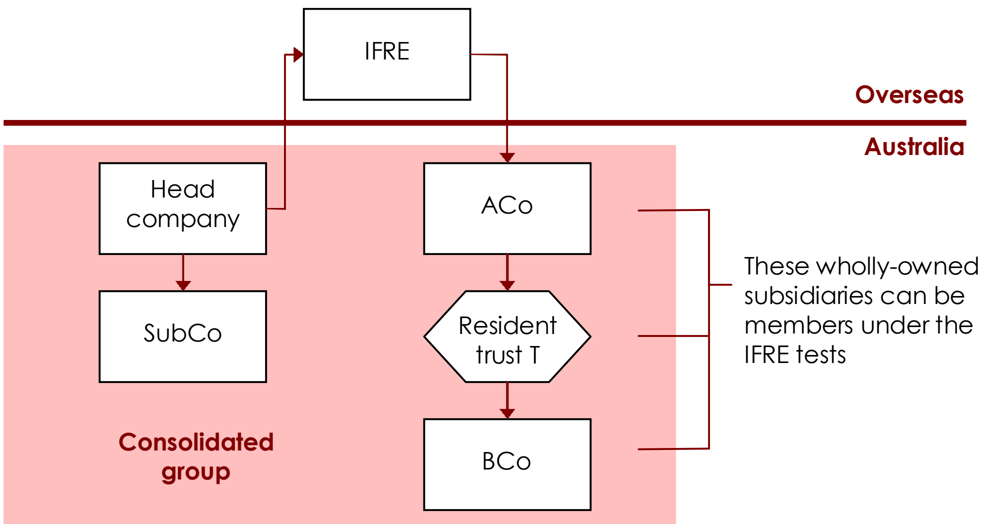
Figure 7: A company as a member under the IFRE tests



Example: A trust as a member under the IFRE tests – formation before 1 July 2004

In figure 8, resident trust T is a wholly-owned subsidiary of company ACo, which is a subsidiary member of the consolidated group under the IFRE tests, so trust T and its subsidiary company BCo can be members of the consolidated group.

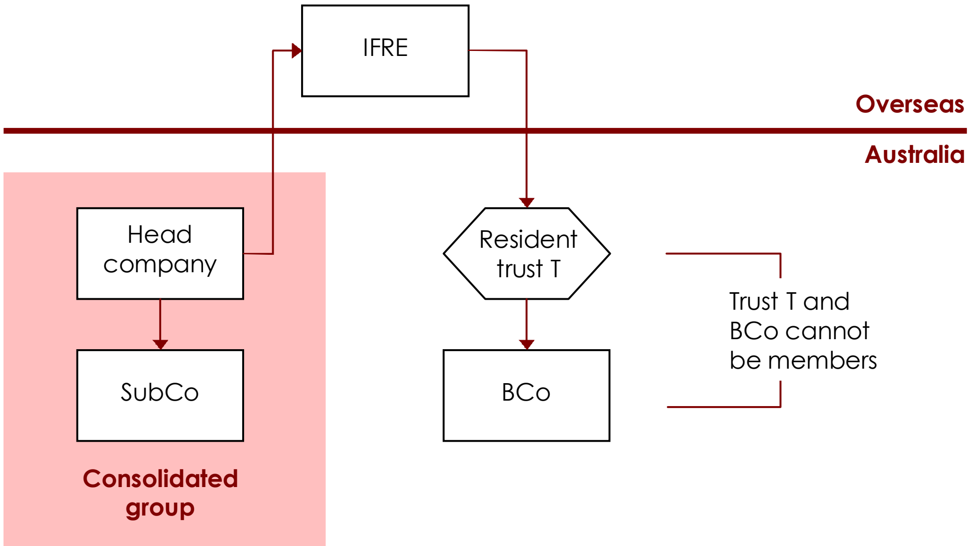
Figure 8: A trust as a member under the IFRE tests



Example: A trust ineligible to be a member under the IFRE tests

In figure 9, resident trust T cannot be a member of a consolidated group under the IFRE tests as it is the first resident entity following the IFRE. Nor can BCo, which is a subsidiary of trust T, be a member.

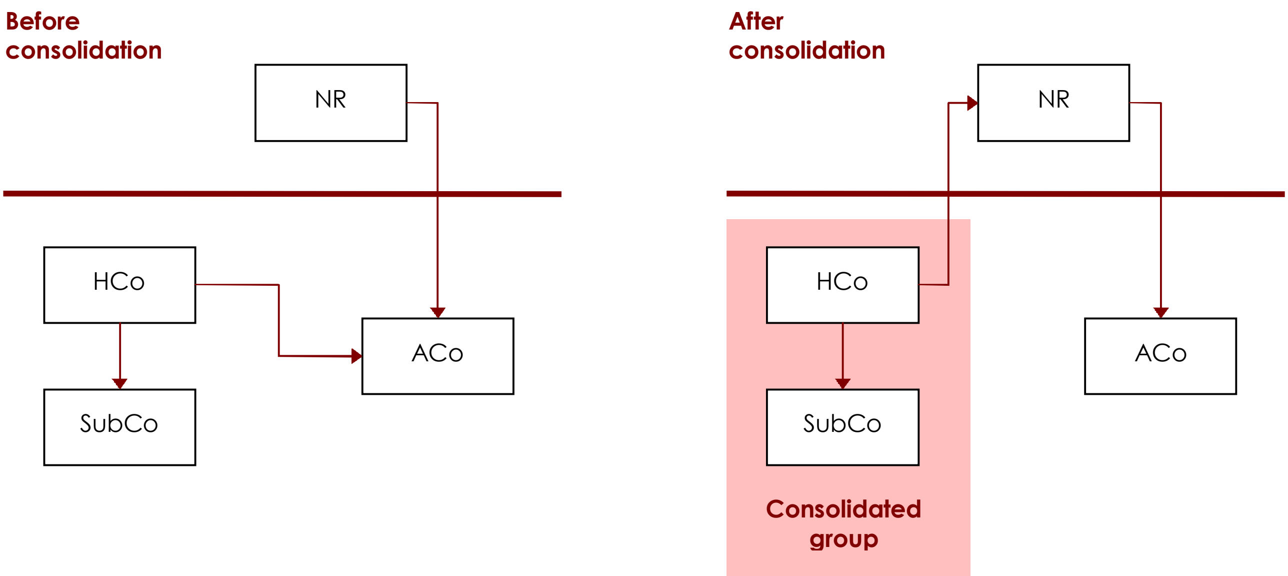
Figure 9: When a trust cannot be a member under the IFRE tests



Example: A wholly-owned group that has a foreign-held subsidiary consolidates after 1 July 2004

HCo, ACo, SubCo and NR are members of a wholly-owned group. If the group decides to consolidate after 1 July 2004, ACo cannot become a member of the consolidated group.

Figure 10

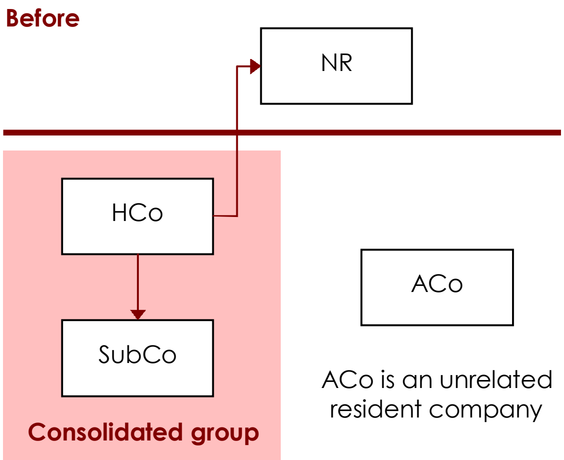


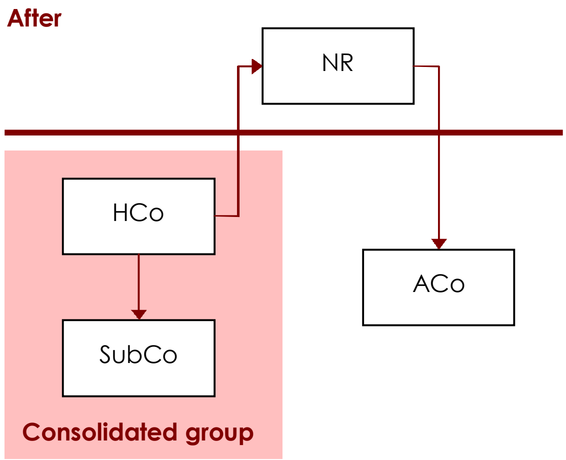
The following three examples show how the rules apply to consolidated groups after formation.

Example: A wholly-owned non-resident subsidiary of the head company acquires a resident entity after the group has formed

HCo is the head company of a consolidated group and NR is its wholly-owned non-resident subsidiary. ACo is an unrelated Australian-resident company. NR acquires all the membership interests in ACo after consolidation. ACo cannot become a member of the consolidated group.

Figure 11

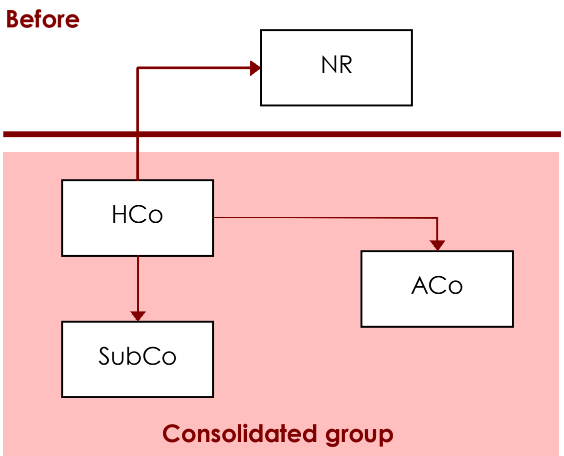


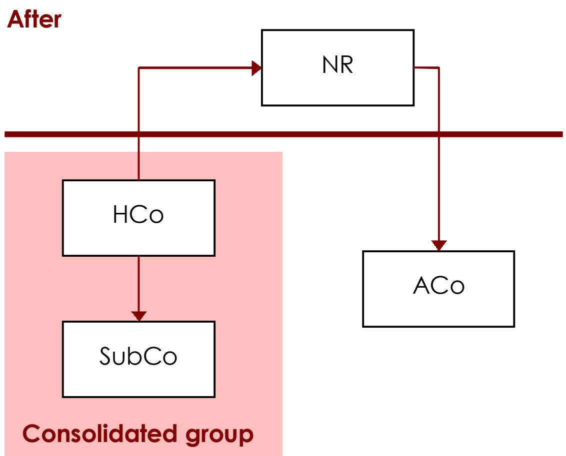


Example: A wholly-owned non-resident subsidiary of the head company acquires a member of the consolidated group in which it had no membership interests

HCo is the head company of a consolidated group formed by HCo, SubCo and ACo. NR is a non-resident wholly-owned subsidiary of HCo. NR acquires all the membership interests in ACo from HCo. ACo cannot continue to be a member because the non-resident interposed entity NR did not have any membership interests in ACo at the time the consolidated group was formed.

Figure 12

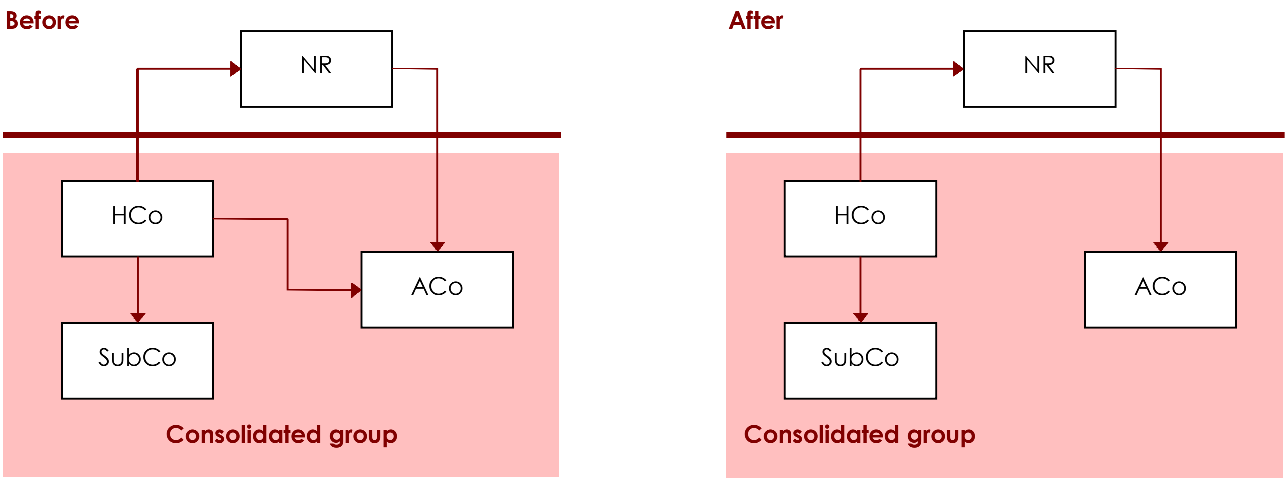




Example: A wholly-owned non-resident subsidiary of the head company acquires a member of the consolidated group in which it had some membership interests at the formation time

ACo is a transitional foreign-held subsidiary member of the consolidated group formed before 1 July 2004; i.e. NR had some membership interests in ACo at the formation time. NR acquires HCo's membership interests in ACo, and ACo becomes a wholly-owned subsidiary of NR. ACo can continue to be in the consolidated group as a foreign-held subsidiary member.

Figure 13



References

Income Tax Assessment Act 1997, Division 703; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Income Tax Assessment Act 1997, Subdivision 960-G, section 995-1; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 5

Income Tax Assessment Act 1997, subsection 703-20(2); as amended by *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 1

Income Tax Assessment Act 1997, subsection 703-15(2) (cell at table item 2, column 4); as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 16, Part 1

Income Tax Assessment Act 1997, section 703-45; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 16, Part 1

Income Tax Assessment Act 1997, Subdivision 713-C; as inserted by *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (No. 83 of 2004), Schedule 2, Part 2

Income Tax Assessment Act 1997, section 995-1 (definitions of 'partnership' and 'limited partnership'); as amended by *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (No. 83 of 2004), Schedule 3 and *Taxation Laws Amendment Act No. 1, 2004* (No. 101 of 2004), Schedule 10

Income Tax Assessment Act 1997, subsection 703-30(3); as inserted by *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1, Part 2

Income Tax (Transitional Provisions) Act 1997, Division 701C; as inserted by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 16, Part 2

Income Tax Assessment Act 1997, Division 50, Subdivisions 375-H, 974-B and 974-C, section 995-1

Income Tax Assessment Act 1936, subsection 6(1), sections 6H and 23G, Divisions 5A, 6, 6B, 6C and 13A

Income Tax Rates Act 1986, section 3

Taxation determinations

TD 2004/42 – Income tax: consolidation: capital gains: does the single entity rule in section 701-1 of the Income Tax Assessment Act 1997 affect the application of CGT event I1 in section 104-160 if a company which is a subsidiary member of a consolidated group stops being an Australian resident?

Revision history

Section C1-1 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
23.12.03	Change to the definition of a 'corporate limited partnership' (p. 6).	Reflects amendments to ITAA 1936 by Taxation Laws Amendment (Venture Capital) Act 2002 (No. 136 of 2002).
23.4.04	Inclusion of note to the effect that rights and options in a joining company are not membership interests for purpose of determining whether a company is wholly owned (p. 14).	For clarification.
14.7.04	Note on recent and proposed changes to consolidation rules.	Recent and proposed legislative amendments.
26.10.05	Updates to notes advising of recent and proposed amendments affecting the consolidation status of corporate unit trusts and public trading trusts, corporate limited partnerships and companies under external administration.	Legislative amendments.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Business structures and eligibility

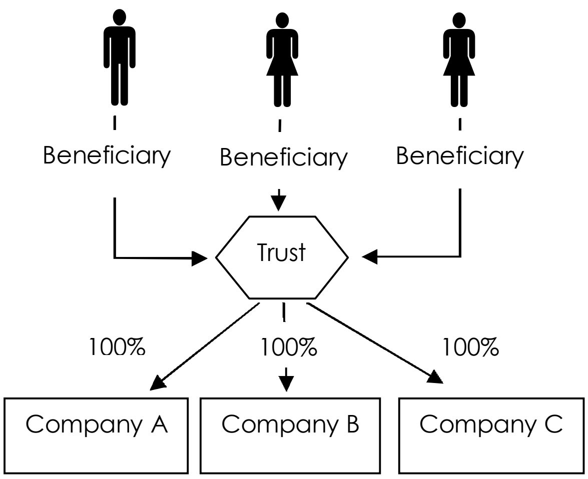
Structures that *cannot* consolidate

The following are examples of business structures that *cannot* consolidate under the general membership rules. → Division 703, ITAA 1997

Note that in these examples, unless otherwise indicated, all the entities are Australian residents and are not specifically excluded from being part of a consolidatable group.

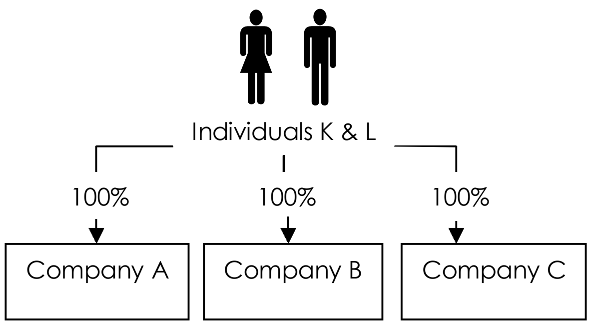
Example 1: Groups headed by a trust cannot consolidate

This is not a consolidatable group, as a trust is ineligible to be the head company of a consolidatable group.



Example 2: Common ownership is not sufficient for consolidation

This is not a consolidatable group even though the same individuals beneficially own all three companies. Consolidation can only occur where one *company* (head company) beneficially owns all of the membership interests (e.g. shares and units) in at least one other company, trust or partnership.

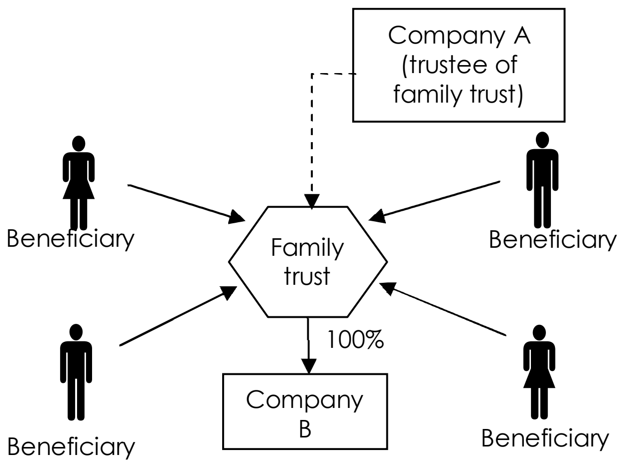


Note

A **corporate unit trust** or a **public trading trust** that satisfies the eligibility criteria (→ C1-1) for being a head company (except that it is not a company) may choose to form a consolidated group as if the trust were a company. If it makes such an election, it will forever after be treated as a company for income tax purposes, even if the group later deconsolidates. → Subdivision 713-C, ITAA 1997.

Example 3: Corporate trustee is not the head company

In this example, the family trust owns company B. Company A is not the head company of a consolidatable group that includes this trust as A is merely the trustee. It does not beneficially own any membership interests in the trust.

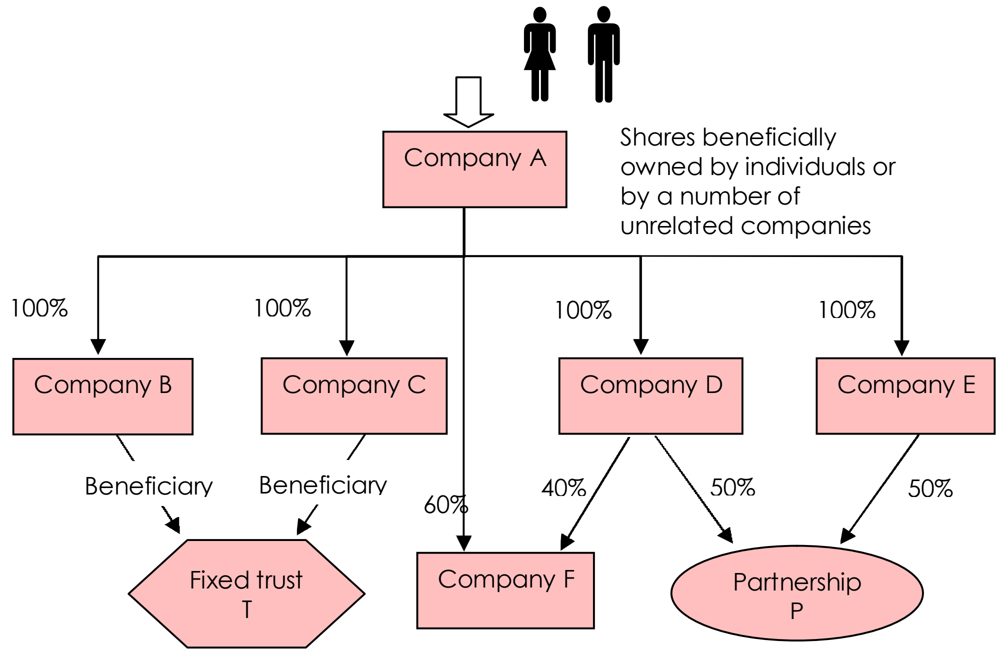


Structures that can consolidate

The following are examples of business structures that contain a consolidatable group under the general membership rules. → Division 703, ITAA 1997

Example 4: Consolidatable group containing all of the different entity types

- All entities are Australian residents and are eligible to be part of a consolidatable group.
- Company A beneficially owns 100% of companies B, C, D and E.
- The only beneficiaries of the fixed trust T are companies B and C.
- Company A also beneficially owns a 60% interest in company F. The remaining 40% is beneficially owned by company D.
- Companies D and E are the only partners in partnership P.

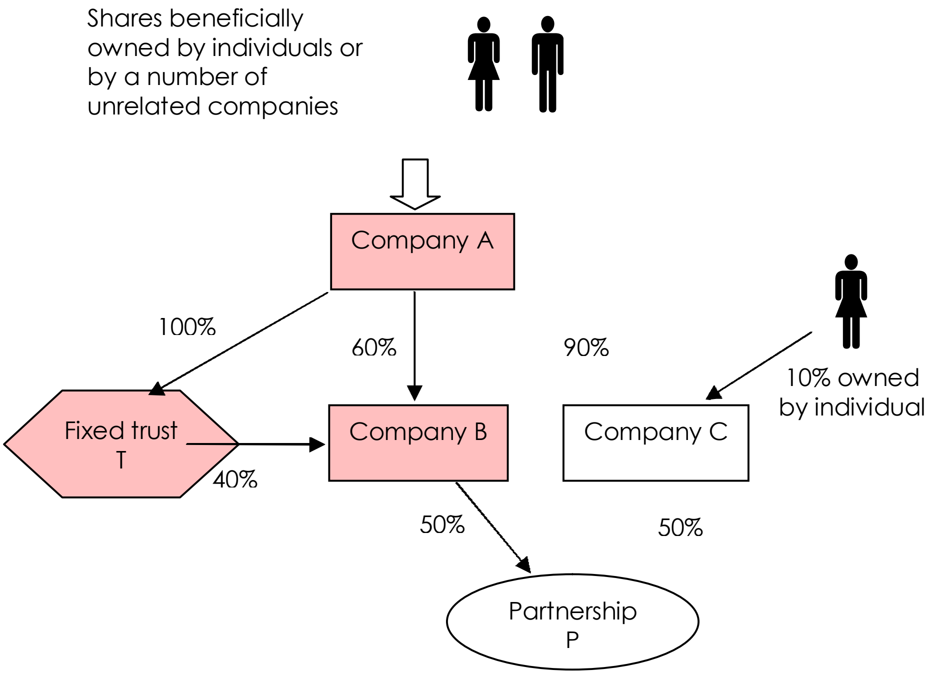


Comments

- Company A qualifies as a head company – see item 1 of section 703-15.
- Companies B, C, D & E are wholly-owned subsidiaries of company A and will qualify as subsidiary members because all the requirements in item 2 of section 703-15 are met.
- Company F is a wholly-owned subsidiary of company A as all of its membership interests are beneficially owned by company A and its wholly-owned subsidiary company D. It will qualify as a subsidiary member of the consolidatable group as all the other requirements of item 2 in section 703-15 have been met.
- Fixed trust T is a wholly-owned subsidiary of A as all of the membership interests (rights and interests of the beneficiaries) in the trust are beneficially owned by companies B and C, which are wholly-owned subsidiaries of company A. It qualifies as a subsidiary member of the consolidatable group as all the requirements of item 2 in section 703-15 have been met.
- Partnership P is a wholly-owned subsidiary of A as all of the membership interests (rights and interests of the partners) are beneficially owned by companies D and E, which are wholly-owned subsidiaries of A. Partnership P qualifies as a subsidiary member of the consolidatable group as all the other requirements of item 2 in section 703-15 are met.

Example 5: Minority holdings in the group

- All entities are Australian residents and are eligible to be part of a consolidatable group, except Co C, Partnership P and the individuals.
- Company A is the sole beneficiary of fixed trust T.
- Fixed trust T owns 40% of the issued ordinary shares in company B, with the remaining 60% being held by company A.
- Company A also holds 90% of the issued capital in company C, with the balance being held by an individual.

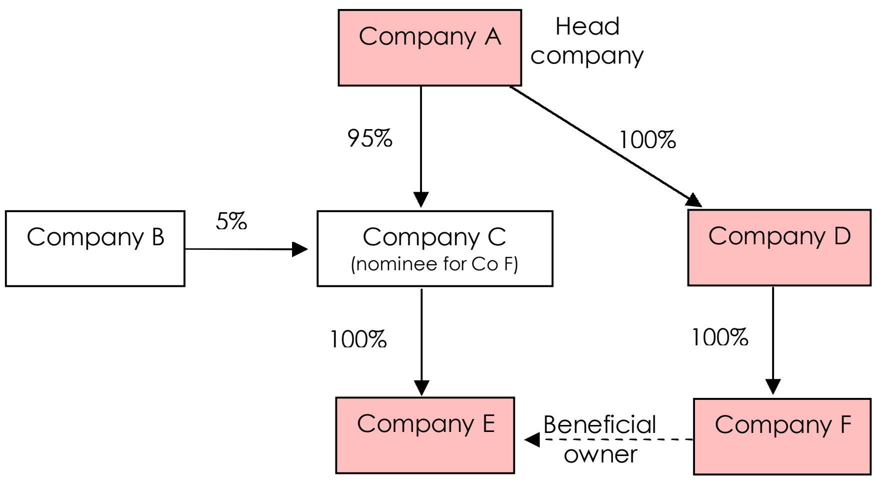


Comments

- Company A qualifies as a head company – see head company requirements in item 1 of section 703-15.
- Fixed trust T: All of the trust's membership interests are beneficially owned by company A, which is therefore the trust's sole beneficiary and sole member (section 960-130(1) ITAA 1997) that beneficially owns all of the trust's membership interests → section 960-135 (ITAA 1997). Accordingly, fixed trust T is a wholly-owned subsidiary of company A → section 703-30(1)(a). As it is also an Australian resident, is not a non-profit company, and is not specifically excluded from being a member of a consolidatable group, it qualifies as a subsidiary member.
- Company B is a wholly-owned subsidiary of company A, because all of the membership interests (that is, shares) in B are beneficially owned by A (60%) and its wholly-owned subsidiary, fixed trust T (40%) → section 703-30(1)(c). As it is also an Australian resident, an entity other than a non-profit company, and not specifically excluded from being a member of a consolidatable group, company B qualifies as a subsidiary member.
- Company C is not a wholly-owned subsidiary of company A because 10% of the membership interests (that is, shares) in C are beneficially owned by an individual. As it is not a wholly-owned subsidiary it cannot be a subsidiary member of the consolidatable group.
- Partnership P is not a wholly-owned subsidiary of company A as one of the partners (company C) is not a wholly-owned subsidiary of A. As it is not a wholly-owned subsidiary it cannot be a subsidiary member of the consolidatable group.

Example 6: Nominee company

- Companies A, D, E and F are members of a consolidatable group of which A is the head company.
- Company B is external to the group, but it has a 5% interest in company C which is 95% controlled by company A.
- Company C owns all of the shares in company E, but only as nominee for company F.



Comments

- Company C is not a subsidiary member of the group, as it is not a wholly-owned subsidiary of the head company – see column 4 of the table in section 703-15(2).
- Company E is a wholly-owned subsidiary of the head company under section 703-30(2)(b) – all of the membership interests in company E are *beneficially* owned by company F, which is a wholly-owned subsidiary of company A – see section 703-30(1)(b). As company E is a wholly-owned subsidiary of the head company, and there is an entity (company C) interposed between the head company and company E, the requirements of section 703-45(1) must be met. In this example, these requirements are met, even though the interposed entity is not a subsidiary member of the group, because the membership interests in company E are held by company C only as a nominee of company F – see section 703-45(2).

References

Income Tax Assessment Act 1997, Division 703; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Income Tax Assessment Act 1997, Subdivision 960-G; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 5

Income Tax Assessment Act 1997, Subdivision 713-C; as inserted by *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (No. 83 of 2004), Schedule 2, Part 2

Revision history

Section C1-2 first published (excluding drafts) 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on recent changes to consolidation rules, p. 1.	Legislative amendments.
26.10.05	Note on changes to consolidation rules, p. 1.	Legislative amendments.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

C2: **Assets**

Assets

About this section

The process for obtaining new tax costs for the assets of joining subsidiaries is described briefly in Part B of this Reference Manual.

→ 'Determining asset values', B2-2

This section (C2) provides a more detailed technical introduction to the treatment of assets under consolidation, supported by:

- high-level worked examples – covering each step of the entry cost setting process (when a consolidated group forms or one or more entities join a consolidated group) and the process on exit (when one or more subsidiaries leaves a consolidated group), and
- a series of worked examples describing in detail some of the individual calculation steps in the entry and exit cost setting processes.

Section contents

Worked examples – cost setting on entry

Treatment of assets

When a consolidated group forms or an entity joins a consolidated group, the tax values of the assets of each joining subsidiary are aligned with the tax values of the membership interests in that subsidiary. In effect, the cost of acquiring the entity is allocated to its assets. → Taxation Ruling TR 2004/13

The rationale behind this approach is that, on entry into a consolidated group (either individually or as consequence of formation), the equity cost base of the joining entity is effectively transferred to the assets of the entity as a representation of the actual cost of those assets to the group.

On exit from the group, the process is reversed and the group's cost base of its equity in the leaving entity is derived from the entity's net assets just before the leaving time, as this aligns the group's cost base of the equity in the leaving entity and its assets.

An overview of this cost-setting process is provided in part B of this manual → 'Determining asset values', B2-2. The rules are set out in detail in Part C as shown in table 1. They vary from case to case to ensure that assets coming into a consolidated group in different circumstances are treated consistently.

Table 1

Step in process or special case	See section …	
Overview of cost setting process on formation and entry; transitional rules	C2-1-010	'Overview of cost setting process on formation and entry (including transitional rules)'
Calculating the entry ACA	C2-1-020	'Calculating the entry ACA (step A)'
Allocating the entry ACA	C2-1-030	'Allocating the entry ACA (steps B to E)'
One consolidated group joins another consolidated group	C2-1-040	'Modifications to entry cost setting rules'
Entities linked through ownership join a consolidated group	"	
A trust or partnership joins a consolidated group	"	
Dealing with errors in tax cost setting amounts and changes in liabilities when discharged	C2-1-050	'Dealing with errors in TCSAs and changes in liabilities when discharged'
An entity leaves a consolidated group	C2-1-060	'Cost setting on exit'
Treatment of internally generated assets, pre-CGT assets and goodwill	C2-1-070	'Treatment of special classes of assets'

There are further rules that apply to the formation of a multiple entry consolidated (MEC) group. → Multiple entry consolidated (MEC) groups, C10-1

Note that where an entity held by the head company through one or more foreign entities joins a transitional consolidated group on formation, the basic case rules apply subject to certain modifications. → 'Transitional foreign held subsidiaries' in 'Eligibility tests and rules', C1-1

Revision history

Section C2-1 first published (excluding drafts) 2 December 2002 and updated 28 May 2003. Revisions since 2007 are described below.

Date	Amendment	Reason
26.6.07	Major restructure involving the break up of the section into a series of shorter sections.	To improve usability.
6.5.11	Reference to 'at the leaving time' replaced by 'just before the leaving time', to reflect changes to leaving time provisions in Division 711 of the ITAA 1997.	Legislative amendment.

Overview of cost setting process on formation and entry (including transitional rules)

Figure 1: Cost setting process on formation and entry

A Calculate joining entity's ACA (allocable cost amount)

B Subtract value of retained cost base assets (e.g. A$ cash)

C Apportion remainder of ACA over reset cost base assets in proportion to their market values, subject to adjustment for revenue-like assets

Market valuation

D Adjust the amounts allocated to depreciating assets

E Adjust the amounts allocated for certain revenue-like assets

= Tax cost setting amounts for the joining entity's reset cost base assets

Calculating the entry ACA

1. Start with cost of membership interests
2. Add liabilities
3. Add undistributed frankable profits accrued to the group

3A. Adjust for certain pre-joining time rollovers from a foreign-resident company or the company that becomes the head company to an Australian-resident company

4. Subtract distributions of profits not accruing to the group, and those accruing to the group that recouped losses
5. Subtract unused losses accrued to the group, except those reducing step 3 profits
6. Subtract an amount equal to transferred losses that did not accrue to the group, multiplied by the general company tax rate
7. Subtract certain inherited deductions to avoid duplication of benefit
8. The ACA is the remaining amount (if positive) or nil (if negative)

On formation or entry the tax cost of each asset of a joining subsidiary is based on a share of the allocable cost amount (ACA) of that subsidiary. The ACA consists of the cost of the membership interests in the entity together with its liabilities, which become liabilities of the group. Adjustments are made to reflect certain undistributed profits, distributions and losses of the joining entity and certain deductions to which the head company becomes entitled.

Part of the ACA is allocated to the subsidiary's *retained* cost base assets (i.e. assets such as cash that retain their cost bases at the joining time). The remainder of the ACA is then apportioned to the subsidiary's *reset* cost base assets in proportion to their market values, subject to further adjustments for assets held on revenue account and over-depreciated assets.

Assets not held by head company at joining time

Note that, at the joining time, tax costs are set for all assets that would be those of the joining subsidiary *if the single entity principle did not apply* → subsection 701-10(2), ITAA 1997; section 701-1, ITAA 1997; 'Single entity treatment', C9-1-110. This means that tax costs are reset even for those assets that are not recognised as being those of the head company under the single entity principle. Commonly, these would be intragroup assets, i.e. assets (such as a loan from the joining subsidiary to a group member) that correspond to a liability of another group member.

In working out any income tax consequences for the head company in relation to those assets, their reset tax costs are not taken into account, consistent with ignoring those assets under the single entity principle → section 701-58, ITAA 1997. However, setting their tax costs at the joining time absorbs some ACA that would otherwise be inappropriately allocated to the other reset cost base assets → paragraphs 2.54 – 2.60 of the Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 2) Bill 2004.

On formation

The cost setting process on formation is essentially the same as that for the entry of a single entity into a consolidated group, with some differences in the ACA calculation (step A in figure 1) and in the apportionment of the ACA over reset cost base assets (step C).

The formation cost setting rules are modifications of the basic case rules that apply when a single entity joins a consolidated group. Therefore, all the basic case rules in Subdivision 705-A of the *Income Tax Assessment Act 1997* (ITAA 1997) apply to the formation case, subject to the modifications contained in Subdivision 705-B. In addition, further modifications to both the basic and formation cases providing for transitional rules are included in Division 701 of the *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A).

No double counting of amounts in the ACA

Under the tax cost setting process, several adjustments are made to the ACA. Section 705-62 of the ITAA 1997 prevents a particular amount being taken into account more than once when calculating the ACA for a joining entity. The aim is to prevent distortion of the tax cost setting amount that would otherwise occur as a consequence of double counting.

Loss integrity issues

Division 715 and Subdivision 719-T of the ITAA 1997 contain provisions that deal with loss integrity issues that may arise on formation and joining of consolidated or MEC groups.

→ 'Formation time treatment of assets owned by head company from a pre-consolidation changeover time', C2-6-510; 'Effect of Subdivision 165-CC for steps 1 and 2 of the ACA calculation at formation and joining times', C2-6-110; 'Effect of Subdivision 165-CD for MEC groups', C2-6-150

Head company's assets

On formation, the head company always retains existing tax values for its assets. When a consolidated group is formed, no changes are made in relation to the head company's assets, other than to the intragroup debt and intra-group membership interests it holds, which are not recognised for income tax purposes during consolidation.

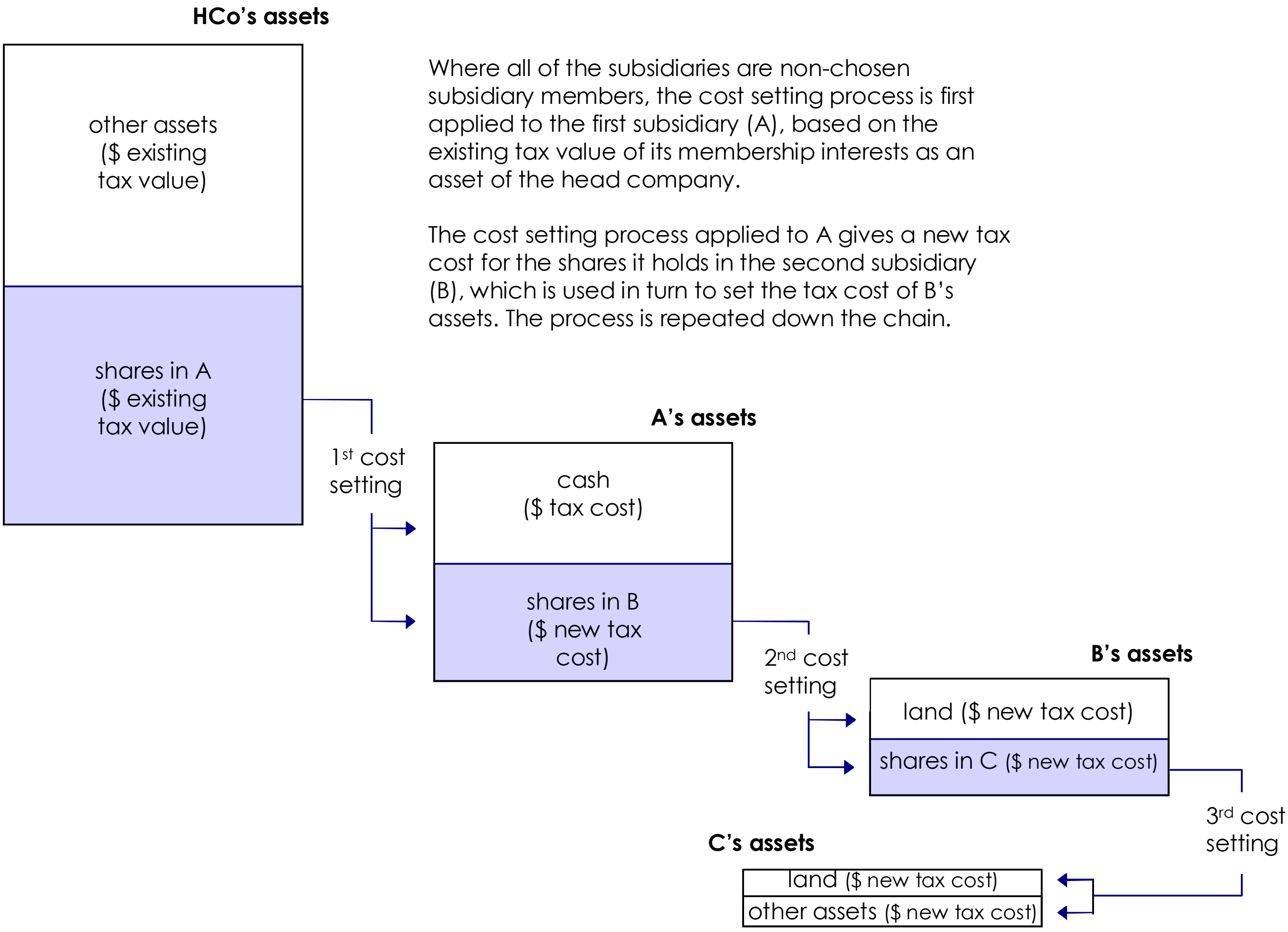
Order of cost setting application

The cost setting process is applied separately to each subsidiary. When a group of entities linked by ownership forms or joins a consolidated group, the process is applied separately to each entity on a top-down basis → figure 2. (But this does not apply when a consolidated group joins another consolidated group → 'Modifications to entry cost setting rules', C2-1-040.)

When, for example, on formation a non-chosen subsidiary member (the first subsidiary) holds membership interests in another non-chosen subsidiary member (the second subsidiary), the membership interests in the second subsidiary are reflected as an asset in the first subsidiary's accounts. The cost setting rules must be first applied to the first subsidiary. The resulting cost setting amount for the membership interests in the second subsidiary is then used in working out the allocable cost amount for the assets in the second subsidiary. This rule only applies if all entities in the chain are non-chosen transitional entities.

In the following example (figure 2), the 1st cost setting application sets a new tax cost for A's shares in B. This new tax cost is then used in the ACA step 1 calculation for B (as part of the 2nd cost setting application) to set a new tax cost for B's shares in C. In turn this new tax cost is used in the ACA step 1 calculation for C (as part of the 3rd cost setting application) to set new tax costs for its assets.

Figure 2: Cost setting is applied top down on group formation



Where all of the subsidiaries are non-chosen subsidiary members, the cost setting process is first applied to the first subsidiary (A), based on the existing tax value of its membership interests as an asset of the head company.

The cost setting process applied to A gives a new tax cost for the shares it holds in the second subsidiary (B), which is used in turn to set the tax cost of B's assets. The process is repeated down the chain.

Note

Linked entities

The same top-down principle as applies to formation is followed when linked entities join a consolidated group. → 'Modifications to entry cost setting rules', C2-1-040; section 705-225, ITAA 1997

Transitional rules

Transitional rules, including concessions intended to reduce compliance costs, apply to groups consolidating during the transitional period (1 July 2002 to 30 June 2004).

In particular, the head company may have the option of retaining the existing tax values for a subsidiary's assets (the 'stick' method) instead of applying the cost setting rules (the 'spread' method). This option is available on a subsidiary-by-subsidiary basis, on the group's formation, provided the subsidiary is wholly owned on or before 30 June 2003 (and once wholly owned after 1 July 2002 it must remain so until the group consolidates). For example, a subsidiary that is a wholly-owned member of a consolidatable group on 1 July 2002, but which leaves the group three months later and then rejoins it on 30 June 2003 (after which the group consolidates) is not eligible for this option.

- A subsidiary that is eligible for the transitional option of retaining existing tax values is a 'transitional entity'.
- A group with at least one transitional entity is a 'transitional group'.
- A subsidiary for which the head company has chosen the transitional option is a 'chosen transitional entity'. → 'Pre-formation changeover times – application of Subdivision 165-CC at formation (transitional period)', C2-6-520

→ sections 701-1 to 701-5, IT(TP)A 1997

The head company can change its decision to stick or spread in relation to an entity provided it:

- makes the choice to use the stick method (assuming it had previously decided to spread) or revoke its original choice to stick (i.e. it has now decided to use the spread method) by 31 December 2005, and
- obtains agreement from any entity that has ceased to be a subsidiary and that held, at the leaving time, an asset previously held by the head company because of the single entity rule.

Where a head company has chosen to revoke a previous choice it should ensure that it keeps a written record of this decision. Where the revocation results in a change to the group's taxable income, the head company is required to lodge an amended income tax return as soon as practical after revoking the original choice.

→ subsections 701-5(4) and (5), IT(TP)A 1997

Note

- The value shifting and loss transfer provisions do not apply to membership interests in chosen transitional entities (that is, subsidiaries for which the head company has opted to retain existing tax values). → section 701-25, IT(TP)A 1997
- The formation rules outlined in this section are modified for a non-chosen subsidiary member in which some or all of the membership interests are held (directly or indirectly) by a chosen transitional entity. In this case, the chosen transitional entity is treated as a head company of a sub-group, and a notional ACA is calculated for the sub-group's interests in the non-chosen subsidiary (together with a corresponding amount for any interests held directly – or indirectly through non-chosen subsidiary members – by the consolidated group's head company). → section 701-20, IT(TP)A 1997

  These amounts are calculated by including at ACA step 1 only the interests held by the sub-group (or head company) and then multiplying each of the ACA step 2 to 7 amounts by a fraction corresponding to the proportionate interest held by the sub-group (or head company) in the non-chosen subsidiary member. The result is the *sub-group's notional allocable cost amount*. Each sub-group's notional ACA (or, in the case of the head company, *the head company adjusted allocable amount*) are then aggregated to determine the actual ACA for the non-chosen subsidiary member.

  → 'Calculating the ACA for non-chosen subsidiary partly held by chosen transitional entity', C2-4-205; section 701-20, IT(TP)A 1997; Taxation Determination TD 2004/73

Note

Pre-formation rollover after 16 May 2002 and transitional groups

If there has been a rollover of an asset under Subdivision 126-B or item 4 of the table in subsection 40-340(1) of the ITAA 1997, and:

- the rollover was after 16 May 2002
- the group consolidates after the rollover but before 1 July 2004
- because of the rollover, the tax values of the group's assets are different from what they would have been had the rollover not happened,

the rollover is disregarded for tax cost setting purposes on consolidation with certain exceptions. → sections 701-35 and 719-163, IT(TP)A 1997

The rule is intended to prevent groups from using rollover relief to maximise their choices for the cost setting of their assets on consolidation.

Exceptions to rule that such rollovers be disregarded for tax cost setting purposes

To enable a foreign-owned group that restructures to reset the cost of its assets on consolidation, an exception exists where the following conditions are satisfied:

- the rollover asset is a membership interest in an entity
- the membership interest is rolled-over from a foreign-resident company to an Australian-resident company
- the entity whose membership interests were rolled-over becomes a subsidiary member of a consolidated or MEC group at the time of formation
- the group is a transitional group, and
- the entity is not an eligible tier-1 company of a MEC group or a group member in which an interposed foreign-resident entity holds membership interests.

There is also an exception if the act, transaction or event that gave rise to the CGT event for which there was a rollover under Subdivision 126-B or section 40-340 happened before a demerger, and in connection with the demerger:

- either the originating company or the recipient company ceased to be a member of the 'demerger group' (as defined in section 125-65 of the ITAA 1997) because of the demerger, and
- the recipient company and the originating company do not both join the same consolidation transitional group.

→ subsection 701-35(2A), IT(TP)A 1997

Concessions when a subsidiary leaves a transitional group

- When a subsidiary leaves a transitional group with an asset that was subject to an over-depreciated asset adjustment on entry, the head company may choose to add back the adjustment to the asset for the purpose of determining its cost base for membership interests.
  → section 701-40, IT(TP)A 1997
- Effective from 1 July 2009, the over-depreciation adjustment in section 705-50 of the ITAA 1997 has been repealed so that it no longer applies to over-depreciated assets of entities that become subsidiary members of a consolidated group on or after that date. As section 705-50 of the ITAA 1997 has been repealed from 1 July, section 701-40 of the IT(TP)A 1997 has also been repealed so that it no longer applies to the over-depreciated assets of entities that ceased to be members of a consolidated group on or after 1 July 2009. → *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010)
- When a subsidiary leaves a transitional group, its head company may choose to use formation time market values, instead of terminating values, for certain pre-CGT assets when reconstructing the cost bases of membership interests. The pre-CGT assets must be assets of the head company immediately before the formation time and not assets that were transferred to the head entity under a rollover. → section 701-45, IT(TP)A 1997

References

Legislation

Income Tax Assessment Act 1997, Subdivision 705-A; as amended by:

New Business Tax System (Consolidation) Act (No. 1) 2002 (No. 68 of 2002), Schedule 1

- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2
- *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedules 3 and 5
- *Taxation Laws Amendment Act (No. 6) 2003* (No. 67 of 2003), Schedule 3

Income Tax Assessment Act 1997, Subdivision 705-B; as amended by:

- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 3
- *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 3

Income Tax Assessment Act 1997, section 705-62; as inserted by *Tax Laws Amendment Act (2010 Measures No.1) Act 2010* (No. 56 of 2010), Schedule 5, Part 4

Income Tax Assessment Act 1997, sections 705-60, 705-93, 705-147, 705-227 and subsection 995-1(1); as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 5

Income Tax Assessment Act 1997, section 705-50 and subsection 995-1(1); as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 6

Income Tax (Transitional Provisions) Act 1997, Division 701; as amended by:

- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 7
- *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 3
- *Taxation Laws Amendment (2005 Measures No 5) Act 2005,* (No 162 of 2005), Schedule 3

Income Tax (Transitional Provisions) Act 1997, subsections 701-5(4) and (5); as amended by the *Taxation Laws Amendment (2005 Measures No. 5) Act 2005* (162 of 2005), Schedule 3

Income Tax (Transitional Provisions) Act 1997, sections 701-35 and 719-163; as amended by:

- *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 17
- *Tax Laws Amendment (2006 Measures No 4) Act 2*006 (No 168 of 2006), Schedule 2

Explanatory Memorandum to New Business Tax System (Consolidation) Bill (No. 1) 2002

Explanatory Memorandum to New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002

Explanatory Memorandum to New Business Tax System (Consolidation and other Measures) (No. 1) Bill 2002

Explanatory Memorandum to Tax Laws Amendment Act (No. 6) 2003, Paragraphs 3.4 and 3.9 to 3.48

Explanatory Memorandum to Tax Laws Amendment (2005 Measures No. 5) Bill 2005

Explanatory Memorandum to New Business Tax System (Consolidation and other Measures) Bill (No. 2) 2002

Explanatory Memorandum to Tax Laws Amendment (2006 Measures No. 4) Bill 2006

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No.1) Bill 2010, paragraphs 5.146 – 5.157, paragraphs 5.158 – 5.179 and paragraphs 5.180 – 5.186

Tax determinations

TD 2004/73 – Income tax: consolidation: where the head company and a chosen transitional entity in a consolidated group hold separate membership interests in a non-chosen subsidiary, how does the group calculate the allocable cost amount for the non-chosen subsidiary?

TD 2005/24 – Income Tax: Consolidation: is an adjustment under section 705-160 of the *Income Tax assessment Act 1997* required where the relevant membership interests are in a chosen transitional entity with losses?

TD 2005/25 – Income tax: consolidation: if a transitional group has a non-chosen subsidiary in which all membership interests of the head company are held indirectly through a chosen transitional entity, and the non-chosen subsidiary has accrued profits, can an adjustment arise under section 705-160 of the *Income Tax Assessment Act 1997* when working out the head company adjusted allocable amount under section 701-20 of the *Income Tax (Transitional Provisions) Act 1997* for another non-chosen subsidiary?

Revision history

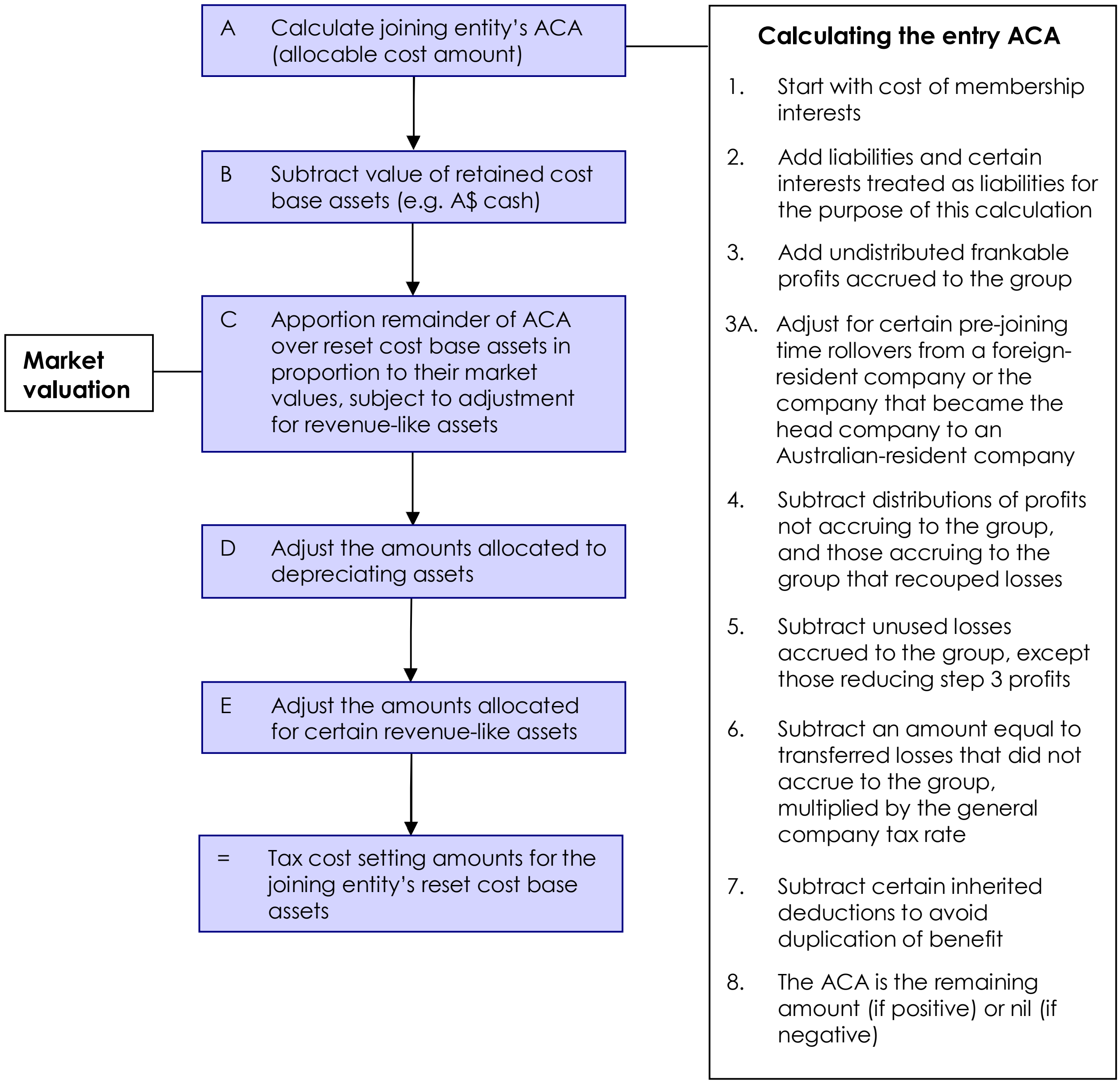
Section C2-1-010 first published as separate section 26 June 2007.

Further revisions are described below.

Date	Amendment	Reason
6.5.11	Minor changes to reflect the repeal of section 705-50, effective 1 July 2009. Minor changes to reflect modifications to the pre-joining time roll-over provisions. Note added to inform of the introduction of the no double counting rules for the ACA, p. 2.	Legislative amendments.

Calculating the entry ACA (step A)

Figure 1: Cost setting process on formation and entry



A – Calculate the entry ACA

The ACA calculation starts with the cost of membership interests, adds the liabilities of the joining entity, then adds undistributed taxed profits that accrued to the joined group, and subtracts certain distributions, losses and inherited deductions. Section 705-60 of the *Income Tax Assessment Act 1997* (ITAA 1997) sets out each of the ACA steps and their particular purpose. The overall purpose is to work out the economic cost to the group of acquiring the joining entity's assets, and to allocate that cost over all of the joining entity's assets, so that when those assets are sold, the group will be taxed on the real economic gain it makes or obtain relief for any real economic loss. The rules aim to prevent double taxation of gains and duplication of losses made by the consolidated group in respect of its interests in a joining entity.

Steps 1 and 2 are about working out the cost of acquiring the joining entity. **Step 1** sums the cost of membership interests. **Step 2** adds to the step 1 amount the joining entity's liabilities. These liabilities can be considered as further amounts that will be required to be paid for the entity's assets and which should therefore be reflected in the ACA as part of the tax cost of its assets.

Step 3 adds the amount of undistributed, taxed profits that accrued to the joined group. After the acquisition time, but before the joining time, the joining entity may have made profits that remain undistributed. The value of the joining entity will have been enhanced to this extent and this value will be reflected in new assets held by the joining entity. Where tax has been paid on the undistributed profits, if there is not a reflection of this enhanced value in the ACA, the full amount of the future sale proceeds of the assets will be subjected to tax should they be subsequently disposed of. Conversely, no ACA uplift would be warranted for the undistributed profits that have not borne tax because they would otherwise be permanently sheltered from tax as costs of the assets.

Looking at step 3 another way, the undistributed profits could otherwise have been distributed to shareholders as they accrued. Had the shareholders re-invested these distributed profits, which then became reflected in the assets of the joining entity, the after-tax amount would have become part of the step 1 amount as a cost to the shareholders of its membership interests. If these distributed profits had been untaxed (and not franked) the recipient shareholders would receive, in economic value, only the after-tax amount. In this case only the net amount would have been available for re-investment and would therefore be reflected in the ACA at step 1.

Whichever way step 3 is looked at, it is the after tax amount that accrued to the membership interests between acquisition time and joining time that is added at step 3.

Where an entity joins a group as a result of it being progressively acquired, the profits accrued to the membership interests of the group would only be a portion of the profits derived since its first acquisition of membership interests. See 'Determining undistributed, taxed (frankable) profits accrued to group before joining time (ACA step 3)', C2-4-261 for details on what is meant by a profit accrued to the joined group in such a situation.

Step 3A adds or subtracts an adjustment in respect of pre-joining time CGT rollovers to a subsidiary member of the consolidated group from a foreign-resident company or the company that became the head company of the group.

At **step 4**, certain distributed profits are subtracted. The purpose of step 4 is to prevent the ACA reflecting the return of part of the amount paid to acquire the membership interests in the joining entity. → subparagraph 705-95(b)(i), ITAA 1997

This step requires the subtraction of all distributions made by the joining entity since the acquisition time, but before the joining time, out of acquired profits → subparagraph 705-95(b)(i). These acquired profits are the undistributed profits of the joining entity that would attach to membership interests when the membership interests were acquired. The cost to the group of the acquired profits will be reflected in the step 1 amount. If these are subsequently paid out before the joining time, the step 1 amount would be effectively overstated.

The step also requires subtraction of distributions of accrued profits that recouped losses of any sort that accrued to the group before the joining time → subparagraph 705-95(b)(ii). A profit can only 'recoup' a loss of any sort if it has been included as part of the assessable income against which the loss of any sort has been allowed as a deduction or otherwise set-off. If the accounting loss gives rise to the loss of any sort referred to in subparagraph 705-95(b)(ii) and assessable income is reflected in the accounting profit that recoups the earlier accounting loss, that profit will not have been taxed.

The reduction for distributed accrued profits which recouped accrued losses under step 4 requires working out whether distributed profits have recouped losses for income tax purposes. This reduction deals with the situation where the relevant loss is not subtracted at step 5 because the loss has been utilized.

Steps 4 and 5 both deal with 'losses of any sort'. The phrase is defined in subsection 701-1(4) of the ITAA 1997 and encompasses, broadly, tax losses within Division 36 and certain other particular kinds of losses calculated under the *Income Tax Assessment Act* 1936 (ITAA 1936) and the ITAA 1997.

Step 5 deals with losses that have not been utilised (in the sense that a deduction or other set-off has not been allowed in respect of them), but a loss is not to be taken into account under step 5 to the extent that it has reduced the undistributed profits comprising the step 3 amount. Step 5 subtracts the losses accrued to the joined group.

Step 6 subtracts an amount equal to losses transferred to the head company that did not accrue to the joined group multiplied by the general company tax rate.

Step 7 subtracts certain inherited deductions or part of them to avoid duplication of benefit.

Note that where a particular amount could be taken into account more than once when calculating the entry ACA, section 705-62 may apply to eliminate duplication. → 'No double counting of amounts in the ACA', p. 13

The result after all seven steps in the calculation is the entry ACA.

Note

Asset rollover

The ACA calculation will disregard an asset rollover if:

- the rollover was under Subdivision 126-B or under item 4 of the table in subsection 40-340(1) of the ITAA 1997
- the rollover was after 16 May 2002
- the group consolidates after the rollover but before 1 July 2004, and
- because of the rollover, the tax values of the assets of the group are different from what they would have been had the rollover not happened. (However, certain exceptions exist where a foreign-owned group restructures by rolling over membership interests in its subsidiaries, or where the roll-over is in connection with a demerger.)
  → sections 701-35 and 719-163, IT(TP) Act 1997)

Non-chosen subsidiary held by chosen transitional entity

In the formation case, the ACA calculation is modified for a non-chosen subsidiary member where some or all of its membership interests are held (directly or indirectly) by a chosen transitional entity. → 'Overview of cost setting process on formation and entry (including transitional rules)', C2-1-010

Linked assets and liabilities

There are special rules for cost setting in relation to linked assets and liabilities. A set of linked assets and liabilities consists of at least one asset and one liability that the accounting standards or authoritative pronouncements of the Australian Accounting Standards Board require to be set-off against each other in preparing an entity's statement of financial position, and presented as a net amount.
→ subsection 705-59(2), ITAA 1997

The linked assets and liabilities rules can affect:

- the amount of the step 2 liabilities that are added
- allocation of the ACA to linked retained cost base assets
- the inclusion of linked reset cost base assets in the allocation of the ACA
- market values of linked reset cost base assets used to allocate the ACA

→ section 705-59

Apart from these special rules, the consolidation regime treats assets and liabilities that the accounting standards require to be set-off as separate assets and liabilities. That is, in general the linked assets and liabilities are not netted; their gross amounts are used. → section 705-58, ITAA 1997

The application of these rules is explained in detail in a later section.
→ 'Linked assets and liabilities', C2-1-310

An amount not to be included at both step 1 and step 2

In relation to the ACA calculation, the law is not intended to allow more than one tax benefit flowing from a single outlay; that is, if an amount could be categorised as a cost of membership interest for step 1 and as a liability for step 2, the intent is that it be included only once in either step 1 or step 2. → Taxation Determination TD 2004/74

Step 1: Start with the cost of membership interests

Add up the total cost of all membership interests that the consolidated group holds in the joining entity.

When a single entity is joining an existing consolidated group, the calculation will be adjusted:

- to set a single cost base where the reduced cost base is different from the cost base (this will occur where some of the interests were acquired before 21 September 1999, and in some other cases) → subsection 705-65(1), ITAA 1997
- but no amount is added for indexation when determining the cost base of pre-CGT membership interests → subsection 705-65(2)
- by application of the value shifting or loss transfer provisions as if some of the joining entity's membership interests had been disposed of, just before the joining time → subsection 705-65(3), and
- by adding back adjustments to the reduced cost base of membership interests for rebatable dividends, and certain reductions under Subdivision 165-CD of the ITAA 1997 → subsections 705-65(3A), (5) & (5A); 'Treatment of assets owned by head company at both formation time and pre-consolidation changeover time (no changeover time at formation)', C2-6-530.

Non-membership equity interests held by members of the group in the joining entity are treated as membership interests for the purposes of step 1. → section 705-65(6)

Where the head company makes a deferred acquisition payment (i.e. after the joining time it pays money or gives property, or an obligation arises for it to make a payment or give property, in relation to acquiring membership interests in the joining entity), the head company must recalculate the step 1 amount to take account of the deferred payment. This could happen, for example, if a commercial arrangement for the acquisition of the entity required such a payment on the contingency that the acquired entity met a certain profit forecast. → subsection 705-65(5B), ITAA 1997; paragraphs 2.100 – 2.106, Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 2) Bill 2004

On formation

On formation, the amount used for membership interests in the joining entity will be either:

- calculated in the same way as for a single entity joining an existing consolidated group (this applies in respect of interests held directly by the head company), or
- where the tax cost setting amount (new tax cost) has already been set for the membership interests (as a result of the completion of the cost setting process for a subsidiary further up the chain), that amount is treated as the cost of the membership interests to be used in this step. This amount is *not* adjusted by application of the value shifting or loss transfer provisions → subsections 705-145(3) & (4), ITAA 1997.

On formation, non-membership equity interests are similarly treated as if they were membership interests. → subsection 705-145(5), ITAA 1997

Note

Discretionary interests in a trust are treated differently. → 'Modifications to entry cost setting rules', C2-1-040

Step 2: Add liabilities

A joining entity's liabilities at the formation or joining time are part of the group's cost of the entity's assets. The liabilities are therefore added to the amount worked out in step 1. Generally the amount added is the total of the joining entity's liabilities in accordance with its accounting principles for tax cost setting. The joining entity's accounting principles for tax cost setting are the accounting standards or authoritative pronouncements of the Australian Accounting Standards Board that the entity would use if it were to prepare its financial statements just before the joining time. → subsection 705-70 (1), subsection 705-70(3) and section 995-1, ITAA 1997; Taxation Ruling TR 2004/14; Taxation Ruling TR 2006/6

Adjustments may be made to this amount:

- where the joining entity owns linked assets and liabilities – the linked liabilities may be reduced or excluded → section 705-59, ITAA 1997; 'Linked assets and liabilities', C2-1-310
- where the amount of the accounting liability of the joining entity would be different when it becomes an accounting liability of the joined group – the latter amount is treated as the amount of the liability → subsection 705-70(1A), ITAA 1997, and worked example: 'Determining the amount of a deferred tax liability to be used at ACA step 2, including use of administrative short cuts', C2-4-242. (However, this adjustment is not required in the case of a transitional entity. → section 701-32, IT(TP)A 1997; paragraphs 1.156 – 1.162, Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004)
- to exclude an amount that is inextricably linked to an asset of the joining entity → subsection 705-70(2), ITAA 1997; Taxation Determination TD 2004/72
- to reduce the amount for some or all of a liability that will become an income tax deduction to the head company → subsection 705-75(1), ITAA 1997
- to reduce the amount of the liability for amounts owed to a member of the group → subsection 705-75(2), ITAA 1997; 'Effect of Subdivision 165-CC for steps 1 and 2 of the ACA calculation at formation and joining times', C2-6-110; 'Treatment of assets owned by head company at both formation time and pre-consolidation changeover time (no changeover time at formation)', C2-6-530
- where there is a timing difference between income tax provisions and accounting standards in recognising the liability – there may be an increasing or decreasing adjustment → section 705-80, ITAA 1997; 'Adjustment at ACA step 2 to allow for timing differences between accounting and tax recognition of liabilities', C2-4-245; Taxation Determination TD 2004/70; Taxation Determination TD 2004/71; Taxation Determination TD 2004/77; Taxation Determination TD 2004/78; and
- by adding the amount received from the issue of non-membership equity interests to a person who is not a member of the group → subsection 705-85(3), ITAA 1997.

Membership interests in the joining entity that are not held by members of the group (that is, disregarded employee shares) are treated in a similar way to a liability. The market value of these membership interests is added to the amount of liabilities. → 'Adjustment for employee shares (in ACA step 2)', C2-4-241

Note

Finance leases

Where the joining entity is a lessee under a lease of a depreciating asset, the liability represented by the obligation to make lease payments is only taken into account at step 2 if, just before the joining time, the joining entity holds the depreciating asset under Division 40 of the ITAA 1997. If the lessee doesn't hold the depreciating asset just before the joining time it does not have a step 2 amount for that lease liability. → subsection 705-56(4), ITAA 1997

Provision for doubtful debts

A provision (or allowance) for doubtful debts does not constitute a liability under accounting standards or concepts, notwithstanding that the doubtful debts expense which relates to the provision reduced the amount of taxed profits that accrued to the joined group at step 3 of the entry ACA calculation. A modification in section 705-27 of the ITAA 1997 allows for the reduction of any CGT event L3 capital gain in respect of doubtful debts treated as retained cost base assets with a corresponding adjustment to the tax cost setting amount of the debts.

Step 3: Add undistributed taxed and accrued profits

Undistributed profits at the formation or joining time that accrued to direct or indirect membership interests that the group held continuously, and that could be distributed as a fully franked dividend, are added to the ACA. The purpose of this adjustment is to allocate a cost to assets acquired by undistributed taxed profits. → section 705-90, ITAA 1997

This amount is further adjusted to exclude certain income years where the joining entity was previously a member of a consolidated group. → subsection 705-90(5), ITAA 1997

Undistributed profits are the cumulative retained profits of the joining entity that would be recognised in its financial statements if those statements were to be prepared at the joining time. This is an accounting concept and is in essence a net amount in that it may be an amalgam of accounting profits and accounting losses for the accounting periods before the joining time, including pre-acquisition accounting periods. → subsection 705-90(2), ITAA 1997; Taxation Determination TD 2004/55 and Addendum TD 2004/55A

Retained profits may include reserves that have been created out of a Retained Profits Account (RPA). However, reserves that have a source other than retained profits, such as Asset Revaluation Reserve (ARR) and Foreign Currency Translation Reserve, are not considered to be part of retained profits for the purposes of subsection 705-90(2). Generally, retained profits should not include any unrealised gains transferred from ARR. However, where an asset has been disposed of, and the resulting realised gain has been transferred from ARR to RPA in accordance with the accounting standards, the realised gain does not need to be excluded from the balance of the RPA.

→ Taxation Determination TD 2004/55 and Addendum 2004/55A

In working out the undistributed profits, any losses that did not accrue to the joined group are not counted. → subsection 705-90(2A), ITAA 1997; see paragraphs 1.149 – 1.155, Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004 for further information and examples

The extent to which tax is paid on undistributed profits is based on the balance of the franking account that would be available to be fully franked according to the current corporate tax rate → subsection 705-90(3), ITAA 1997. This puts a ceiling on the amount of undistributed profits that can be subsequently dealt with → subsection 705-90(3), ITAA 1997. (Throughout this manual, taxed profits are referred to as frankable profits and untaxed profits as unfrankable profits where there would be no franking credit available.)

Subsection 705-90(6) of the ITAA 1997 then requires the taxed amount to be apportioned between pre-acquisition undistributed profits and post-acquisition profits. The calculation may be seen as a netting-off of accounting profits and accounting losses (if any) over the various accounting periods from the acquisition time to the joining time to see what proportion of the undistributed profits have accrued during that period (accrued profits).

An accrued profit is a profit that would be received by the head company of a group in respect of membership interests that it continuously held, either directly or via interposed entities, on the assumption that a distribution had been made in relation to those membership interests as that profit accrued → subsection 705-90(7), ITAA 1997. This is sometimes referred to as an 'owned' profit. Profits that do not accrue to the head company in this way are sometimes referred to as 'acquired' profits.

The amount remaining after the subsections 705-90(2), (3) and (6) calculations is the undistributed profits that have accrued to the consolidated group from its continuously held membership interests as limited by the available franking credits. This amount cannot be more than the amount calculated under subsection (3). The cost to the group of pre-acquisition profits will already have been recognised at step 1.

To help reduce the costs of compliance, subsection 705-90(9) allows the amount of profit that accrued to the joined group in a particular period to be worked out using the most reliable basis for estimation that is available. This recognises that detailed records may not always be available to permit a precise calculation of the profits (or losses) that accrued to the group. One such reliable basis for estimation is specifically provided for by subsection 705-90(10). This permits a last-in-first-out (LIFO) method of sourcing dividends to the profits of individual years. → 'Estimating undistributed, frankable profits accruing to group before joining time (ACA step 3)', C2-4-260

Continuously held membership interests are membership interests of the joining entity held (directly or indirectly) by the head company from the acquisition date to the formation or joining time. A membership interest will be taken not to have been held continuously in certain situations even if there was no disposal of the membership interest (for example, when the membership interest stops being a pre-CGT asset). → section 705-105, ITAA 1997

On formation

A transitional group may increase the ACA at step 3 for undistributed, untaxed profits that accrued to the group for a non-chosen subsidiary member. This applies to a transitional group that comes into existence on or before June 2003.

It also applies to a transitional group that comes into existence in the period starting 1 July 2003 and ending 30 June 2004 if the day it comes into existence is on or before the first day of the head company's income year that started after 30 June 2003. → *Tax Laws Amendment Act (2010 Measures No. 1) Act 2010*

This period allows such a group to benefit from an increase in the ACA regardless of whether the head company has a substituted accounting period or an ordinary accounting period. → former section 701-30, IT(TP)A 1997; Taxation Determination TD 2004/62 and Addendum 2004/62A

Note: For the purpose of determining the ACA of entities forming a group, a profit of a higher-tier entity in the group will not be held to have accrued to the group where it has arisen from a dividend paid by a lower-tier entity out of profits that did not accrue to the group (acquired profits). This will also apply where multiple linked entities join a group. → Taxation Determination TD 2004/53 and Addendum 2004/53A

Note

Step 3 is modified for **trusts**. → 'Modifications to entry cost setting rules', C2-1-040

Step 3A: Pre-joining time rollover from a foreign-resident company or the company that becomes the head company

An adjustment to the ACA is made where there is a pre-joining time rollover from a foreign-resident company or the company that became the head company to a resident company that then joins a consolidated group. The adjustment is an increase or a reduction to the ACA depending on whether a capital loss (prior to loss deferral provisions) or a capital gain is rolled over.
→ sections 705-93, 705-147 and 705-227, ITAA 1997

Broadly, where there was a pre-joining time rollover of a CGT asset under Subdivision 126-B (ITAA 1997), or former section 160ZZO (ITAA 1936), from a foreign-resident company or from the company that became the head company to an Australian-resident group company and the entity that holds the asset then joins the group, there will be a step 3A amount if that entity was either the recipient of the asset or received the asset as a result of a further rollover. If a capital gain is rolled over, the step 3A amount is the amount of the deferred rollover gain; and if a capital loss is rolled over, the step 3A amount is the amount of the deferred rollover loss. However, no adjustments are made where the rollover asset is both a non-membership interest and a pre-

CGT asset, or if the recipient of the rollover was the company that became the head company of the consolidated group.

The purpose of this provision is to offset any effect that a rollover would otherwise have in altering a group's aggregate cost for its assets. Where this step applies to more than one rollover asset, the ACA is increased or reduced by the net result after taking into account all reduction (that is, deferred rollover gain) and increase (that is, deferred rollover loss) amounts.

Where after applying step 3A, the result of the ACA calculation so far is negative, CGT event L2 will happen. The head company will make a capital gain equal to the negative amount → section 104-505, ITAA 1997; 'CGT events arising out of the cost setting rules', C2-1-410. If this happens you do not need to proceed with the remaining steps of the ACA calculation. The tax cost setting amount of your assets will be set to nil.

On formation

Step 3A adjustment

An adjustment is made to the ACA where there is a pre-formation time rollover from a foreign-resident company or the company that became the head company to an Australian-resident company that joins a consolidated group at the formation time and the rollover asset becomes that of the head company under the single entity rule → section 705-93. An adjustment is also made where the rollover asset is a membership interest in an entity that becomes a subsidiary member → section 705-93 as modified by section 705-147.

If the rollover amount was a capital gain (deferred rollover gain), the ACA is reduced. If the rollover amount was a capital loss (deferred rollover loss), the ACA is increased. However, if the rollover is disregarded because of the operation of the transitional provisions (→ section 701-35, IT(TP)A) 1997), this rule does not apply.

Note

Step 3A is modified for **linked entities** in a similar way to the modification for formation. → section 705-227, ITAA 1997

Step 4: Subtract adjustments for certain distributions by the joining entity

There are two circumstances where an adjustment is made:

1. First, distributions by the joining entity that would reflect a net return of the cost of membership interests included in the step 1 amount are deducted. The purpose of this adjustment is to reduce the cost of membership interests where some or all of that amount has been returned as a distribution. → subparagraph 705-95(b)(i), ITAA 1997

On formation

Notwithstanding that there have been successive distributions of the same amount, the adjustment is made only in working out the ACA for the entity that distributes profits directly to the head company and in circumstances where profits have been effectively returned to the head company. → 'Adjustment in working out step 4 of allocable cost amount for successive distributions of profits at formation (ACA step 4)', C2-4-280; section 705-155, ITAA 1997

Before the formation time it may be that dividends are paid by a lower-tier member of the group to a higher-tier member out of profits that did not accrue to the group (acquired profits), and those dividends are not paid up to the head company. For the purposes of the ACA calculation at the formation time, those profits will retain the character of 'acquired' profits in the hands of the recipient subsidiary member of the group. This will also apply where multiple linked entities are joining a group.

Note

Step 4 is modified for **linked entities** in a similar way to the modification for formation. → 'Modifications to entry cost setting rules', C2-1-040

2. Second, distributions by the joining entity of profits that accrued to direct or indirect membership interests that the head company held continuously are deducted. This deduction only applies to the extent that those profits recouped losses that accrued to direct or indirect membership interests that the head company held continuously. The purpose of this step is to reduce the cost of membership interests included in the step 1 amount where some of that cost has been lost and, when recouped, returned as a distribution. → subparagraph 705-95(b)(ii), ITAA 1997; Taxation Determinations TD 2004/57, TD 2004/58, TD 2004/60

Note

Subsection 705-90(10) permits a **last-in-first-out (LIFO)** method of sourcing dividends to the profits of individual years. → 'Estimating undistributed, frankable profits accruing to group before joining time (ACA step 3)', C2-4-260

Step 5: Subtract the joining entity's losses accruing to the head company

If the joining entity has carry-forward losses (such as tax losses or net capital losses) accruing to continuously held membership interests, those amounts are subtracted. An adjustment is made even where the losses have not been transferred to the head company. → subsection 705-100(1), ITAA 1997

However, a loss is not to be taken into account to the extent that it reduced the undistributed profits comprising the step 3 amount. → subsection 705-100(2), ITAA 1997; Taxation Determination TD 2004/59 and Addendum 2004/59A

The purpose of step 5 is to reflect the losses in the ACA and prevent a double benefit arising from them. Without this adjustment, there would be a reinstatement of the lost value in the ACA. This would result in either reduced gains or increased losses on disposal of the assets brought into the group.

Step 6: Subtract tax benefit from certain losses transferred by the joining entity

If the joining entity is transferring carry-forward losses to the head company at the formation or joining time, work out the extent to which those losses did not accrue to the group joined (and in respect of which their transfer was not cancelled). Multiply the result by the general company tax rate and subtract the answer at this step. → section 705-110, ITAA 1997; 'Adjustments for losses (ACA steps 5 and 6)', C2-4-300

Without this adjustment, the group would get a double tax benefit if it received both an uplift in the terminating values of the assets of the subsidiary entity at the formation or joining time and the ability to utilise those losses against the group's income after that time.

Step 7: Subtract certain inherited deductions to avoid duplication of benefit

Deduct an amount for certain unclaimed deductions inherited by the head company for expenditure incurred by the joining entity before the formation or joining time. The purpose of this adjustment is to stop the group getting benefits both through the tax cost of the joining entity's assets being set and through certain tax deductions of the joining entity being inherited by the head company.

Deductions are not subtracted for expenditure:

- that becomes part of, or reduces the cost of the relevant asset
- to which section 110-40 (about expenditure on assets acquired before 7.30pm on 13 May 1997) applies
- to the extent that it reduced the ACA step 3 amount (e.g. where earlier profits were reduced by an accounting loss), or
- that arises under section 43-15 (which relates to undeducted construction expenditure) if the joining entity acquired the asset to which the deduction

relates at or before 7.30pm on 13 May 1997. → section 705-115, ITAA 1997; 'Adjustment for certain inherited deductions (ACA step 7)', C2-4-340

Note that there are special rules dealing with the treatment of **allowable capital expenditure, transport capital expenditure** and **exploration and prospecting assets** to ensure that the value of the notional asset is reduced where real assets are created from this expenditure pool (affects ACA step 7). → Subdivision 705-E, IT(TP)A 1997; *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1, Part 4, 'Expenditure relating to mining or quarrying'; Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004, paragraphs 1.49 – 1.92

Step 8: ACA result

If the amount calculated up to step 7 is positive, it is the joining entity's ACA. If it is negative, the ACA is nil.

No double counting of amounts in the ACA

Under the tax cost setting process, several adjustments are made to the ACA. In some circumstances a particular amount can be taken into account more than once when calculating the ACA for a joining entity, and as a result, the tax costs allocated to the joining entity's assets can be distorted. Section 705-62 of the ITAA 1997 prevents duplication of amounts when calculating the ACA.

A particular amount can be taken into account more than once because, for example, integrity measures in the income tax law prevent the duplication of losses by reducing the cost base of membership interests. At the time the ACA is calculated, this reduction could cause a potential double adjustment to the ACA by being reflected in the membership interests at step 1, and again in losses at step 5.

Where section 705-62 of the ITAA 1997 applies, the head company may choose to specify which alteration is made to the ACA calculation. The choice must be made, in writing, by the day the head company lodges its income tax return for the income year in which the joining time occurs or within such further time allowed by the Commissioner. If no choice is made, the alteration that is most appropriate, in the light of the object of the cost setting rules, is to be made.

Section 705-62 of the ITAA 1997 applies on or after 10 February 2010 unless the head company makes a written choice, within the prescribed time, to apply the section from 1 July 2002. Should the head company choose to apply section 705-62 retrospectively, it may make a written choice within the prescribed time specifying which alteration it wants to use to ensure there is no double counting of amounts in the ACA calculation.

Note

Retrospective application – *Tax Laws Amendment (2010 Measures No. 1) Act 2010*

There is a choice to apply certain amendments (including Part 20, non-membership equity interests) from 1 July 2002. Making this choice may affect the tax cost setting amounts (TCSAs) of a large number of reset cost base assets of the joining entity. Although these TCSAs may have been worked out correctly according to the law as it stood at the time, they may become incorrect because of the retrospective application of the choice. Rather than recalculating the TCSAs and amending the necessary income tax returns to correct the errors, it may be possible, subject to certain conditions being met, to regard the incorrect TCSAs as being correct and to net off the errors as a single capital gain or capital loss under CGT event L6.

There may be a reduction in the capital gain or capital loss if the ATO becomes aware of the errors outside the period during which it may amend all the returns necessary to correct the errors. If the normal amendment period ends before 3 June 2012, it is extended to that date.

→'Dealing with errors in TCSAs and changes in liabilities when discharged', C2-1-050; Taxation Ruling TR 2007/7; subsection 4(2), *Tax Laws Amendment (2010 Measures No. 1) Act 2010*

References

Legislation

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- *New Business Tax System (*Consolidation*) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation,* Value Shifting, Demergers and Other Measures) Act 2002 (No. 90 of 2002), Schedule 2
- *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002 (*No. 117 of 2002), Schedules 3 and 5
- *Tax Laws Amendment Act (No. 6) 2003* (No. 67 of 2003), Schedule 3
- *Tax Laws Amendment Act (2004 Measures No. 6) Act 2005* (No 23 of 2005, Schedule 1

Income Tax Assessment Act 1997, Division 126-B; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 3

Income Tax Assessment Act 1997, sections 40-340 and 110-40

Income Tax (Transitional Provisions) Act 1997, sections 701-35 and 719-163; as amended by:

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- *Tax Laws Amendment (2006 Measures No 4) Act 2006* (No. 168 of 2006), Schedule 2

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Tax rulings

TR 2004/14 – Income tax: consolidation: recognising and measuring the liabilities of a joining entity under subsection 705-70(1) of the *Income Tax Assessment Act 1997*

TR 2006/6 – Income tax: consolidation: recognising and measuring the liabilities of a joining entity under subsection 705-70(1) of the *Income Tax Assessment Act 1997* where the joining time occurs in a financial reporting period of the joining entity beginning on or after 1 January 2005

Tax determinations

TD 2004/53 and Addendum TD 2004/53A – Income tax: consolidation tax cost setting rules: are distributions paid up a chain of entities sourced from profits in a lower-tier entity that did not accrue to the joined group added at step 3 of the entry allocable cost amount of the higher-tier entity?

TD 2004/55 and Addendum TD 2004/55A – Income tax: consolidation tax cost setting rules: step 3 of the allocable cost amount: is the 'retained profits' amount referred to in subsection 705-90(2) of the Income *Tax Assessment Act 1997* a cumulative retained profits balance?

TD 2004/57 – Income tax: consolidation tax cost setting rules: will an amount be subtracted under step 4 of the allocable cost amount under subparagraph 705-95(b)(ii) of the *Income Tax Assessment Act 1997* where there has been a distribution of profits accrued to the joined group that recouped losses accrued to the group?

TD 2004/58 – Income tax: consolidation tax cost setting rules: should distributions of profits accrued to the joined group that recoup losses accrued to the group be counted when determining the step 4 amount of the allocable cost amount on formation of a transitional consolidated group?

TD 2004/59 and Addendum TD 2004/59A – Income tax: consolidation tax cost setting rules: how do you work out the amount subtracted at step 5 of the allocable cost amount where the loss taken into account under subsection 705-100(1) of the *Income Tax Assessment Act 1997* has also reduced the step 3 amount?

TD 2004/60 – Income tax: consolidation tax cost setting rules: step 4 of the allocable cost amount: should tax losses or net capital losses transferred to a joining entity be taken into account when determining whether there will be a subtraction at subparagraph 705-95(b)(ii) of the *Income Tax Assessment Act 1997*?

TD 2004/70 – Income tax: consolidation: does the phrase 'is taken into account at a later time' in paragraph 705-80(1)(a) of the *Income Tax Assessment Act 1997* require that an accounting liability, or a change in the amount of an accounting liability, of a joining entity that is first recognised after the joining time be examined when determining whether or not section 705-80 of that Act applies?

TD 2004/71 – Income tax: consolidation: can section 705-80 of the *Income Tax Assessment Act 1997* apply to a liability (or a change in a liability) that is recognised for accounting purposes because of an event that occurred after the joining time that provides new evidence of conditions that existed at the joining time?

TD 2004/72 – Income tax: consolidation: when calculating step 2 of the allocable cost amount for a joining entity, do section 705-75 or 705-80 of the *Income Tax Assessment Act 1997* apply to an accounting liability covered by subsection 705-70(2)?

TD 2004/74 – Income tax: consolidation: can an amount be included in step 1 as well as step 2 of the allocable cost amount calculation in section 705-60 of the *Income Tax Assessment Act 1997*?

TD 2004/77 – Income tax: consolidation: general insurance: are accounting liabilities for unearned premiums adjusted under subsections 705-75(1) and 705-80(1) of the *Income Tax Assessment Act 1997* for the purposes of working out the allocable cost amount for a joining entity that is a general insurance company?

TD 2004/78 – Income tax: consolidation: general insurance: do subsections 705-75(1) and 705-80(1) of the *Income Tax Assessment Act 1997* apply to any part of an accounting liability for outstanding claims for the purposes of working out step 2 of the allocable cost amount for a joining entity that is a general insurance company?

Revision history

Section C2-1-020 first published as separate section 26 June 2007.

Further revisions are described below.

Date	Amendment	Reason
30.6.09	Minor changes including removal of note at step 5 to reflect new rules for treatment of foreign losses.	Legislative amendment.
6.5.11	Changes to commentary to reflect changes to the treatment of certain inherited deductions.	Legislative amendments.
	Replacement of note on proposed changes with note on legislated changes to the treatment of doubtful debts for tax cost setting purposes.	
	New reference to ‘accounting standards for tax cost setting’, and consequential minor changes throughout.	
	Removal of note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used.	
	Revisions to reflect changes to the pre-joining time rollover provisions (step 3A).	
	New section added on the introduction of the no double counting rules for the ACA.	
	Removal of references to TD 2005/19 and TD 2006/60.	Tax determinations withdrawn.

Allocating the entry ACA (steps B to E)

B – Subtract values of, and allocate to, *retained* cost base assets

The ACA is reduced by subtracting the sum of the tax cost setting amounts (TCSAs) of the following assets, which are retained cost base assets:

- *Australian currency or a right to receive a specified amount of Australian currency (other than a right that is a marketable security under section 70B, ITAA 1936)*
  The TCSA is the amount of Australian currency concerned, except where the asset is a qualifying security under Division 16E of Part III of the ITAA 1936. A special rule applies to these securities to obtain a tax neutral result at the joining time → section 705-30, ITAA 1997.
  Note: Any Australian currency that is also trading stock or a collectable of a joining entity is not a retained cost base asset → subsection 705-25(5), ITAA 1997; Taxation Ruling TR 2005/10.
  Note: A receivable would be a retained cost base asset where there is an indefeasible, present right to the receipt of a fixed, nominal amount of Australian currency → Taxation Ruling TR 2005/10. Where the joining entity has such receivables that are reduced by a provision or allowance for doubtful debts, the receivables are retained cost base assets even where the market value of the receivables is substantially less than the face value.
- *An entitlement that is subject to a prepayment*
  The TCSA for this asset is equal to the sum of deductions that the head company would be entitled to because of the entity history rule.
  → subsection 705-25(4) and section 705-30, ITAA 1997
- *Trading stock in certain circumstances*
  While ordinarily a reset cost base asset, trading stock is treated as a *retained* cost base asset where the joining entity was a continuing majority-owned entity. A joining entity is a continuing majority-owned entity where a person or persons continued to be majority beneficial owners (directly or indirectly) of it from the start of 27 June 2002 until the joining time. The TCSA for trading stock as a retained cost base asset is equal to the joining entity's year-end valuation. → section 701A-5, IT(TP)A 1997; 'Applying the continuing majority–owned entity test to multi-tiered structures', C2-4-855; 'Accounting for trading stock on entry', C9-5-320

The head company will make a capital gain if the sum of the TCSAs for all the joining entity's retained cost base assets is greater than the ACA for the joining entity. The capital gain (made under CGT event L3) is equal to the difference between the total TCSAs of the retained cost base assets (as defined by paragraph 705-35(1)(b)) and the entity's ACA. The head company makes the gain just after the entity becomes a subsidiary of the consolidated group or the MEC group. → section 104-510, ITAA 1997

Note

Treatment of doubtful debts

The treatment of doubtful debts for cost setting purposes is modified to allow for the reduction of any CGT event L3 capital gain in respect of doubtful debts as retained cost base assets with a corresponding reduction to the tax cost setting amount of the head company's outstanding debts. These modifications apply from 10 February 2010, unless a written choice to apply the changes from 1 July 2002 is made within the prescribed time by the head company of the group.
→ section 705-27, ITAA 1997

Note that paragraph 705-59(5)(b), item 4, which relates to the treatment of linked assets and linked liabilities, can operate to exclude linked retained cost base assets from paragraph 705-35(1)(b). → 'Linked assets and liabilities', C2-1-310

A head company will make a capital loss if a joining entity does not have any reset cost base assets and not all of the ACA in respect of that entity can be allocated to the joining entity's retained cost base assets. The capital loss the head company makes is the unusable portion of the ACA. The head company makes the capital loss under CGT event L4 just after the entity becomes a subsidiary of the consolidated or MEC group. → section 104-515, ITAA 1997

Application of de minimis principle

For the purpose of determining whether a loss is available under CGT event L4, where the sum of the costs of reset cost base assets and the sum of their market values are very small or trifling those assets could be ignored for the purpose of allocating ACA under section 705-35. This will depend on the facts and circumstances of each case → Taxation Determination TD 2005/54. Where both the sum of the costs of all of the assets of a non-operating joining entity and the sum of their market values are less than $5,000, the ATO will accept that the assets are *de minimis*, and they can be ignored.

C – Apportion remaining ACA over *reset* cost base assets, adjusting for revenue-like assets

Any asset that is not a *retained* cost base asset, or an *excluded* asset, is a *reset* cost base asset. The remaining ACA is allocated to the entity's reset cost base assets in proportion to their market values.

The TCSA calculated up to this point may be altered because of five rules that cap the TCSA of certain classes of reset cost base assets (and in one case redistributes the excess to other reset cost base assets), as shown in table 1.

Table 1: Assets for which the TCSA is capped

Asset class	See for more information …
Assets held on revenue account	This step; section 705-40, ITAA 1997
Accelerated depreciation assets	'D – Adjust the amounts allocated to depreciating assets', p. 5; section 705-45, ITAA 1997
Certain privatised assets	'D – Adjust the amounts allocated to depreciating assets', p. 5; section 705-47, ITAA 1997
Over-depreciated assets	'D – Adjust the amounts allocated to depreciating assets', p. 5; former section 705-50, ITAA 1997
Assets held on revenue account where there is a loss of pre-CGT status of membership interest in the joining entity	'E – Adjust the amounts allocated to certain revenue-like assets', p. 7; section 705-57, ITAA 1997

The first four of these 'capping rules' are applied in the order listed above, unless the head company elects that they apply in another order → section 705-55, ITAA 1997. The fifth rule is always applied last → subsection 705-57(6), ITAA 1997.

On formation

For the purpose of allocating the ACA among the reset cost base assets, the value to be used as the market value of an asset of a subsidiary that constitutes direct or indirect membership interests in another subsidiary is modified if the lower subsidiary has profits that will be added under step 3 of the ACA calculation or losses that will be deducted under step 5. → section 705-160 ITAA 1997 'Adjustment for ACA allocation at formation to membership interests in linked subsidiaries with losses (step C)', C2-4-540

Note

Step C is modified for **linked entities** in a similar way to formation. → 'Modifications to entry cost setting rules', C2-1-040

Step C may also be modified by the operation of the rules for linked assets and liabilities. → section 705-59, ITAA 1997; 'Linked assets and liabilities', C2-1-310

Adjust the amounts allocated to revenue-like assets

Where the TCSA calculated up to this point for a reset cost base asset that is a revenue-like asset (i.e. trading stock, depreciating assets and revenue assets) exceeds both the market value and the terminating value of the asset, the TCSA is reduced to the greater of those two amounts. The excess is redistributed to other reset cost base assets → section 705-40, ITAA 1997. This reduction does not apply to trading stock treated as a retained cost base asset.

This reduction addresses the potential for unrealised capital losses to be converted to revenue losses or smaller revenue gains when an entity joins a consolidated group. This relates to situations where assets still held by a subsidiary entity have declined in value after the group purchases membership interests in it.

A head company may make a capital loss where all the reset cost base assets of the joining entity are revenue-like assets. The amount of ACA that can be allocated to such assets is limited to the greater of the asset's market value and its terminating value → section 705-40, ITAA 1997. If this limit results in some of the ACA not being allocated (because there are no reset cost base assets other than revenue-like assets) the head company will make a capital loss equal to the amount of ACA not allocated. This will give rise to a CGT L8 event.

→ section 104-535, ITAA 1997

→ 'CGT events arising out of the cost setting rules', C2-1-410

Finance leases

Where the joining entity is the lessor or lessee under a lease of a depreciating asset (the underlying asset) to which Division 40 of the ITAA 1997 applies, and the lease is classified according to accounting standards as a finance lease, special cost setting rules apply depending on whether or not the joining entity holds the underlying asset under that Division. These rules are set out in table 2. → section 705-56, ITAA 1997

Table 2: Treatment of underlying asset

Joining entity is …	Cost setting treatment
lessor and *holds* the underlying asset	The underlying asset has its tax cost set at the joining time. The asset that is the right to receive lease payments ('Lease Receivable') is not taken into account for cost setting purposes and its TCSA is taken to be nil. → subsection 705-56(2), ITAA 1997
lessor and *does not hold* the underlying asset	The underlying asset is not taken into account for cost setting purposes and its TCSA is taken to be nil. The asset that is the Lease Receivable is taken to be a retained cost base asset with a TCSA equal to its market value just before the joining time. → subsection 705-56(3), ITAA 1997
lessee and *holds* the underlying asset	The underlying asset has its tax cost set at the joining time. The liability that is the obligation to make lease payments (Lease Payable) is taken into account at step 2 of the ACA calculation. → note to subsection 705-56(4), ITAA 1997
lessee and *does not hold* the underlying asset	The underlying asset is not taken into account for cost setting purposes and its TCSA is taken to be nil. The liability that is the Lease Payable is not taken into account at step 2 of the ACA calculation. → subsection 705-56(4), ITAA 1997

Note

Partly constructed assets

An asset is a depreciating asset if it has a limited effective life and it can reasonably be expected to decline in value over the time it is used. → section 40-30(1)

If, on commencement of construction of an asset, a conclusion is reached that it will have a limited effective life, the partly constructed asset will satisfy the definition of depreciating asset. Such a partly constructed asset is a reset cost base asset that is a revenue-like asset. → 'Reduction for revenue-like assets (Step C), C2-4-530

Where an asset was not previously depreciated (as is the case with partly constructed assets), section 40-65 allows the head company to choose which method to use in working out the asset's decline in value once it is completed and installed. The head company is required to adopt an effective life under section 40-95 from that time. This allows the reset cost of such an asset, together with additional costs incurred by the head company in bringing the asset to completion, to be claimed under Division 40.

D – Adjust the amounts allocated to depreciating assets

Choice of retaining accelerated depreciation rates

The head company may choose under section 705-45 to reduce the TCSA of a depreciating asset acquired before 21 September 1999 to equal its terminating value. Where a depreciating asset's TCSA does not exceed its terminating value, section 701-80 permits the head company to use the accelerated depreciation provisions. → sections 705-45 and 701-80, ITAA 1997; 'Capital allowances – with accelerated depreciation', C9-5-310

Unlike the adjustment to the TCSA for revenue-like assets in step C above, the excess after exercising the choice to reduce TCSAs to terminating value is not reallocated to other assets, but is lost to the group.

Note that special rules dealing with the treatment of **allowable capital expenditure (ACE), transport capital expenditure (TCE)** and **exploration and prospecting assets** allow taxpayers to retain accelerated depreciation concessions available for ACE and TCE before 1 July 2001. → Subdivision 716-E, IT(TP)A 1997; *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1, Part 4, 'Expenditure relating to mining or quarrying'; Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004, paragraphs 1.49 – 1.92,

Adjust the amounts allocated to privatised depreciating assets

A privatised depreciating asset is a depreciating asset in respect of which, as a result of a past or simultaneously occurring privatisation, Division 58 of the ITAA 1997 (or another similar regime) directly or indirectly affects the amount the joining entity could deduct for decline in value of the previously exempt asset.

Where the TCSA calculated up to this point for a privatised depreciating asset exceeds the terminating value of the asset, the TCSA is reduced to the terminating value. → section 705-47, ITAA 1997; 'Reduction for privatised depreciating assets (at step D)', C2-4-605

Unlike the adjustment to the tax cost setting amount for revenue-like assets in step C above, the amount of the reduction is not reallocated to other assets.

The purpose of this adjustment is to ensure that the limiting of decline in value deductions under privatised assets provisions (such as Division 58 of the ITAA 1997) is not over-ridden by the consolidation tax cost setting process. Reducing the TCSA to the joining entity's terminating value for the asset ensures that decline in value deductions allowable to the head company for such privatised depreciating assets continue to be appropriately limited.

This adjustment *does not* apply where the privatised depreciating asset has been held for at least 24 months by an earlier consolidated group that is not an associate of the joined group.

Adjust the amounts allocated for over-depreciated assets

A further reduction may apply where a depreciating asset's market value, at formation or joining time, exceeds its adjustable value at that time. Where the joining entity paid an unfranked dividend after it acquired the asset, and the dividend attracted the intercorporate dividend rebate, there is potential for indefinite deferral of tax on the income sheltered by the over-depreciation.

In these situations the over-depreciation will not have been fully 'clawed back' in the form of lower depreciation deductions in relation to the asset, and an adjustment may be made to reduce the head company's TCSA for the depreciating asset. Amounts that have already reduced the ACA at steps 4 and 5 are not counted again here. → former section 705-50, ITAA 1997; Taxation Determination TD 2004/4

A worked example shows how to work out the over-depreciation reduction for each asset. → 'Reduction for over-depreciated assets (step D)', C2-4-610

Unlike the adjustment to the TCSA for revenue-like assets in step C above, the excess is not reallocated to other assets, but is lost to the group.

In cases where taxpayers do not have sufficient information available to work out the reduction for over-depreciation on an asset-by-asset basis, an administrative short-cut may be used. Some acceptable methods are shown in a worked example → 'Reduction for over-depreciated assets (step D) – administrative short-cuts', C2-4-640.

On formation

There will also be a reduction in the TCSAs for over-depreciated assets where the transitional provisions applied to step 3 of the ACA. That is, where the step 3 amount has been increased for undistributed unfrankable pre-formation profits, there may be a reduction to the extent that those unfranked profits related to over-depreciation.

Note

Consolidated group joins another

Step D is modified when a consolidated group joins another consolidated group.
→ "Modifications to entry cost setting rules', C2-1-040

Changes to the over-depreciation provisions

The over-depreciation provisions in the tax cost setting rules have been modified for an entity that becomes a member of a consolidated group between 9 May 2007 and 30 June 2009. In this case a head company will only need to look at five years of dividend history immediately before the joining time to determine whether an over-depreciation adjustment is required in relation to the joining entity's asset. Effective from 1 July 2009, the over-depreciation adjustment in section 705-50 has been repealed, so it will no longer apply to over-depreciated assets of entities that become subsidiary members of a consolidated group on or after that date. → *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010)

E - Adjust the amounts allocated to certain revenue-like assets

A further reduction may apply to certain revenue-like assets (i.e. trading stock, depreciating assets and revenue assets), if:

- the asset's TCSA exceeds its terminating value, and
- before consolidation, Division 149 (ITAA 1997) or its predecessor reset the cost bases of pre-CGT membership interests in the joining entity at a higher value (because of a change in the entity's majority ownership)
  → section 705-57, ITAA 1997.

In these circumstances, the entry ACA will need to be recalculated and reallocated. The first calculation and allocation of the ACA sets the TCSAs for all assets other than those revenue-like assets mentioned above. The second calculation and allocation sets the TCSAs for those revenue-like assets.

Those revenue-like assets will be given reduced TCSAs that remove the effect of the change in majority ownership on the cost bases of membership interests. The reduction amount gives rise to a capital loss for the head company and can be offset against capital gains over a minimum period of five income years. → section 104-500, ITAA 1997

The calculation at this step is shown in worked examples. → 'Limiting the tax cost setting amounts of revenue-like assets (step E)', C2-4-710; 'Pre-CGT factor for assets of a joining entity', C2-4-810; 'Pre-CGT status of membership interests in a joining entity – pre-CGT proportion rules', C2-4-813; section 705-57, ITAA 1997; Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, paragraphs 1.87-1.114

On formation

A reduction only applies where the cost base or reduced cost base of the direct membership interests of the head company in a subsidiary member has been increased by the operation of Division 149 (ITAA 1997) or its predecessor.
→ section 705-163 ITAA 1997; Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, paragraphs 1.102 – 1.105

For a high-level example of how the cost setting process on entry is applied from beginning to end see → 'The cost setting process on entry', C2-2-110.

References

Legislation

Income Tax Assessment Act 1997, Subdivision 705-A; as amended by:

- New *Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2
- *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedules 3 and 5

Taxation Laws Amendment Act (No. 6) 2003 (No. 67 of 2003), Schedule 3

Income Tax Assessment Act 1997, Section 705-56; as inserted by *Tax Laws Amendment (2004 Measures No 6) Act 2005* (No 23 of 2005), Schedule 1, Part 3

Income Tax Assessment Act 1997, section 705-125; as inserted by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1, and amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 3

Income Tax Assessment Act 1997, section 705-50 and subsection 995-1(1); as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010 (No. 56 of 2010),* Schedule 5, Part 6, Part 11 and Part 13.

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002

Explanatory Memorandum to the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002

Explanatory Memorandum to the New Business Tax System (Consolidation and other Measures) Bill (No. 1) 2002

Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 6) 2003

Explanatory Memorandum to the Taxation Laws Amendment (2004 Measures No 6) Bill 2004, paragraphs 1.29 – 1.48

Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5

Tax ruling

TR 2005/10 – Income tax: consolidation: retained cost base assets consisting of Australian currency or a right to receive a specified amount of such currency

Tax determinations

TD 2004/4 – Income tax: Is a dividend paid before 1 July 1987 an unfranked dividend for the purposes of section 705-50 of the *Income Tax Assessment Act 1997*?

TD 2005/54 – Income tax: consolidation: asset cost setting rules: where the cost and value of the reset cost base assets of a joining entity are so small or trifling that they are de minimis, can they be ignored when determining whether a CGT event L4 loss is available under section 104-515 of the *Income Tax Assessment Act 1997*?

Revision history

Section C2-1-030 first published as separate section 26 June 2007.

Further revisions are described below.

Date	Amendment	Reason
6.5.11	Minor changes to reflect changed wording in former section 705-50. Removal of note on proposed changes to the treatment of units in a cash management trust. Link to worked example for pre-CGT proportion rules inserted. Replacement of note on proposed changes with note on legislated changes to the treatment of doubtful debts for tax cost setting purposes, p. 2.	Legislative amendments.

Modifications to entry cost setting rules

Consolidated group joins another consolidated group

To reduce compliance costs, an existing consolidated group joining another consolidated group is effectively treated as a single entity.

Specifically, the head company of the acquired group is treated, with some modification, as a single joining entity. It is the only entity that joins the acquiring group. The subsidiary members of the acquired group are treated as parts of its head company, with their assets being treated as the head company's assets, which have their tax costs set at the acquisition time. Intra-group assets, liabilities and membership interests are ignored.

→ Subdivision 705-C, *Income Tax Assessment Act 1997* (ITAA 1997)

The modifications to the basic case for the entry of a consolidated group are as follows:

Modification to entry ACA step 1

Subsection 705-65(6) of the ITAA 1997 is modified so as to include in entry ACA step 1 the cost of any non-membership equity interest issued by a subsidiary member of the acquired group that is held by a member of the acquiring group at the acquisition time. The non-membership equity interests are treated as membership interests in the head company of the acquired consolidated group. → section 705-195, ITAA 1997

Modification to entry ACA step 2

Section 705-85 of the ITAA 1997 is modified so as to increase the entry ACA step 2 amount for the cost attributable to, but not held by, members of either the acquired or acquiring consolidated group, for:

- certain employee share interests in subsidiary members of the acquired group, and
- non-membership equity interests in subsidiary members of the acquired group.

These modifications are required to ensure that these equity interests issued by subsidiary members of the joined group (and not just those in the head company itself) are appropriately taken into account. → section 705-200, ITAA 1997

Modification to step D

Section 705-50 of the ITAA 1997 is modified to ensure that the TCSAs are not inappropriately reduced for over-depreciated assets that were brought into the acquired group by a joining entity. There will be no reduction for over-depreciation to the extent that rebatable dividends paid out of profits sheltered from tax by the over-depreciation have not left the acquired group.

Note that section 705-50 applies appropriately to an over-depreciated asset that was, just before the time of consolidation of the acquired group, held by the head company of that group, and is still over-depreciated at the time the acquired group becomes part of the acquiring group. → former section 705-190, ITAA 1997

For a high-level example of how the cost setting process applies when a consolidated group joins another consolidated group see → 'Consolidated group joins another consolidated group', C2-2-120.

Note

Retrospective application – *Tax Laws Amendment (2010 Measures No. 1) Act 2010*

There is a choice to apply certain amendments to Part 20 (non-membership equity interests) from 1 July 2002. Making this choice may affect the tax cost setting amounts (TCSAs) of a large number of reset cost base assets of the joining entity. Although these TCSAs may have been worked out correctly according to the law as it stood at the time, they may become incorrect because of the retrospective application of the choice. Rather than recalculating the TCSAs and amending the necessary income tax returns to correct the errors, it may be possible, subject to certain conditions being met, to regard the incorrect TCSAs as being correct and to net off the errors as a single capital gain or capital loss under CGT event L6.

There may be a reduction in the capital gain or capital loss if the ATO becomes aware of the errors outside the period in which it may amend all the returns necessary to correct the errors. If the normal amendment period ends before 3 June 2012, it is extended to that date.

→ 'Dealing with errors in TCSAs and changes in liabilities when discharged', C2-1-050; Taxation Ruling TR 2007/7; *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), subsection 4(2)

Changes to the over-depreciation provisions

As a consequence of the repeal of section 705-50 effective from 1 July 2009, section 705-190 of the ITAA 1997 has also been repealed with effect from that date. → *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010)

Linked entities join a consolidated group

When a consolidated group acquires two or more entities linked by ownership, the following modifications to the basic case apply. In a similar way to the formation case modifications, these provide for cost setting of the assets of multiple entities joining at the same time. → Subdivision 705-D, ITAA 1997

Order of cost setting

The cost setting process for linked entities is applied top-down as in formation. The rules are applied separately to each subsidiary, starting with the first linked entity (a linked entity that owns membership interests in a second linked entity) → 'Overview of cost setting process on formation and entry (including transitional rules)', C2-1-010. The resulting tax cost setting amount for the asset of the first linked entity that reflects membership interests in the second linked entity is then used in determining the second linked entity's ACA. → section 705-225, ITAA 1997

Modification to ACA step 3A

Step 3A is modified for linked entities in a similar way to the modification for formation. → section 705-227, ITAA 1997

Modification to ACA step 4

The reduction to the entry ACA at step 4 because of a distribution of profits from a linked entity is made only for profits that have been effectively distributed to the head company in respect of its direct membership interests in the entity. → section 705-230, ITAA 1997

Modification to step C

Where there is an increase in the entry ACA at step 3 or a reduction at step 5 for direct or indirect membership interests in a linked entity because it has owned profits or losses, the value to be used for the higher linked entity's asset reflecting membership interests in the lower linked entity is its market value, less the amount of that membership interest's pro-rata share of the profits or plus the amount of its pro-rata share of the losses. → section 705-235, ITAA 1997

For an example of how the cost setting process applies when linked entities join a consolidated group see → 'Linked entities join a consolidated group', C2-2-130.

Partnership joins a consolidated group

The cost setting process for a partner joining a consolidated group depends on whether:

- all partners in the partnership join the same consolidated group, or
- at least one (but not all) of the partners in the partnership joins a particular consolidated group.

All partners join the group

Due to the characteristics of a partnership, the basic case rules that apply to entry into a consolidated group are modified in the case of a partnership to achieve a comparable outcome to other entry circumstances → Subdivision 713-E, ITAA 1997. Specifically:

- A 'partnership cost pool' (PCP) replaces the allocable cost amount (ACA) in the tax cost setting process for the partnership assets. The PCP is worked out based on the sum of all the cost bases or tax costs for all of the partners' fractional interests in the partnership → section 713-210, ITAA 1997. These fractional interests are known as partnership cost setting interests (PCSI) → section 713-210, ITAA 1997.
- If a partner in the partnership joins the consolidated group at the same time as the partnership, the tax cost setting amounts (TCSA) are worked out for the assets of the partner (including PCSIs) before TCSAs are worked out for the assets of the partnership. A worked example shows how to work out the TCSAs for a partner's assets including the partnership cost setting interests → 'Partnership – *not all* partners join consolidated group', C2-2-155.

- PCSIs in the partnership held by the head company cease to be recognised once the partnership joins the group. Tax costs are set for the partnership's underlying assets, which become the only partnership assets recognised by the head company.

Not all partners join the group

Due to the characteristics of a partner's interests in the assets of a partnership, the basic case rules that apply to entry into a consolidated group are modified in the case where not all partners join the consolidated group, to achieve a comparable outcome to other entry circumstances → Subdivision 713-E, ITAA 1997. Those modifications include:

- The tax cost setting amount is calculated for the partner's fractional interests in the partnership assets. These fractional interests are known as partnership cost setting interests (PCSI) → section 713-210, ITAA 1997. The tax costs for the underlying assets of the partnership are not reset.
- The adjustment for the partnership's over-depreciated assets is made to the allocable cost amount (ACA), *not* to the tax cost setting amount (TCSA) of the PCSI (unlike non-partnership over-depreciation cases, where the adjustment is made to the TCSA of the asset).

  → subsection 713-225(5), ITAA 1997
- The TCSA of a PCSI in a partnership asset that is trading stock or a depreciating asset is equal to the interest's individual share of the terminating value of the partnership asset (unlike non-partnership trading stock or depreciating assets, which are reset cost base assets).

  → subsection 713-225(4), ITAA 1997

Trust joins a consolidated group

Due to inherent differences between trusts and companies, the basic case rules are modified as follows for a trust joining a consolidated group:

Modification to entry ACA step 1 for discretionary interests

This modification increases the amount worked out at step 1 of the entry ACA calculation if:

- the joining entity is a trust
- some or all of the membership interests in the joining entity are not interests or units in it – i.e. they are held by a discretionary beneficiary (a discretionary beneficiary does not have an interest or a unit in a trust but it can still have a membership interest), and
- some or all of the trust capital is settled capital that can be distributed tax free – i.e. it can be distributed to a discretionary beneficiary without attracting capital gains tax by the operation of CGT event E4.

→ subsection 713-20(1), ITAA 1997; Taxation Determination TD 2003/28

This modification ensures that, where a membership interest in a trust does not have or is not given a cost base, the membership interest will still have an amount added at step 1 of the entry ACA calculation.

Without this modification there would be a reduced or nil amount of ACA to allocate to the assets of the discretionary trust. If the assets were then sold, the head company of the joined group would realise an assessable gain that would not otherwise have arisen had the discretionary trust remained outside the group.

The modification provides that the entry ACA step 1 amount is increased by the amount or property settled on the trust by the head company plus any amount or property settled by a person independent of the group, but only to the extent that it could have been distributed tax free had the trust not joined the consolidated group.

Membership interests to which the step 1 modification applies

This modification to step 1 of the ACA calculation *will* apply to a membership interest in a trust that:

- is a discretionary interest (i.e. it is neither a unit nor a fixed interest in the trust)
- has no cost base, and
- is owned by the discretionary beneficiary only because something was settled on the trust.

→ subsection 713-20(2), ITAA 1997

This modification *does not* apply where an entity that is a discretionary beneficiary of the trust joins a consolidated group and has the tax cost of its assets determined using the ACA process. In this case, the membership interests held by the discretionary beneficiary in the trust are given a cost base by this process.

Calculating the step 1 modification

The lesser of the following two amounts is added to the step 1 amount in the ACA calculation:

- the total of the amounts or value (market value at settlement) of property settled on the trust that would be distributed tax free by the trustee, had the trust been terminated, to the holders of membership interests that satisfy the three requirements listed under the previous heading ('Membership interests to which the step 1 modification applies'), or
- the total amount settled on the trust directly by the head company of the consolidated group or by an entity that is independent of, and unconnected to, the consolidated group. The types of entities that do not satisfy this latter requirement are listed in subsection 713-20(3) of the ITAA 1997. This second amount effectively caps the amount that can be added at step 1 to those amounts settled by either the head company or by unrelated third parties.

→ subsections 713-20(2) and (3), ITAA 1997

Modification to entry ACA step 3 for trusts other than corporate unit trusts and public trading trusts

In the basic case, an amount is added at entry ACA step 3 for an entity's undistributed, frankable profits that had previously accrued to the group.

No modifications to the basic case are required for corporate unit trusts and public trading trusts, as they keep franking accounts and can frank their distributions to beneficiaries. However, step 3 has been modified for other types of trusts (discretionary or otherwise), because they cannot frank their distributions.

The amount added at this step will be the realised, undistributed profits of the trust that accrued to the group before the joining time, except to the extent that:

- the profits would have been covered by CGT event E4 if distributed by the trust as they accrued, or
- the profits recouped losses that accrued to the group before the joining time.

→ section 713-25, ITAA 1997

A profit is held to be distributed whether it has been physically or constructively distributed.

These modifications apply equally to non-discretionary, as well as to discretionary, interests. → sections 705-60 and 713-25, ITAA 1997; *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1, Part 11

For a high-level example of how the cost setting process applies when a trust joins a consolidated group see → 'Trust joins a consolidated group', C2-2-140.

The basic case rules that apply when a subsidiary *leaves* a consolidated group are also modified for trusts. → 'Cost setting on exit', C2-1-060

References

Legislation

Income Tax Assessment Act 1997, Subdivision 705-C and 705-D; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 4

Income Tax Assessment Act 1997, Subdivision 713-E; as amended by *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (No. 83 of 2004), Schedule 2, Part 5

Income Tax Assessment Act 1997, Subdivision 713-A; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 5

Income Tax Assessment Act 1997, sections 705-60 and 713-25; as amended by *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1, Part 11

Income Tax Assessment Act 1997, section 705-227; as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 5

Income Tax Assessment Act 1997, section 705-50 and subsection 995-1(1); as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 6

Income Tax Assessment Act 1997, sections 705-195 and 705-200; as amended by *Tax Laws Amendment (2010 Measures No.1) Act 2010* (No. 56 of 2010), Schedule 5, Part 20

Explanatory Memorandum to the New Business Tax System (Consolidation and other Measures) Bill (No. 1) 2002

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 2) Bill 2004, paragraphs 2.61 – 2.99

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004, paragraphs 1.163 – 1.167

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No.1) Bill 2010, Chapter 5

Tax determination

TD 2003/28 – Income tax: capital gains: does CGT event E4 in section 104-70 of the *Income Tax Assessment Act 1997* happen if the trustee of a discretionary trust makes a non-assessable payment to:

(a) a mere object; or

(b) a default beneficiary?

Revision history

Section C2-1-040 first published as separate section 26 June 2007.

Further revisions are described below.

Date	Amendment	Reason
6.5.11	References to 'rights or options' replaced by 'non-membership equity interests', p. 1, and note inserted on application of corresponding amendment, p. 2. Minor changes to reflect repeal of section 705-190.	Legislative amendments.

Dealing with errors in TCSAs and changes in liabilities when discharged

Dealing with errors in the TCSAs

Errors made in working out the tax cost setting amounts (TCSAs) of assets of a joining subsidiary would normally be dealt with by recalculating the TCSAs and amending the relevant assessments to give effect to the recalculations.

However, an alternative approach may be used where:

- the errors are made in calculating the TCSAs of reset cost base assets of the joining subsidiary
- some or all of those TCSAs are consequently incorrect
- it would not be reasonable to require the recalculations and amendments, taking into account the factors listed below, and
- the errors are not due to fraud or evasion.

→ section 705-315, *Income Tax Assessment Act 1997* (ITAA 1997)

Under this alternative approach:

- the erroneous TCSAs are taken to be correct for income tax purposes (apart from certain penalty provisions) → section 705-320, ITAA 1997, and
- any net overstated amount or net understated amount in respect of those TCSAs is brought to account as a capital gain or capital loss respectively under CGT event L6 in the income year in which the Commissioner becomes aware of the errors → section 104-525, ITAA 1997.

Whether or not it is reasonable to carry out the recalculations and amendments must be decided objectively on a case-by-case basis, taking into account:

- the net size of the errors as a proportion of the ACA for the entity
- the number of TCSAs that would have to be recalculated and the difficulty of doing so
- the number of adjustments that would be required in assessments that are able to be amended and in information necessary for the preparation of future tax returns, and
- the difficulty in obtaining any necessary information.

→ subsection 705-315(4), ITAA 1997

The head company must, as soon as practicable after becoming aware of the errors, notify the Commissioner in the approved form → section 705-315(6), ITAA 1997. The approved form and further information is available at **www.ato.gov.au/consolidation**

Section 104-525 of the ITAA 1997 explains how to work out the capital gain or capital loss (if any) under CGT event L6. If the Commissioner becomes aware of the errors during the period in which the Commissioner may amend all of the assessments necessary to correct the errors, the capital gain or capital loss is equal (respectively) to the net overstated amount or net understated amount in respect of the erroneous TCSAs.

If the Commissioner becomes aware of the errors outside this period, the capital gain or capital loss is a fraction of the net overstated amount or net understated amount. That fraction is worked out by:

1. adding together the TCSAs of all the reset cost base assets held continuously by the head company from the time the joining subsidiary joined the group until the beginning of the earliest income year for which the Commissioner could amend the head company's assessment to correct any of the errors
2. dividing this sum by the sum of the TCSAs of all the reset cost base assets that the joining subsidiary held at the time it joined the group.

For further guidance, including examples, see → Taxation Ruling TR 2007/7; Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, paragraphs 5.17 to 5.34

→ 'CGT events arising out of the cost setting rules', C2-1-410; Subdivision 705-E, ITAA 1997

Dealing with changes in liabilities when discharged

Where a liability is discharged before 10 February 2010 for a greater amount than the liability used to work out the ACA, and the use of the discharged amount would have resulted in a greater ACA at the joining time, a CGT event L7 loss may arise.

CGT event L7 does not arise in relation to:

- amounts of a liability that accrue after the entity with the liability joined the consolidated group → Taxation Determination TD 2004/64
- the discharge of intragroup liabilities → Taxation Determination TD 2004/65
- liabilities brought into the consolidated group by chosen transitional entities → Taxation Determination TD 2004/66.

In working out whether the ACA would have been greater using the discharged amount, a full reconstruction of the ACA is required. This involves substituting the realised amount of the liability for the amount used in the original ACA and taking into account the changes that would flow from this.
→ paragraph 104-530(3)(c), ITAA 1997; Taxation Determination TD 2004/67

References

Legislation

Income Tax Assessment Act 1997, Subdivision 705-E

Income Tax Assessment Act 1997, sections 104-525 and former 104-530; as amended by *Taxation Laws Amendment Act (No. 8) 2003* (No. 107 of 2003), Schedule 2, and *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 12

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, paragraphs 5.8-5.11 and 5.17-5.43

Taxation ruling

TR 2007/7 – Income tax: consolidation: errors in tax cost setting amounts of reset cost base assets

Taxation determinations

TD 2004/64 – Income tax: consolidation: capital gains: does section 104-530 (CGT event L7) of the *Income Tax Assessment Act 1997* apply to amounts of a liability that accrue after the time that the entity with the liability became a subsidiary member of a consolidated group?

TD 2004/65 – Income tax: consolidation: capital gains: does section 104-530 (CGT event L7) of the *Income Tax Assessment Act 1997* apply where: (a) an entity becomes a member of a consolidated group; (b) the entity owes a liability to another member of the group at that time; and (c) the liability is later discharged?

TD 2004/66 – Income tax: consolidation: capital gains: can section 104-530 (CGT event L7) of the *Income Tax Assessment Act 1997* only apply if an allocable cost amount is worked out for an entity?

TD 2004/67 – Income tax: consolidation: capital gains: does the determination of a capital gain or loss under section 104-530 (CGT event L7) of the *Income Tax Assessment Act 1997* require a full reconstruction of the allocable cost amount in relation to the relevant liability?

Revision history

Section C2-1-050 first published as a separate section 26 June 2007, with text under 'Dealing with errors in the TCSAs' reworded for clarification.

Further revisions are described below.

Date	Amendment	Reason
6.5.11	Significant changes throughout.	Legislative amendments and for clarification.

Cost setting on exit

An entity leaves a consolidated group when one or more membership interests are sold outside the group or the entity becomes otherwise ineligible to be a member.

Where a subsidiary member (the leaving entity) leaves a consolidated group, the head company recognises, just before the leaving time, the membership interests in the leaving entity. These membership interests are not recognised while the entity is a member of the group.

The process at the joining time is now reversed and the group's cost base of membership interests is derived from the net assets of the leaving entity just before the leaving time. This preserves the alignment between the costs for membership interests in the entity and its assets.

The tax cost setting amount for membership interests in the leaving entity is based on the ACA (allocable cost amount) worked out just before the leaving time, and consists of the terminating values of the assets of the leaving entity reduced by its liabilities. Adjustments are made to the ACA to reflect the value of certain inherited deductions and intra-group liabilities.

→ figure 1: Cost setting process on exit

Note that Division 715 and Subdivision 719-T apply loss integrity measures to consolidated and MEC groups.

→ 'Effect of Subdivision 165-CC where an entity leaves a consolidated group', C2-6-120
→ 'Effect of Subdivision 165-CD for consolidated groups', C2-6-130
→ 'Effect of Subdivision 165-CC for MEC groups', C2-6-140
→ 'Effect of Subdivision 165-CD for MEC groups', C2-6-150
→ 'Subdivision 165-CD widely held company concession for an eligible tier-1 company that is a head company of a consolidated or MEC group', C2-6-155

If the head company ceases to be eligible to be a head company of a consolidated group, the group usually ceases to exist → 'Changing group membership', B3-5.

However, with the aim of reducing compliance costs, these rules are modified in the following circumstances to allow the consolidated group to continue:

- where an existing consolidated group acquires another consolidated group → 'Consolidated group joins another consolidated group', in 'Modifications to entry cost setting rules', C2-1-040
- where a shelf company is interposed between the head company and its shareholders. The shelf company must be eligible to be a head company, and must choose that the existing group is to continue its existence. In these circumstances, the shareholders are taken to have chosen rollover relief, and there is no resetting of the tax costs of the group's assets. The

shelf company becomes the group's new head company, replacing the old head company for the whole of the year in which the interposition occurred. The new head company is treated as deriving group income and expenses for the whole of that year, and the tax attributes of the old head company become those of the new head company.

→ sections 703-65 to 703-80, ITAA 1997

Note that Subdivision 716-G has rules on how to deal with deductions for decline in value for assets in a low value pool and deductions for expenditure on software development pools when a subsidiary member leaves a consolidated group. Under these rules, the head company gets the deduction in the leaving income year and the leaving entity gets the deduction in the subsequent income years.

Also note that when a subsidiary member leaves a consolidated group and takes with it some or all of the head company's notional asset in respect of allowable capital expenditure (ACE), transport capital expenditure (TCE) and exploration or prospecting expenditure, the rules in Subdivision 712-E require the head company to reduce the adjustable value of its notional asset by the adjustable value of the leaving entity's notional asset. This ensures that only the leaving entity gets a deduction for the notional asset that leaves the group.

→ Subdivision 712-E of IT(TP)A 1997

Multiple leaving entities

Where the leaving entity holds membership interests in another subsidiary member of the consolidated group, that subsidiary will also cease to be a member at the leaving time.

The cost of the membership interests in each of the leaving subsidiary members must be worked out on a bottom-up basis, as the membership interests in the lower level entity (which represent an asset of the higher level entity) must be given a cost which is used in turn to calculate the cost of membership interests in the higher level entity.

→ section 711-55, ITAA 1997; Explanatory Memorandum to New Business Tax System (Consolidation) Bill (No. 1), paragraph 5.142

Figure 1: Cost setting process on exit

A Calculate leaving entity's ACA (allocable cost amount)

B Allocate the result to each of the membership interests by dividing the result by the number of those membership interests

C If there is more than one class of membership interest in the leaving entity, allocate the ACA to each class in proportion to the market value of all of the membership interests in the class

Market valuation

D Allocate the result to each of the membership interests in the class by dividing the result by the number of those membership interests in the class

= Tax cost setting amounts for the leaving entity's membership interests

Calculating the exit ACA

1. Start with terminating values of the leaving entity's assets just before the leaving time
2. Add certain inherited deductions not reflected in the terminating value of the leaving entity's assets just before leaving time
3. Add intra-group liabilities owed to the leaving entity at the leaving time
4. Subtract liabilities and certain interests treated as liabilities for the purpose of this calculation
5. The ACA is the remaining amount (if positive) or nil (if negative)

The exit cost setting process

A – Calculate exit ACA

→ Figure 1: Cost setting process on exit
→ 'Effect of Subdivision 165-CD for consolidated groups', C2-6-130

Step 1: Add up the terminating values of the leaving entity's assets just before the leaving time

Add up the head company's terminating values of all the assets that it holds just before the leaving time because the leaving entity is taken to be part of the head company. → section 711-25, ITAA 1997

There is an increase in the step 1 amount for certain privatised depreciating assets leaving the group that either:

- had their tax cost setting amount reduced under section 705-47 of the ITAA 1997 when an entity joined the group, or
- had their first element of cost reduced because of subsection 58-70(5) of the ITAA 1997 when they were acquired by the group.

The step 1 amount is increased by the amount of that reduction.

→ subsections 711-25(3) and (4), ITAA 1997; 'Increase for certain privatised depreciating assets (at exit ACA step 1)', C2-5-220

Note

Finance leases

Where the leaving entity is the lessor and just before leaving time has a Lease Receivable that was taken to be a retained cost base asset under subsection 705-56(3) at the joining time, the head company's terminating value of the right is its market value at the leaving time → subsection 711-30(3), ITAA 1997; subsection 705-56(3), ITAA 1997; 'Finance leases', in 'Allocating the entry ACA (steps B to E)', C2-1-030.

Rules for transitional groups

- When a subsidiary leaves a transitional group with an asset that was subject to an over-depreciated asset adjustment on entry, the head company may choose to add back the adjustment to the terminating value of the asset for the purpose of determining its cost base for membership interests.
  → section 701-40, IT(TP)A 1997
- Effective from 1 July 2009, the over-depreciation adjustment in section 705-50 of the ITAA 1997 has been repealed so that it will no longer apply to over-depreciated assets of entities that become subsidiary members of a consolidated group on or after that date. As section 705-50 of the ITAA 1997 has been repealed from 1 July, section 701-40 of the IT(TP)A 1997 has also been repealed so that it will no longer apply to the over-depreciated assets of entities that ceased to be members of a consolidated group on or after 1 July 2009. → *Tax Laws Amendment (2010 Measures No.1) Act 2010* (No.56 of 2010)
- Where subsidiary members leave a transitional group with certain pre-CGT assets that were held by the head company just before the formation time, the head company may choose to use formation time market values, instead of terminating values, when reconstructing the cost bases of membership interests. The pre-CGT assets must not be assets that were transferred to the head entity under rollover. → section 701-45, IT(TP)A 1997
- Where a subsidiary leaves a transitional group with a privatised depreciating asset that was brought into the group by a chosen transitional entity affected by Division 58 of the ITAA 1997 (or another similar regime), the step 1 amount is increased in certain circumstances by an amount representing the extent to which decline in value deductions for the asset were limited under the relevant privatised asset provisions. → section 701-50, IT(TP)A 1997

Step 2: Add certain deductions inherited from the head company

Add an amount for certain unclaimed deductions that the leaving entity inherits from the head company. The purpose of this adjustment is to ensure that the value of the deductions that is not reflected in the terminating value of the leaving entity's assets is reflected in the ACA.

→ section 711-35, ITAA 1997

Step 3: Add liabilities owed by members of the group

Add liabilities owed by members of the group to the leaving entity at the leaving time. The purpose of this adjustment is to ensure that the intragroup liabilities, which were not recognised for income tax purposes while the leaving entity was in the consolidated group, are reflected in the ACA. → section 711-40, ITAA 1997

Step 4: Subtract liabilities of the leaving entity

Subtract the leaving entity's liabilities, including liabilities owed to members of the group and certain interests that are treated as liabilities under this step (such as employee share interests disregarded for the purpose of consolidation and non-membership equity interests). → section 711-45, ITAA 1997

If the amount remaining after step 4 is negative, the head company will make a capital gain equal to that amount at the time the entity leaves the group (CGT event L5). → section 104-520, ITAA 1997; 'CGT events arising out of the cost setting rules', C2-1-410

The amount of a particular liability of the leaving entity included at step 4 under section 711-45 will be adjusted under subsection 711-45(10) if the four conditions in subsection 711-45(8) are satisfied and:

- the liability was previously taken into account in working out the entry ACA for that entity or another entity
- the amount of the liability on entry differs from the amount on exit, and
- the entry ACA would have been different if the amount on exit had been used in working it out.

→ subsections 711-45(8), (9) and (10), ITAA 1997

Note

Finance leases

Where the leaving entity is the lessee, no amount is included at step 4 for an accounting liability that is the leaving entity's obligation to make lease payments (Lease Payable) if that liability was not taken into account at step 2 of the entry ACA at the joining time because of subsection 705-56(4). → subsection 711-45(2A), ITAA 1997; subsection 705-56(4), ITAA 1997; 'Finance leases', 'Allocating the entry ACA (steps B to E)', C2-1-030

Step 5: ACA result

If the amount remaining after step 4 is positive, it is the leaving entity's ACA. If it is negative, the ACA is nil.

B – Allocate exit ACA to membership interests

Allocate the exit ACA to each of the membership interests by dividing the ACA by the number of membership interests in the leaving entity. The allocated amount is the tax cost setting amount for each membership interest, and forms the cost base and reduced cost base of those interests. If it is necessary to work out the amount of a capital loss on disposal by the head company of the membership interests at or after the leaving time, the exit ACA must be recalculated using reduced cost bases instead of cost bases at step 1 for assets that use cost base as their terminating value on exit.

→ paragraph 711-15(1)(a), ITAA 1997

C – Multiple classes of membership interests

If there is more than one class of membership interests in the leaving entity, the exit ACA will be first allocated among the different classes in proportion to the aggregate of the market values of each class. → paragraph 711-15(1)(b), ITAA 1997

D – Allocation of exit ACA within each class of membership interests

The allocated amount for each class is then allocated to each of the membership interests in the class by dividing the amount by the number of membership interests in the class. → paragraph 711-15(1)(c), ITAA 1997

If at the leaving time a member of the old group holds a non-membership equity interest in the leaving entity, that interest is treated as if it were a membership interest and a different class than any other membership interest in the leaving entity. → subsection 711-15(2), ITAA 1997

For an example of how the cost setting process on exit is applied from beginning to end see → 'The cost setting process on exit', C2-2-210.

Partnership leaves a consolidated group

When a partnership joins a consolidated group the cost setting rules in Division 705 of the ITAA 1997 are modified. → 'Partnership – *all* partners join consolidated group', C2-2-150

Similarly, when a partnership leaves a consolidated group the rules in Division 711 of the ITAA 1997 are modified → Subdivision 713-E, ITAA 1997. A partnership can cease to be a member of a consolidated group in two ways: either when the partner leaves the group (because, for example, the head company disposes of membership interests in the partner) or when the head company disposes of some or all of its fractional interests in the partnership (that is, its partnership cost setting interests).

In both cases the underlying assets of the partnership cease to be assets of the head company. The assets that the head company recognises just before the leaving time are its partnership cost setting interests. The tax cost setting amount of each of those interests is the partner's share of the terminating value of each of the underlying partnership assets.

Where a partnership leaves as a result of the group disposing of some or all of its partnership cost setting interests, the reset tax costs of the interests are used to calculate any capital gain or capital loss on their disposal.

When a partner leaves the group, its assets just before the leaving time will include its relevant partnership cost setting interests.

Trust leaves a consolidated group

The tax cost setting amount allocated to a membership interest in a trust leaving a consolidated group is reduced to nil where the membership interest:

- is a discretionary interest in the trust (i.e. it is neither a unit nor a fixed interest)
- has no cost base, and
- only began to be held by the beneficiary of the trust because something was settled on the trust.

This effectively ensures membership interests held by discretionary beneficiaries of a trust are given a cost base of nil when the trust leaves the group. → paragraph 711-15(1)(d), ITAA 1997

Application dates for certain amendments

Non-membership equity interests

Legislative changes (enacted in *Tax Laws Amendment (2010 Measures No. 1) Act 2010*) in relation to non-membership equity interests in subsection 711-15(2) of the ITAA 1997, and the insertion of subsection 711-45(6B) of the ITAA 1997 apply from 10 February 2010, unless a written choice to apply the changes from 1 July 2002 is made within the prescribed time by the head company of the group.

References

Legislation

Income Tax Assessment Act 1997, sections 703-65 to 703-80; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 2

Income Tax Assessment Act 1997, sections 711-35, 711-40 and 711-55; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Income Tax (Transitional Provisions) Act 1997, sections 701-40 to 701-50; as amended by:

- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 7
- *Tax Laws Amendment (2004 Measures No 2) Act 2004* (No. 83 of 2004), Schedule 2

Income Tax Assessment Act 1997, subsection 711-45(8), (9) and (10); as inserted and amended by:

- *Tax Laws Amendment (2004 Measures No. 7) Act 2005* (No. 41 of 2005), Schedule 6, Part 2 and
- *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 7, Division 2

Income Tax Assessment Act 1997, section 711-15; as amended by:

- *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 5
- *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 20

Income Tax Assessment Act 1997, Subdivision 713-E; as amended by *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (No. 83 of 2004), Schedule 2, Part 5

Income Tax Assessment Act 1997, section 711-25; as amended by:

- *New Business Tax System (Consolidation, Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 7, Division 1

Income Tax Assessment Act 1997, section 705-50 and subsection 995-1(1); as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 6

Income Tax Assessment Act 1997, sections 711-20, 711-35, 711-45 and subsection 713-265(4); as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 7, Division 1 and Part 20

Income Tax Assessment Act 1997, sections 719-740 and 715-265; as inserted by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 16

Income Tax Assessment Act 1997, sections 165-115X, 165-115Y, 715-230, 715-255, 715-270, 715-450 and 715-610; as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 16

Explanatory Memorandum to the New Business Tax System (Consolidation and other Measures) Bill (No. 1) 2002

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002

Explanatory Memorandum to the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, paragraphs 1.108-1.114

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No 2) Bill 2004, paragraphs 2.246- 2.251

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 7) Bill 2004, paragraphs 6.10 – 6.23

Explanatory Memorandum to the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, paragraphs 175-179

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 2) Bill 2004, paragraphs 2.61 – 2.99

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.180 to 5.186, paragraphs 5.188 – 5.197, paragraphs 5.198 – 5.215, paragraphs 5.325 – 5.348 and paragraphs 5.444 – 5.471

Supplementary Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 2.26 – 2.32

Tax ruling

TR 2005/17 – Income tax: goodwill: identification and tax cost setting for the purposes of Part 3-90 of the *Income Tax Assessment Act 1997*

Tax determinations

TD 2005/45 - Income tax: Consolidation: What is the meaning of 'liability owed' in section 711-40 of the *Income Tax Assessment Act 1997*

TD 2005/53 - Income Tax: Consolidation: exit tax cost setting rules: where an accounting liability added at subsection 711-45(1) of the *Income Tax Assessment Act 1997* is modified by the operation of subsections 711-45(3) and (5), does the amount determined under subsection 711-45(5) override the adjustment made by subsection 711-45(3)?

TD 2006/38 - Income Tax: Consolidation: can Division 711 of the *Income Tax Assessment Act 1997* apply for the purpose of the core rules in Division 701 upon an entity ceasing to be a subsidiary member of an acquired consolidated group where Subdivision 705-C operates?

TD 2006/19 - Income Tax: Consolidation: for the purposes of working out step 1 of a consolidated group's exit allocable cost amount in the leaving entity under section 711-25 of the *Income Tax Assessment Act 1997*, is the terminating value for a CGT asset determined under Division 110 for assets that have their tax cost set under subsection 701-10(4)?

TD 2006/53 - Income Tax: Consolidation: exit tax cost setting rules: how is the terminating value of an asset that is treated as if it were a CGT asset under subsection 705-30(5) of the *Income Tax Assessment Act 1997* worked out for the purposes of subsection 711-25(1) of that Act?

TD 2006/58 - Income Tax: Consolidation: will a subsidiary company that is deregistered cease to be a member of a consolidated group with the consequence that it is treated as a leaving entity for the purposes of Division 711 of the *Income Tax assessment Act 1997*?

Revision history

Section C2-1-060 first published as separate section 26 June 2007.

Further revisions are described below.

Date	Amendment	Reason
6.5.11	Figure 1 – change from 'certain membership interests' to 'certain interests'. References to non-membership equity interests, p. 3 & following. References to CGT event L7 deleted. Minor changes to reflect the repeal of section 705-50, effective 1 July 2009. Changes to reflect the changed wordings to clarify 'leaving time' in sections 711-20, 711-25, 711-45 and 713-265. Changes to reflect changed wording in 711-45(8).	Legislative amendments.

Treatment of special classes of assets

Internally generated assets

Internally generated assets that are depreciating assets are treated as reset cost base assets. Special rules may apply where a joining entity brings an internally generated asset into a consolidated group and the joining entity was a continuing majority-owned entity. A joining entity is a continuing majority-owned entity if a person or persons continued to be majority beneficial owners (directly or indirectly) of it from the start of 27 June 2002 until the joining time. An internally generated asset is an asset for which more than 50% of the total expenditure incurred in constructing or creating it was of a revenue nature and was deductible to the joining entity.

A dual 'cost' is ascribed on consolidation for a depreciating, internally generated asset where:

- its terminating value is less than its tax cost setting amount, and
- for each balancing event that occurred for that asset before the continuing majority-owned entity became a subsidiary member of the group there was rollover relief under section 40-340 of the *Income Tax Assessment Act 1997* (ITAA 1997).

This dual cost consists of:

- a cost that is used when working out the decline in value under Division 40 of the ITAA 1997 and which is based on the entity's terminating value for the asset, and
- a cost that is used when a balancing adjustment event occurs or if the asset leaves the group with a leaving entity, and which is based on the asset's tax cost setting amount less any decline in value that has since been calculated.

When the head company ceases to hold the internally generated asset, the head company is allowed to either claim a deduction or increase the exit allocable cost amount (ACA) for the shortfall between the deductions for the asset's decline in value and the deductions that would have been worked out using the asset's actual tax cost setting amount.

→ 'Continuing majority-owned entity and internally generated assets', C2-5-810; section 701A-10, IT(TP)A 1997; Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill (No. 1), paragraphs 1.118 – 1.120 and 1.131-1.174; 'Applying the continuing majority–owned entity test to multi-tiered structures', C2-4-855

Pre-CGT assets

Treatment of pre-CGT assets on entry

A pre-CGT asset (that is, an asset acquired before 20 September 1985) of the joining entity will continue to be a pre-CGT asset in the hands of the head company if Division 149 of the ITAA 1997 does not apply to the asset as a result of the entity joining the consolidated group.

Pre-CGT membership interests

The pre-CGT status of the membership interests acquired by the group before 20 September 1985 is preserved by either:

- working out a pre-CGT proportion (measured by market value) for an entity that joins a consolidated group on or after 10 February 2010 (or where the head company makes a choice to apply the pre-CGT proportion changes to an entity that joins before 10 February 2010) → section 705-125, ITAA 1997; 'Pre-CGT status of membership interests in a joining entity – pre-CGT proportion rules', C2-4-813. When an entity leaves a consolidated group, its pre-CGT proportion is used to work out the number of membership interests held by members of the old group that are treated as pre-CGT assets.

  → section 711-65, ITAA 1997; 'Pre-CGT membership interests in a leaving entity – pre-CGT proportion rules', C2-5-713; or
- attaching a pre-CGT factor to each asset (other than current assets) of the joining entity for an entity that joins a consolidated group before 10 February 2010 (and the head company does *not* makes a choice to apply the pre-CGT proportion changes to an entity that joins before 10 February 2010). This allows a proportion of the membership interests in a leaving entity to be treated as pre-CGT assets by reference to the pre-CGT factors attached to the assets that leave with it. → 'Pre-CGT membership interests in a leaving entity (with pre-CGT factor attached to assets)', C2-5-710

On formation

Formation on or after 10 February 2010

Where a consolidated group forms on or after 10 February 2010, it does not matter in what order the head company works out the pre-CGT proportions (where applicable) of its subsidiaries.

Formation before 10 February 2010

Where a group forms before 10 February 2010 (and where the head company does not make a choice to apply the pre-CGT proportion changes to an entity that joins the group on or after 1 July 2002), the pre-CGT status of membership interests held directly by the head company (that is, in the first subsidiary) is preserved by attaching a pre-CGT factor to the assets (other than current assets) of the first subsidiary at the formation time.

If, on formation, the first subsidiary holds membership interests in another subsidiary member (the second subsidiary), the pre-CGT factor must first be worked out for the first subsidiary's assets before any pre-CGT factor can be worked out for the second subsidiary's assets.

The market value of each membership interest owned by the first subsidiary in the second subsidiary is multiplied by the pre-CGT factor that was worked out and attached to the first subsidiary's assets. → 'Pre-CGT factor for assets where subsidiary has membership interests in another member – formation before 10 February 2010', C2-4-820

Consolidated group joins another consolidated group

For entities that had a pre-CGT proportion worked out on entry to the old consolidated group

The entry history rule applies in relation to the acquiring group. The pre-CGT proportion as worked out for an entity on joining the old consolidated group may be inherited by the head company of the new consolidated group, subject to the integrity rule in section 711-70 of the ITAA 1997.

A pre-CGT proportion may also need to be calculated in respect of any pre-CGT membership interests (if any) held by the new consolidated group directly in the head company of the old consolidated group (subject also to the integrity rule in section 711-70) of the ITAA 1997.

For a discussion of the integrity rules see → 'Pre-CGT membership interests in a leaving entity – pre-CGT proportion rules', C2-5-713, p. 2.

For any assets of members of the old consolidated group with a pre-CGT factor

Section 705-125 of the ITAA 1997 is modified to make it clear that pre-CGT factors formerly worked out for assets of entities when they became subsidiary members of the acquired group cease to have any relevance. They are replaced with new pre-CGT factors determined under section 705-125 if the acquiring group holds any pre-CGT membership interests in the acquired group.

→ section 705-205, ITAA 1997

Note

While section 705-205 of the ITAA 1997 was repealed on 10 February 2010, it continues to apply where a consolidated group joins another consolidated group and there are one or more entities that joined the old consolidated group before 10 February 2010 (and the head company of the old group does not makes a choice to apply the pre-CGT proportion changes to an entity that joins before 10 February 2010). → *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 3; former section 705-205 (reproduced at the end of this section (C2-1-070)

Linked entities join a consolidated group

Where linked entities join a consolidated group on or after 10 February 2010 (or where the head company makes a choice to apply the pre-CGT proportion rules from 1 July 2002), it does not matter in what order the head company works out the pre-CGT proportions (where applicable) of the linked entities.

Where linked entities join a consolidated group before 10 February 2010 (and where the head company does *not* make a choice to apply the pre-CGT proportion rules from 1 July 2002), the rules for determining the pre-CGT factors for assets of the linked entities are modified. → section 705-245, ITAA 1997

Note: section 705-245 of the ITAA 1997 was repealed on 10 February 2010. → *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 3

Pre-CGT status of membership interests in a discretionary trust

Where the head company makes a choice to apply the pre-CGT proportion rules from 1 July 2002

When working out the pre-CGT proportion of the membership interests in a trust joining a group, any pre-CGT membership interests of the group that are discretionary interests in the trust are disregarded.

When a trust leaves a group any membership interests that are discretionary interests in the trust are disregarded for the purposes of determining the number of membership interests in the leaving trust to which the pre-CGT proportion is to be applied. → paragraph 711-15(1)(d) and subsection 711-65(8), ITAA 1997

Where the head company does ***not*** *make a choice to apply the pre-CGT proportion rules from 1 July 2002*

When working out the pre-CGT factor to be attached to the non-current assets of a trust joining a group, any pre-CGT membership interests of the group that are discretionary interests in the trust are disregarded.

When a trust leaves a group any membership interests that are discretionary interests in the trust are disregarded for the purposes of determining the number of membership interests in the trust to which the pre-CGT proportion is to be applied. → paragraph 711-15(1)(d), and subsection 711-65(8), ITAA 1997

Treatment of pre-CGT assets on exit

When a leaving entity's asset was a pre-CGT asset in the hands of the head company immediately before the leaving time, it remains a pre-CGT asset after the entity leaves the group if Division 149 of the ITAA 1997 does not apply to the asset as a result of the entity leaving the consolidated group.

Pre-CGT membership interests

For entities that have a pre-CGT proportion worked out on entry (or where the head company makes a choice to apply the pre-CGT proportion rules from 1 July 2002)

When an entity leaves a consolidated group, its pre-CGT proportion is used to work out the number of membership interests held by members of the old group that are treated as pre-CGT assets. → section 711-65, ITAA1997; 'Pre-CGT membership interests in a leaving entity – pre-CGT proportion rules', C2-5-713

For any assets with a pre-CGT factor (where the head company does ***not*** *make a choice to apply the pre-CGT proportion changes from 1 July 2002)*

Where, just before the leaving time, any of the leaving entity's assets had a pre-CGT factor, a proportion of the membership interests in the leaving entity held by members of the group are treated as pre-CGT membership interests. → 'Pre-CGT membership interests in a leaving entity (with pre-CGT factor attached to assets)', C2-5-710

Note

The amendments to section 711-65 contained in *Tax Laws Amendment (2010 Measures No. 1) Act 2010,* Schedule 5, Part 3, have no effect where an entity leaves a consolidated group and pre-CGT factors are attached to some or all of its assets. This will occur where pre-CGT factors were calculated for an entity (in which pre-CGT membership interests were held) that joined the consolidated group before 10 February 2010 and the head company did not make a choice to apply the new pre-CGT proportion rules to that entity. → former section 711-65 (reproduced at the end of this section (C2-1-070)

Goodwill

On entry, goodwill owned by the joining entity is treated as one of its reset cost base assets, whether or not an amount has been recognised in its accounting statements. → Taxation Ruling TR 2005/17

When an entity leaves the group, goodwill lost to the group as a consequence is used, along with other reset cost base assets, to derive the group's cost base of membership interests in the leaving entity.

Note

Exception for demutualised general insurance company

Where a general insurance company that has demutualised joins a consolidated group and was wholly owned by the same group during the period from demutualisation to the joining time, a goodwill asset of the company just before the joining time is treated as a retained cost base asset. → section 713-705, ITAA 1997

Legislative framework

Goodwill is one of the assets that has a tax cost allocated to it under subsection 705-35(1) of the ITAA 1997. Subsection 705-35(3) provides special rules to apply to certain synergistic goodwill when an entity joins a consolidated group. When a subsidiary member leaves a group, subsection 711-25(1) deals with the goodwill of the leaving entity generally. Subsection 711-25(2) applies to a specific type of synergistic goodwill in the leaving case.

Taxation Ruling TR 2005/17 shows in detail how these provisions apply to the treatment of goodwill when a subsidiary member joins or leaves a consolidated group (including the formation case).

Synergistic goodwill existing in a business of the joined group due to its ownership or control of the joining entity

In economic terms, not all the value of the goodwill paid for on acquisition of an entity or making up the market value of an entity may be reflected in a goodwill asset of that entity. At subsection 705-35(3) of the ITAA 1997 the legislation anticipates an argument that in certain circumstances some proportion of the amount paid for the joining entity may have been paid in expectation of benefits accreting to a business of the acquirer. In this view the source of such benefits is an asset of the joined group rather than asset of the joining entity and is not therefore addressed by subsection 705-35(1).

Where objective analysis shows that some of the goodwill acquired with the joining entity is an asset of the joined group at the joining time, subsection 705-35(3) applies. However, as subsection 705-35(3) is essentially an integrity measure, it has no role if all the goodwill underlying the value of a joining entity is identified under subsection 705-35(1) as an asset of the joining entity.

Working out whether subsection 705-35(3) of the ITAA 1997 applies to an asset

Assets recognised for cost setting purposes under Part 3-90 of the ITAA 1997 take their ordinary meaning as commercial or business assets.

Synergistic goodwill is identifiable as an asset if it has a value at the joining time. Australian Accounting Standards Board (AASB) 1013 paragraph 5.1.3 provides a useful, though not definitive, reference point for commercial or business practice in recognising assets. It states that goodwill can be recognised as an asset if:

- it is expected that the future benefits in the unidentifiable assets will eventuate, and
- it possesses a cost or other value that can be reliably measured.

(AASB 1013 does not apply after 31 December 2004.)

→ Taxation Ruling TR 2004/13

Synergistic goodwill addressed by subsection 705-35(3) only crystallises as an asset where its value at the joining time can be determined by objective analysis. Such an analysis would typically take into account the time in the future when such benefits can be expected to emerge, the cost of achieving the benefits and the probability that the synergies will be realised taking into account the likely risks. Potential benefits that are costly to achieve, remote in time or have a low probability of occurring could be expected to have little or no value as an asset at the joining time. A commercial or business asset cannot be said to exist unless it can be demonstrated, using objective analysis, that a commercial value can be attributed to it.

The goodwill addressed by subsection 705-35(3) only crystallises as an asset of an acquirer once economic control has passed to the acquirer. While control may be achieved before an entity joins a group it is certain to exist at the joining time because of the 100% ownership rule. The test for whether an asset exists is applied at the joining time although the provisions require that the asset is valued at just after this time for cost allocation purposes. Subsection 705-35(3) is not applied in the formation case. → Taxation Ruling TR 2005/17

Note

For information about market valuation issues in relation to goodwill → *Market valuation for tax purposes* (NAT 72508) at **www.ato.gov.au**

Contracts

Treatment of contracts as assets

These guidelines apply to partially performed or mutually unperformed contracts for the provision and acquisition of goods or services or the acquisition or disposal of assets, other than purely financial transactions.

Such contracts are capable of being treated as assets of an entity joining or leaving a consolidated group where it can be established they are separately identifiable from the other assets of the joining or leaving entity, and a market value can be reliably determined that does not attribute any of the value of the joining or leaving entity's other assets to the contract.

In recognising assets for cost setting purposes a key principle is that *all* the assets underlying the value of the joining entity need to be recognised. There must be a clear commercial or business practice for recognising a particular type of contract as an asset. Commercial or business practice should also guide the level of composition at which an asset is recognised; i.e., the extent to which different components are treated as part of a single asset.

There is evidence from commercial and business practice that contracts are treated as assets in some circumstances and that a market value can be determined.

In recognising assets it must also be shown that the economic benefit of a contract is separately identifiable from that of other assets. A market value must also be able to be determined in accordance with a recognised valuation methodology → 'Valuation approaches', p. 11 of this section. The accounting methods for assigning a value to beneficial or onerous contracts as defined in accounting standards *do not* provide such a methodology → 'The accounting approach to contracts', p. 9. As with other intangible assets, the valuation methodology must be able to ensure that economic benefits of the contract are segregated from the benefits flowing from other assets employed in the business, goodwill in particular.

Caution needs to be exercised in valuing contracts as they tend to be unique between two parties in the context of their individual cost and asset structures. It can therefore be difficult to establish a reliable contract value with evidence of trades in the same or similar instruments or find a suitable market indicator such as a market-based expected rate of return.

The basis of recognising assets for cost setting

The basis of recognising assets for tax cost setting purposes is contained in the provisions of section 701-10 and Subdivision 705-A of the ITAA 1997. Assets subject to the cost setting provisions are referred to simply at subsection 705-35(1) as each asset of the joining entity. This is expanded on at paragraph 5.19 of the Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002:

> *An asset, for the purposes of the cost setting rules, is anything of economic value which is brought into a consolidated group by an entity that becomes a subsidiary member of the group. This includes those assets which subsequently cease to be recognised as a consequence of the single entity rule whilst the asset is within the consolidated group.*

The meaning of asset in this context has been interpreted in TR 2004/13, paragraph 5 of which states in part:

> *... an asset for the purposes of the tax cost setting rules is anything recognised in commerce or business as having economic value to the joining entity at the joining time for which a purchaser of its membership interests would be willing to pay. The business or commercial assets of a joining entity would include the things that would be expected to be identified by a prudent vendor and purchaser as having value in the making of a sale agreement in respect of all the membership interests in the entity and its business.*

The preliminary test, therefore, for determining whether a contract is an asset for cost setting purposes is whether it would be regarded as an asset in ordinary commercial or business usage.

The conceptual framework behind asset recognition

In interpreting the meaning of 'asset' in subsections 700-10(2) and 705-35(1) of the ITAA 1997, TR 2004/13 notes that the perspective to apply in identifying assets coming into a consolidated group in a joining entity is that of a prudent vendor and buyer identifying what the assets are. More specifically, subsection 701-10(2) of the ITAA 1997 provides that the section applies to each asset that would be an asset of the entity at the time it becomes a subsidiary member assuming the single entity rule does not apply. That it applies to each asset and not just assets that exist for the purposes of the head company core purposes is clear from section 701-58 of the ITAA 1997, which addresses intra-group assets that are not recognised as assets of the head company except in some circumstances as they leave the group.

For cost setting purposes when an entity joins a group, an asset is anything of economic value that is brought into the consolidated group by the joining entity. The context for determining whether contracts are such assets is provided by the object of section 701-10 and Division 705 of the ITAA 1997, which is to recognise the cost to the head company of such assets as an amount reflecting the group's cost of acquiring the entity. → subsection 701-10(3), ITAA 1997

For the purposes of working out an allocable cost amount (ACA) to be distributed across the assets of a joining entity, the group's cost of acquiring an entity (equity = total assets less debt) is represented as membership interests (step 1) + liabilities (step 2) = total assets → section 705-60, ITAA 1997. While step 1 adjusts the amount of the actual payment for membership interests for the purposes of the ACA calculation, the basic accounting principle of equity = total assets – liabilities is retained. Conceptually the acquirer has chosen the assets identified under section 701-10 of the ITAA 1997, and the value of those assets is reflected in the amount paid for the membership interests together with the liabilities assumed on acquiring ownership.

In the acquisition of an entity, the total value of its identified assets cannot exceed the acquisition cost and assumed liabilities. This means that, where an asset such as a contract for the disposal of another asset is said to exist, the acquirer needs to identify which assets contain the value reflected in the entity value for which it paid. Given that entities are ordinarily acquired as going concerns, it can be assumed that contracts will be fulfilled unless there is evidence to the contrary. Importantly, it needs to be established that the contract is a separate asset to any underlying assets being traded under the contract.

The accounting approach to contracts

The accounting standards define assets as future economic benefits controlled by an entity as a result of past transactions or other past events → Statement of Accounting Concepts (SAC) 4, paragraph 14[6]. Control of an asset is defined as the capacity of the entity to benefit from the asset in the pursuit of the entity's objectives and to deny or regulate the access of others to that benefit. By comparison, the reference to assets in the Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002 is to 'anything of economic value'.

The standards (which are designed to provide for the broad information needs of the users of general purpose financial reports → SAC 2) provide for assets to be recognised where:

[6] While SACs 3 and 4 have been replaced by the Accounting Framework from 1 January 2005, the principles referred to here are substantially carried on in the Framework.

(a) *it is probable that the future economic benefits embodied in the asset will eventuate and*

(b) the asset possesses a cost or other value that can be measured reliably.

→ SAC 4, paragraph 38

The bringing together of separate entities or businesses into one reporting entity is addressed by AASB 3, paragraph 4. The result of nearly all business combinations is that one entity, the acquirer, obtains control of one or more businesses from an acquiree. For present purposes, business combinations include parent-subsidiary relationships in which the acquirer is the parent and the acquiree the subsidiary of the acquirer. → AASB 3, paragraph 6

All business combinations are to be accounted for by applying the purchase method → AASB 3, paragraph 14. This views a business combination from the perspective of the combining entity that is identified as the acquirer. The acquirer purchases the net assets and recognises the assets acquired and liabilities and contingent liabilities assumed, including those not previously recognised by the acquiree. The cost of the business combination is the aggregate of the fair values (at date of exchange) of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer in exchange for control of the acquiree. The conceptual basis of treating business combinations in accounting is similar to steps 1 and 2 in section 705-60 of the ITAA 1997. Under both regimes, failure to recognise an asset that is contributing to the value of an entity can distort the value assigned to other assets. Similarly a stream of economic benefits cannot be counted more than once.

The acquirer shall recognise separately the acquiree's identifiable assets and liabilities at the acquisition date → AASB 3, paragraph 37. Intangible assets must be identifiable and their fair value capable of being measured reliably. Fair value is defined as 'the amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in an arm's length transaction'.
→ AASB 3, Appendix A, p 37

Intangible assets

A non-monetary asset without physical substance must be identifiable to meet the definition of an intangible asset → AASB 3, paragraph 46. This means that the intangible asset must be separable (capable of being separated from the entity and sold or transferred either individually or together with a related contract, asset or liability) or arises from contractual or other legal rights, regardless of whether those rights are transferable → AASB 138. Customer contracts, purchase and sale orders, lease agreements and servicing contracts can be recognised as intangible assets (and therefore separately to goodwill) provided they can be separately identified and their fair values measured reliably.

However, it might not be possible to measure reliably the fair value of an intangible asset if either the asset is not separable or is separable but 'there is no history or evidence of exchange transactions of the same or similar assets, and otherwise estimating fair value would be dependent on immeasurable variables' → AASB 138, paragraph 38. In some cases agreed proxies can be substituted for exchange values determined from the market when applying AASB 3 to business combinations. For example, it specifies that the fair value of receivables, beneficial contracts and other identifiable assets shall use present values of the amounts to be received, determined at appropriate current interest rates less allowances for uncollectibility and collection costs. → AASB 3, paragraph 16(c)

In referring to the fair value of receivables, beneficial contracts and other identifiable assets, AASB 3 paragraph B16(c) does not define a beneficial contract but treats it as a counterpart to onerous contracts as defined in AASB 137. (The latter applies to all entities in accounting for provisions, contingent liabilities and contingent assets except those resulting from executory contracts, except where the contract is onerous → AASB 137, paragraph 1). An onerous contract is '...a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it' → AASB 137, paragraph 68. Some industries, including insurance and construction, have specific treatments that may lead to an asset and a liability being recognised.

It is considered that executory contracts cannot be included as beneficial contracts because the latter only apply to contracts under which an amount has been earned or partially earned but is not yet recoverable. This state would not exist for a mere executory contract. It is important to note also that income that is merely prospective (fully unearned) is not included in the value of the beneficial contract. In essence, the recognition of beneficial contracts as assets provides a way of bringing forward the recognition of income and associated future expenses when accrual of that income is virtually certain.

In summary, a value worked out under a prescribed methodology can be included in accounts in respect of contacts under the limited notions of beneficial or onerous contracts. It seems that service contracts and customer contracts can also be recognised provided their value can be measured reliably by reference to trades in similar instruments or other means.

Because of the nature of the framework for asset cost setting, whereby the cost of the entity is transferred to all the assets that underlie its value at the joining time, or a tax value is transferred from all the assets of a leaving entity to membership interests at the leaving time, it is accepted that it is not necessary to show that each type of asset recognised is capable of being traded in the market. This is analogous to the accounting treatment of assets in business combinations. However, a recognised market valuation methodology must be applied.

Valuation approaches

While very little has been published in Australia on determining a market value for contracts, detailed treatments have been published elsewhere. In addressing the issue of valuing contracts, US authors Reilly and Schweihs (1999) refer to contract intangibles as generally representing '…value *attributable* to that broad category of rights accruing to an individual or business entity as a result of a written, legally enforceable contractual arrangement'.

They set out key elements of a contract that lend it value:

> *While common logic dictates that two parties generally would not enter into a contractual agreement unless it was viewed as economically advantageous by both parties, a change in general industrial or economic conditions subsequent to the original consummation of a contract may exert a positive or negative impact on the current value of an existing contract, based on the contract terms initially established.*

Three valuation methods are recommended: the cost approach, the market approach and the income approach → pp. 313-14. The cost approach is in essence replacement cost. Its primary defect is that costs change in the market so that today's contract may cost more or less to replace in the future. The market approach is essentially value in exchange. Its deficiencies stem from the lack of active markets in most forms of contracts and the difficulty of establishing exactly what is being exchanged in transactions. Under the income approach the future cost savings expected to be realised over the remaining term of a supplier contract can be discounted to its present worth (net present value) at a discount rate equal to the (market) required rate of return of the investment generating the savings. Under this approach, comparative data needs to be obtained for similar businesses or transactions to determine the market rate of return. Because of the complexity of contracts and the scarcity of data it is not possible to be definitive on suitable methods.

Net present value methods can also be used to show any positive value in a contact over and above the amount it was expected to earn when entered into. For example, if it was determined at the initiation of a contract that it would yield 10% per annum (being the necessary rate of return on the assets employed as determined by the market), a net present value analysis of the project's net cash flow using the present market discount rate will reveal any improvement in the value of the contract above its presumed nil starting value. However some contracts can be favourable or unfavourable to a given party from the beginning, possibly reflecting advantages in bargaining power.

Key issues that should be taken into account in valuing contracts include:

- the number and different types of contracts maintained by an entity
- an entity's history regarding renewal and the premature termination of contracts
- the average service life of contracts by category
- an entity's history regarding breach of contract claims and related litigation
- break clauses and penalties for breach, and
- the terms of the contract generally.

In summary the factors that can contribute to the value of a contract include the cost of establishing the contract, any work carried out under the contract and movements in the market conditions that may make the contract favourable in the hands of one or more of the parties. Where income methods are employed to value a contract it is the net income that is used rather than gross future receipts. Basing a valuation on gross receipts where expenses will be incurred in earning that income will invariably attribute value to a contract that is more properly attributed to another asset.

References

Legislation

Income Tax Assessment Act 1997, section 40-340

Income Tax Assessment Act 1997, section 705-35; as inserted by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Income Tax Assessment Act 1997, subsection 705-35(1); as amended by *Taxation Laws Amendment Act (No. 6) 2003* (No. 67 of 2003), Schedule 3

Income Tax Assessment Act 1997, section 705-125; as inserted by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1, and amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 3

Income Tax Assessment Act 1997, section 705-205; as inserted by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 4, and repealed by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 3

Income Tax Assessment Act 1997, section 705-240; as inserted by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 4

Income Tax Assessment Act 1997, section 705-245; as inserted by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 4, and repealed by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 3

Income Tax Assessment Act 1997, sections 711-15; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 5

Income Tax Assessment Act 1997, section 711-25; as amended by:

- *New Business Tax System (Consolidation, Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 7, Division 1

Explanatory Memorandum to New Business Tax System (Consolidation and other Measures) Bill (No. 1) 2002, paragraphs 1.118 – 1.120 and 1.131 – 1.174

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.111 – 5.142

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.188 – 5.197

Tax rulings

TR 2004/13 – Income tax: the meaning of an asset for the purposes of Part 3-90 of the *Income Tax Assessment Act 1997*

TR 2005/17 – Income tax: goodwill: identification and tax cost setting for the purposes of Part 3-90 of the *Income Tax Assessment Act 1997*

Other

Australian Accounting Standards Board:

- Statement of Accounting Concepts (SAC) 4
- AASB 3 Business Combinations
- AASB 137 Provisions, Contingent Liabilities and Contingent Assets
- AASB 138 Intangible Assets

Robert F. Reilly and Robert P. Schweihs, Valuing intangible assets, McGraw Hill, 1999

Revision history

Section C2-1-070 first published as separate section 26 June 2007.

Further revisions are described below.

Date	Amendment	Reason
28.02.08	New section on Contracts, p. 7.	For clarification.
6.5.11	Major revisions to reflect changes to rules on pre-CGT assets.	Legislative amendment.
15.7.11	Change to date of effect , p. 2.	Correction

Section 705-205 of the *Income Tax Assessment Act 1997* as it stood before *Taxation Laws Amendment (2010 Measures No. 1) Act 2010*

Section 705-205 Modified application of section 705-125

Object

705-205(1) The object of this section is to make it clear that, in view of the fact that *pre-CGT factors are worked out for assets of the acquired group on acquisition by the acquiring group, pre-CGT factors formerly worked out for assets of entities when they became *subsidiary members of the acquired group cease to have any relevance.

Pre-CGT factors for assets of members on joining acquired groups no longer relevant

705-205(2) Section 705-125 (which provides for a pre-CGT factor to be worked out for assets of the acquired group) has effect as if a note were added at the end of the section stating that *pre-CGT factors worked out for assets of entities when they became *subsidiary members of the acquired group cease to have any relevance when the acquired group ceases to exist in circumstances in which this Subdivision applies.

Section 711-65 of *Income Tax Assessment Act 1997* as it stood prior to *Taxation Laws Amendment (2010 Measures No. 1) Act 2010*

711-65 Membership interests treated as having been acquired before 20 September 1985 - simple case

When this section applies

(1) This section applies if:

(a) any of the assets (a *pre-CGT factor asset*), that the *head company of the old group holds at the leaving time because the leaving entity is taken by subsection 701-(1) to be a part of the head company, has a *pre-CGT factor under section 705-125; and

(b) section 711-70 (about the multiple exit of *subsidiary members) does not apply; and

(c) the leaving entity does not cease to be a subsidiary member of the old group where Subdivision 705-C (about the old group joining another consolidated group) applies.

Interests treated as if purchased before 20 September 1985

(2) If this section applies, a number of the *membership interests in the leaving entity that *members of the old group hold are taken to have been acquired before 20 September 1985.

Note: Because of the deemed acquisition of the membership interests, this section is the only basis on which any of these interests can be pre-CGT assets.

Number of pre-CGT membership interests

(3) The number is the result of the formula in subsection (4), rounded down to:

(a) the nearest whole number if the result is not already a whole number; or

(b) zero if the result is a number more than zero but less than one.

Formula

(4) The formula is:

Number of *membership interests in leaving entity held by *members of old group	x	Leaving entity's pre-CGT proportion

where:

leaving entity's pre-CGT proportion is the amount worked out under subsection (5).

Pre-CGT proportion

(5) Work out the leaving entity's pre-CGT proportion in this way:

Leaving entity's pre-CGT proportion

*Step 1***.** For each *pre-CGT factor asset, multiply its *market value before the leaving time by its *pre-CGT factor.

Step 2. Add up all the results of step 1.

Step 3. Add up the *market values of all the assets that the *head company holds at the leaving time because the leaving entity is taken by section 701-1 to be a part of the head company.

Step 4. Divide the result of step 2 by the result of step 3.

Dealing with classes of membership interests

(6) If there are 2 or more classes of *membership interests in the leaving entity, this section operates separately in relation to each class as if the interests in that class were all the interests in the entity.

Allocation of the number to particular membership interests

(7) The *head company must choose which particular *membership interests comprise the number worked out under subsection (2).

Modification if leaving entity is a trust

(8) If the leaving entity is a trust, a *membership interest in it is not taken into account under this section unless the membership interest is either a unit or an interest in the trust.

Linked assets and liabilities

There are special rules for setting the tax cost of a joining entity's assets if, immediately before it joins a consolidated group, it has a set of linked assets and liabilities that must be set-off against each other under the joining entity's accounting principles for tax cost setting. The joining entity's accounting principles for tax cost setting are the accounting standards or authoritative pronouncements of the Australian Accounting Standards Board (AASB) that the entity would use if it were to prepare its financial statements just before the joining time. → section 705-59, subsections 705-70(3), 995-1(1), *Income Tax Assessment Act 1997* (ITAA 1997)

Apart from these rules, the consolidation regime treats assets and liabilities that are required to be set-off, in accordance with accounting principles, as separate assets and liabilities. That is, in general linked assets and liabilities are not netted; their gross amounts are used. → section 705-58, ITAA 1997

Note

Retained cost base assets and excluded assets

The tax cost of *retained* cost base assets is always set by section 705-25. These rules do not affect that section. Also, if the only linked assets in a set are retained cost base assets these rules have no application. → subsection 705-59(4), ITAA 1997

Excluded assets, which are described in subsection 705-35(2), do not have a tax cost setting amount and are ignored by these rules. → subsection 705-59(6)

Linked assets & liabilities under the accounting standards

A set of linked assets and liabilities consists of at least one asset and at least one liability that the joining entity's accounting principles for tax cost setting require to be:

- set-off against each other in preparing an entity's statements of financial position, and
- presented in that statement as a net amount.

→ subsection 705-59(2)

Generally, the accounting standards require assets and liabilities to be set-off and net amounts to be recognised in the balance sheet only when there is both a legally recognised right to set-off and an intention to settle on a net basis or simultaneously → e.g. see AASB 1014, section 9 (AAS 23) and AASB 1033 section 4 (AAS 33). The standards also list circumstances in which set-off would usually be inappropriate, such as where assets and liabilities within a portfolio have the same primary risk exposure but different counterparties.

Applying the special rules

The treatment of linked assets and liabilities under these special rules depends on the number and type of assets in a set of linked assets and liabilities, and their market value in relation to the 'available amount' (see definition below).

The number of liabilities in a set is not relevant.

The rules are set out in two tables in section 705-59, one applying where there is a single reset cost base asset and the other applying to all other cases (except where the only linked assets in a set are retained cost base assets, in which case the rules have no application). Within the tables a further series of tests determine the treatment of the linked assets and liabilities. These tests and their application are set out in this section of the Reference Manual.

The available amount

The available amount is the ACA step 2 amount for the linked liabilities in a set worked out as if we ignore the special rules for linked assets and the accounting standards that apply to them. → subparagraph 705-59(3)(a)

Where in the cost setting process do the rules need to be considered?

The ACA step 2 amount is firstly worked out ignoring the special rules for linked assets and liabilities.

If the linked asset and liability rules apply to a joining entity, their application may not only set the tax costs of the affected assets, but it may also affect the ACA step 2 calculation for the entity. → subsection 705-70(1), ITAA 1997

Where the linked asset rules operate to set the tax cost of an asset, sections 705-40, 705-45 and 705-50 (adjustments for revenue-like assets, accelerated depreciation assets and over-depreciated assets respectively) still apply where relevant. → subsection 705-59(7)

Note that, effective from 1 July 2009, the over-depreciation adjustment in section 705-50 of the ITAA 1997 has been repealed so that it will no longer apply to over-depreciated assets of entities that become subsidiary members of a consolidated group on or after that date. → former subsection 705-50, ITAA 1997

What information is needed to apply the rules?

Before the rules can be applied the following amounts need to be determined:

- the market values of the linked reset cost base assets at the joining time
- the tax cost setting amounts for the linked retained cost base assets
- the available amount of the linked liabilities.

→ subsection 705-59(3) and (5)

Only one linked asset – a reset cost base asset

When the only asset in a set of linked assets and liabilities is a single reset cost base asset the following rules apply:

1. Where the linked asset's market value ≤ the total available amount of the liabilities:

- the linked reset cost base asset's tax cost setting amount is its market value, and the linked asset does not share in the allocation of the ACA, and
- the difference between the market value of the linked asset and the available amount of the linked liabilities is included at ACA step 2.

→ subsection 705-70(1)

In effect, the linked liability is dedicated firstly to setting the tax cost of the asset to which the liabilities are linked. In relation to the linked liabilities, only the excess of the available amount over the asset's market value is added to the ACA at step 2 for use in increasing the tax cost of the other assets. The linked asset does not share in the allocation of the ACA and does not affect how it is allocated among the other assets of the joining entity. This limits the transfer of value to or from the linked asset.

→ paragraph 705-59(3)(b), item 1 in the table

Example 1

A consolidated group pays $6,000 for 100% of the membership interests in JCo, which therefore joins the group. At the joining time, JCo owns land with a market value of $8,000 and has a net liability of $2,000. The net liability represents a reset cost base asset with a market value of $4,000, which is required to be set-off, under the joining entity's accounting principles for tax cost setting, against a liability of $6,000. The liability's available amount is the full $6,000.

The available amount of $6,000 exceeds the market value of the linked reset cost base asset of $4,000. Therefore, the linked asset's tax cost setting amount is $4,000, its market value. When calculating the ACA step 2 amount, only the $2,000 difference between the available amount of $6,000 and the market value of the linked asset of $4,000 is included.

The ACA for JCo is $8,000 ($6,000 purchase price plus the $2,000 of the liability not used to set the linked asset's tax cost). As the linked asset already has a tax cost setting amount of $4,000, it does not share in the ACA allocation under paragraph 705-35(1)(c). The total of the ACA is allocated to the land, being the only other reset cost base asset.

2. Where the linked asset's market value > the total available amount of the liabilities:

- the linked asset's tax cost setting amount is the sum of:
  - the available amount, plus
  - the amount worked out under subsection 705-35(1) as if the asset's market value were equal to the difference between the market value of the linked asset and the available amount

and

- the linked liabilities are not taken into account at step 2 of the ACA.

The linked liability is again dedicated firstly to setting the tax cost of the asset to which it is linked. In this situation the asset has a greater market value than the liability to which it is linked. As a result, the linked asset, in addition to the dedicated available amount, will also get a proportionate share of the ACA, based on the difference between the market value of the asset and the available amount of the liability.

The proportion is worked out as follows:

$$\left(\frac{\text{market value of the linked reset cost base asset} - \text{available amount}}{(\text{market value of the linked reset cost base asset} - \text{available amount}) + \text{market values of all other reset cost base assets}}\right) \times \text{ACA}$$

→ paragraph 705-59(3)(b), item 2 in the table

Example 2

RCo joins a consolidated group. In RCo's balance sheet there is a net asset of $4,000 which represents a set of linked assets and liabilities as follows:

reset cost base asset	$16,000	(market value)
liability	$12,000	(the available amount)

RCo also owns reset cost base assets land 1 and land 2:

land 1	$1,000	(market value)
land 2	$2,000	(market value)

RCo is acquired for $7,000, the net value of the linked assets and liability plus the land.

The market value of the linked reset cost base asset of $16,000 exceeds the available amount of $12,000. Therefore the ACA for RCo is calculated as $7,000, the purchase price (step 1 amount). There is no step 2 amount as the linked liability is not taken into account. The linked liability will be dedicated to setting the linked asset's tax cost setting amount.

The linked reset cost base asset is allocated a proportionate share of the ACA based on the difference between its market value and the available amount (i.e. $16,000 – $12,000 = $4,000). The ACA is allocated to the linked asset as follows:

[$4,000 ÷ ($4,000 + $3,000 (land 1 & 2))] × $7,000 = $4,000

This amount is then increased by the available amount of $12,000 which sets the asset's tax cost at $16,000.

Land 1 & 2 then have their tax cost setting amounts calculated based on an ACA of $7,000. The ACA is distributed to the land as follows:

land 1: [$1,000 ÷ ($4,000 + $3,000 (land 1 & 2))] × $7,000 = $1,000

land 2: [$2,000 ÷ ($4,000 + $3,000 (land 1 & 2))] × $7,000 = $2,000

More than one linked asset

1. Where all linked assets are reset cost base assets and their total market values are ≤ the total available amount of the liabilities:

- each linked reset cost base asset's tax cost setting amount is its market value, and the linked assets do not share in the allocation of the ACA, and
- the difference between the market value and the available amount is included at ACA step 2.

This is the same treatment as applies to a single reset cost base asset with a market value equal to or less than the liability to which it is linked. The linked assets do not share in the allocation of the ACA and do not affect how the ACA is distributed among the other assets of the joining entity.

→ paragraph 705-59(5)(b), item 1 in the table

2. Where all linked assets are reset cost base assets, and their total market values are > the total available amount of the liabilities:

- each linked asset's tax cost setting amount is equal to:
  - a proportionate share of the available amount (based on the assets' market values), plus
  - a proportionate share of the ACA based on an amount equal to its market value reduced by its share of the available amount;

and

- the liabilities are not taken into account at ACA step 2.

Again this is similar to the case of single reset cost base asset above. The amounts are now apportioned among the various assets based on their market values.

→ paragraph 705-59(5)(b), item 2 in the table

Example 3

Consider again RCo joining a consolidated group, but in this case it has two linked reset cost base assets and a liability.

In RCo's balance sheet there is a net asset of $4,000, which represents a set of linked assets and liabilities as follows:

reset cost base asset 1	$10,000	(market value)
reset cost base asset 2	$6,000	(market value)
liability	$12,000	(the available amount)

RCo also owns reset cost base assets land 1 and land 2:

land 1	$1,000	(market value)
land 2	$2,000	(market value)

RCo is acquired for $7,000, the net value of the linked assets and liability plus the land.

As in the previous example, the market value of the linked reset cost base assets of $16,000 exceeds the available amount of $12,000. The ACA for RCo is the $7,000 purchase price (step 1 only applies). The linked liability is not taken into account. The liability is dedicated to the tax cost setting amount of the linked reset cost base assets.

As the linked assets are worth more than the liabilities, the assets will split the available amount of $12,000 between them in proportion to their market values.

reset cost base asset 1: [$10,000 ÷ ($10,000 + $6,000)] × $12,000 = $7,500

reset cost base asset 2: [$6,000 ÷ ($10,000 + $6,000)] × $12,000 = $4,500

Reset cost base asset 1 will also get a share of the ACA based on its $10,000 market value less its $7,500 share of the available amount (i.e. $2,500). Reset cost base asset 2 will use an amount of $1,500 (i.e. $6,000 – $4,500) in working out its share of the ACA.

reset cost base asset 1:
[$2,500 ÷ ($2,500 + $1,500 + $3,000 (land 1 & 2))] × $7,000 = $2,500

reset cost base asset 2:
[$1,500 ÷ ($2,500 + $1,500 + $3,000 (land 1 & 2))] × $7,000 = $1,500

Each of the linked assets will have a tax cost equal to its share of the available amount plus its share of the ACA.

reset cost base asset 1 tax cost setting amount: $7,500 + $2,500 = $10,000

reset cost base asset 2 tax cost setting amount: $4,500 + $1,500 = $6,000

Land 1 & 2 then have their tax cost setting amount calculated based on an ACA of $7,000. The ACA is distributed as follows:

land 1:
[$1,000 ÷ ($2,500 (linked asset 1) + $1,500 (linked asset 2) + $3,000 (land 1 & 2))]× $7,000 = $1,000

land 2:
[$2,000 ÷ ($2,500 (linked asset 1) + $1,500 (linked asset 2) + $3,000 (land 1 & 2))] × $7,000 = $2,000

3. Where the linked assets include reset and retained cost base assets and the retained cost base assets' total tax cost setting amounts are ≥ the total available amount of the liabilities:

The linked asset and liability rules do not effect the treatment of the linked assets or linked liabilities in the ACA process. All of the linked liabilities should be dedicated to the retained cost base assets and the normal rules for allocating the ACA will achieve this. The step 2 amount will include the available amount for the linked liabilities and the retained assets will be deducted from the ACA prior to allocation.

→ paragraph 705-59(5)(b), item 3 in the table

4. Where the linked assets include reset and retained cost base assets and the retained cost base assets' total tax cost setting amounts are < the total available amount of the liabilities:

- the linked retained cost base assets are disregarded for the purposes of paragraph 705-35(1)(b) (reduces the ACA by the tax cost setting amount of retained cost base assets), and
- the linked reset cost base assets and liabilities are then treated as if the set included only reset cost base assets. Tests 1 or 2 above, as appropriate, are used to determine the result for these assets and liabilities. The available amount used in tests 1 or 2 is reduced by the total of the tax cost setting amounts of the retained cost base assets.

The same rules apply as if there were only reset cost base assets. The linked retained cost base assets are not deducted from the ACA – i.e. subsection 705-35(1)(b) disregards these assets. However, they are deducted from the available amount.

→ paragraph 705-59(5)(b), item 4 in the table

Example 4

Consider again RCo joining a consolidated group with linked assets and liabilities that include a retained and a reset cost base asset.

RCo's balance sheet shows a net asset of $4,000, representing a set of linked assets and liabilities as follows:

one retained cost base asset	$10,000	(tax cost setting amount)
one reset cost base asset	$6,000	(market value)
liability	$12,000	(the available amount)

RCo also owns reset cost base assets land 1 and land 2:

land 1	$1,000	(market value)
land 2	$2,000	(market value)

RCo is acquired for $7,000, the net value of the linked assets and liability plus the land.

As the linked assets and liabilities include a retained and a reset cost base asset, and the retained cost base asset's tax cost setting amount of $10,000 is less than the available amount of $12,000, subsection 705-59(5), table item 4 applies (test 4 above).

In respect of the reset cost base asset, item 4 refers to 'item 1 or 2, as appropriate, of this table on the basis that: (a) the available amount is reduced by the retained cost base total …'. Therefore the reset cost base asset's market value of $6,000 is compared to the available amount of $12,000 less the $10,000 retained cost base asset (i.e. $2,000). The market value of $6,000 is greater than $2,000 so item 2 of the table applies.

The reset cost base asset's market value of $6,000 exceeds the $2,000 available amount by $4,000. An amount of $4,000 is used to allocate the ACA as follows:

The ACA for RCo is the $7,000 purchase price. Note that under items 2 & 4 the ACA does not include an amount for the linked liabilities.

The $12,000 liability has been dedicated to the retained cost base asset and the reset cost base asset. The linked retained cost base asset's tax cost setting amount is not deducted from the ACA because part of the linked liability has already been dedicated to the retained cost base asset and that liability has not been added to the ACA at step 2.

The linked reset cost base asset's market value share of the ACA is:

$4,000 ÷ ($4,000 + $3,000 (land 1 & 2)) ×$7,000 = $4,000

The reset cost base asset's tax cost setting amount is calculated by adding the available amount to a portion of the ACA calculated above. There is only one reset cost base asset so the $2,000 available amount is all apportioned to that asset. The reset cost base asset's tax cost setting amount is:

$4,000 + $2,000 = $6,000

Land 1 & 2 then have their tax cost setting amount calculated based on an ACA of $7,000. The ACA is distributed as follows:

land 1: [$1,000 ÷ ($4,000 + $3,000 (land 1 & 2))] × $7,000 = $1,000

land 2: [$2,000 ÷ ($4,000 + $3,000 (land 1 & 2))] × $7,000 = $2,000

Example 5

MCo joins a consolidated group. MCo's balance sheet shows a net liability of $5,000 representing a set of linked assets and liabilities as follows:

one retained cost base asset	$3,000	(tax cost setting amount)
one reset cost base asset	$8,000	(market value)
liability	$16,000	(the available amount)

MCo also owns a reset cost base asset:

land	$10,000	(market value)

MCo is acquired for $5,000, the net value of the linked assets and liability plus the land.

As the linked assets and liabilities include a retained and a reset cost base asset, and the retained cost base asset's tax cost setting amount of $3,000 is less than the available amount of $16,000, subsection 705-59(5), table item 4 applies.

The ACA is not reduced by the linked retained cost base asset of $3,000 under paragraph 705-35(1)(b). The remaining linked reset cost base assets and liability are therefore treated as a reset cost base asset of $8,000 and a linked liability with an available amount of $13,000 (i.e. $16,000 – $3,000). They are then dealt with under item 1 in the same table.

The reset cost base asset's tax cost setting amount is $8,000, its market value. It does not share in the ACA.

The difference between the available amount (as adjusted under paragraph 705-59(5)(b), table item 4) of $13,000 and the market value of the reset cost base asset of $8,000 (i.e. $5,000) is included at ACA step 2. The ACA to be allocated to the land is therefore the purchase price of $5,000 plus the $5,000 now included at ACA step 2.

CGT event L3

Broadly, under CGT event L3 a capital gain occurs where the total of the tax cost setting amounts of the retained cost base assets exceeds the ACA. Subparagraph 104-510(1)(b)(ii) only considers retained cost base assets that 'are taken into account under paragraph 705-35(1)(b)' (reduces the ACA available for reset cost base assets by the tax cost setting amounts of retained cost base assets).

If the tax cost setting amounts of the retained cost base assets in the set of linked assets is less than the available amount, those retained cost base assets are not taken into account in 705-35(1)(b) – as in item 4 above. This means that they are not included in working out the sum of tax cost setting amounts for the retained cost base assets in paragraph 104-510(1)(b), because of subparagraph 104-510(1)(b)(ii).

In example 4, the $10,000 tax cost setting amount of the retained cost base asset exceeded the $7,000 ACA by $3,000. The tax cost of the linked retained cost base asset was fully funded by the linked liability and that part of the linked liability was not included in the ACA. The retained cost base asset was not deducted from the ACA prior to allocation. CGT event L3 does not count that linked retained cost base asset in working out any capital gain when RCo joins the group. As there are no other retained cost base assets in this example, there will be no capital gain.

Note

A modification has been made to the treatment of doubtful debts for cost setting purposes that allows for the reduction of any CGT event L3 capital gain in respect of doubtful debts as retained cost base assets with a corresponding reduction to the tax cost setting amount of the head company's outstanding debts. These modifications apply from 10 February 2010, unless a written choice to apply the changes from 1 July 2002 is made within the prescribed time by the head company of the group. → section 705-27, ITAA 1997

References

New Business Tax System (Consolidation) Act (No. 1) 2002 (No. 68 of 2002)

Taxation Laws Amendment Act (No. 6) 2003 (No. 67 of 2003), Schedule 3

Tax Laws Amendment (2010 Measures No. 1) Act 2010 (No. 56 of 2010), Schedule 5, parts 6, 8 and 13

Explanatory Memorandum to the Taxation Laws Amendment Bill (No.6) 2003, paragraphs 3.4 and 3.9 to 3.48

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No.1) Bill 2010, Chapter 5

Revision history

Section C2-1-310 first published 8 June 2004.

Further revisions are described below.

Date	Amendment	Reason
26.6.07	Note on proposed changes to the treatment of doubtful debts for cost setting purposes, and proposed changes to clarify both the valuation of liabilities and the accounting principles to be used, p. 10.	Reflect announcement on 8 May 2007 by Assistant Treasurer in media release no. 50.
6.5.11	Removal of note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used. Reference to 'accounting standards for tax cost setting' and definition of that term included on p. 1, and consequential minor changes. Minor changes to reflect the repeal of section 705-50, effective 1 July 2009. Removal of note on proposed changes and insertion of a new note to reflect the changes to the treatment of doubtful debts for tax cost setting purposes, p. 10.	Legislative amendments.

CGT events arising out of the cost setting rules

In calculating the tax cost setting amounts for an entity joining or leaving a consolidated or MEC group, the CGT events listed in the following table may take place, resulting in a capital gain or capital loss for the head company as indicated.

CGT event	**Description**	**Time of event**	**Applies to**	**Capital gain**	**Capital loss**	**Legislative references** (ITAA 1997 and Explanatory Memorandums – EM)
L1	A reduction under section 705-57 in the tax cost setting amounts of assets of an entity becoming a member of a consolidated or MEC group	Just after the entity becomes a member of the group	The head company, which is allowed a capital loss equal to the reduction; the loss being deductible over five years	No capital gain	Amount of reduction Note: Broadly, unless s. 701B-1 of the IT(TP)A 1997 applies, the head company is only able to utilise 1/5th of the capital loss each year, over five years.	s. 104-500 s. 705-57, s. 705-163, s. 705-240 EM to NBTS (Consolidation and Other Measures) Bill (No.1) 2002, paragraphs 1.89 – 1.114 and 1.175 – 1.181
L2	The amount of ACA remaining after applying step 3A for any pre-formation rollover is negative	Just after the entity becomes a member of the group	The head company, which makes a capital gain equal to the amount remaining	Amount remaining	No capital loss	s. 104-505 s. 705-93, s. 705-147, s. 705-227 EM to NBTS (Consolidation and Other Measures) Bill (No.2) 2002, paragraphs 5.119 – 5.122 EM to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.158 – 5.179

CGT event	Description	Time of event	Applies to	Capital gain	Capital loss	**Legislative references** (ITAA 1997 and Explanatory Memorandums – EM)
L3	The sum of the tax cost setting amounts for all the joining entity's retained cost base assets that become those of the head company exceeds the entity's ACA	Just after the entity becomes a member of the group	The head company, which makes a capital gain equal to the excess	Amount of excess Note: If the entity becoming a member has linked assets and liabilities, any retained cost base assets, to the extent they have already been taken into account in working out the ACA, are not counted in working out the amount of the excess. → C2-1-310	No capital loss	s. 104-510 Note to s. 705-25, note 1A to s. 705-35, paragraphs 705-35(1)(b), 705-59(5)(b) – item 4 EMs to: NBTS (Consolidation and Other Measures) Bill (No.2) 2002, paragraphs 5.123 – 5.126 TLAB (No. 6) 2003, paras 3.42 – 3.56
	Note – changes to consolidation rules A modification to the treatment of doubtful debts for cost setting purposes allows for the reduction of any CGT event L3 capital gain in respect of doubtful debts as retained cost base assets with a corresponding reduction to the tax cost setting amount of the head company's outstanding debts. This applies from 10 February 2010, unless the head company makes a written choice within the prescribed time to apply the changes from 1 July 2002. → section 705-27 ITAA 1997					
L4	There are no reset cost base assets against which to apply the remaining amount of the ACA under paragraph 705-35(1)(c)	Just after the entity becomes a member of the group	The head company, which makes a capital loss equal to the amount remaining	No capital gain	Amount of excess	s. 104-515 and note 2 to s. 705-35 EM to NBTS (Consolidation and Other Measures) Bill (No.2) 2002, paragraphs 5.127 – 5.131
L5	In calculating the ACA for a leaving entity, the amount remaining after applying step 4 of the table in section 711-20 is negative	When the entity leaves the group	The head company, which makes a capital gain equal to the amount remaining	Amount remaining	No capital loss	s. 104-520 EM to NBTS (Consolidation and Other Measures) Bill (No.2) 2002, paragraphs 5.132 – 5.135

CGT event	Description	Time of event	Applies to	Capital gain	Capital loss	**Legislative references** (ITAA 1997 and Explanatory Memorandums – EM)
L6	Where the head company of a consolidated or MEC group has a net overstated or a net understated tax cost setting amount for the subsidiary member because of errors in working out the tax cost of its reset cost base assets	Start of the income year in which the Commissioner becomes aware of the errors	The head company, which makes a capital gain if there is a net overstated amount and a capital loss if there is a net understated amount	The net overstated amount resulting from the errors, or a portion of that amount	The net understated amount resulting from the errors, or a portion of that amount	s. 104-525, s. 705-315, s. 705-320 EM to NBTS (Consolidation and Other Measures) Bill (No.2) 2002, paragraphs 5.17 – 5.34
L7	The discharged liability of a subsidiary member is greater than the amount taken into account in working out the entity's ACA	Start of the income year in which the liability is discharged	The head company, provided liability is discharged before 10 February 2010		The ACA calculated using the correct amount for the liability less the ACA calculated at the joining time	Former s. 104-530 EM to NBTS (Consolidation and Other Measures) Bill (No.2) 2002, paragraphs 5.35 – 5.42 IT(TP)A 1997
L8	A reduction in the tax cost setting amounts for reset cost base assets on joining cannot be allocated because of restrictions on amounts allocated for assets held on revenue account	Just after the entity becomes a member of the group	The head company, which makes a capital loss equal to the unallocated amount of the reduction	No capital gain	Amount of reduction that cannot be allocated	s.104-535 ss. 705-40(1) & ss. 705-40(2) EM to TLAB (No. 8) 2003, paragraphs 2.19 – 2.22

References

Legislation

Income Tax Assessment Act 1997, section 104-500; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002)

Income Tax Assessment Act 1997, section 104-505; as amended by:

- *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003)
- *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Parts 5 and 13

Income Tax Assessment Act 1997, sections 104-510, 104-515, 104-520, 104-525 and 104-530; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003)

Income Tax Assessment Act 1997, section 104-535; as amended by *Taxation Laws Amendment Act (Act 107) 2003*

Income Tax Assessment Act 1997, sections 705-93, 705-147, 705-227 and subsection 995-1(1); as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 5

Income Tax (Transitional Provisions) Act 1997, section 701B-1; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002)

Taxation determinations

TD 2004/64 – Income tax: consolidation: capital gains: does section 104-530 (CGT event L7) of the *Income Tax Assessment Act 1997* apply to amounts of a liability that accrue after the time that the entity with the liability became a subsidiary member of a consolidated group?

TD 2004/65 – Income tax: consolidation: capital gains: does section 104-530 (CGT event L7) of the *Income Tax Assessment Act 1997* apply where: (a) an entity becomes a member of a consolidated group; (b) the entity owes a liability to another member of the group at that time; and (c) the liability is later discharged?

TD 2004/66 – Income tax: consolidation: capital gains: can section 104-530 (CGT event L7) of the *Income Tax Assessment Act 1997* only apply if an allocable cost amount is worked out for an entity?

TD 2004/67 – Income tax: consolidation: capital gains: does the determination of a capital gain or loss under section 104-530 (CGT event L7) of the *Income Tax Assessment Act 1997* require a full reconstruction of the allocable cost amount in relation to the relevant liability?

TD 2004/87 – Income tax: consolidation: can the head company of a transitional group make a capital loss under section 104-500 (CGT event L1) of the *Income Tax Assessment Act 1997* in respect of the assets of a chosen transitional entity?

TR 2007/7 – Income tax: consolidation: errors in tax cost setting amounts of reset cost base assets

Revision history

Section C2-1-410 first published 14 July 2004.

Further revisions are described below.

Date	Amendment	Reason
26.10.05	New references to taxation determinations.	
	Changes to L1 row, capital loss column.	For clarification.
26.6.07	Notes on proposed changes to the treatment of doubtful debts for cost setting purposes and to repeal CGT event L7.	Reflect announcement on 8 May 2007 by Assistant Treasurer in media release no. 50.
6.5.11	CGT event L3: Insertion of note on changes to consolidation rules in relation to the treatment of doubtful debts.	Legislative amendments.
	CGT event L7: revision including removal of note on proposed changes.	

High-level worked example

The cost setting process on entry

Description

New tax costs must be obtained for the assets that a subsidiary brings into a consolidated group. The new tax costs are obtained by application of the cost setting rules (unless the head company opts to apply the transitional option of retaining existing tax values). This high-level example shows how the cost setting rules are applied through the steps shown in figure 1 – from the calculation of the allocable cost amount (ACA) through to ascertaining the tax cost setting amount for each of the joining subsidiary's assets.

Some steps in the process are expanded on in worked examples included in this section of the Reference Manual.

Figure 1: The cost setting process on formation and entry

A Calculate joining entity's ACA (allocable cost amount)

B Subtract value of retained cost base assets (e.g. A$ cash)

C Apportion remainder of ACA over reset cost base assets in proportion to their market values, subject to adjustment for revenue-like assets

Market valuation

D Adjust the amounts allocated to depreciating assets

E Adjust the amounts allocated for certain revenue-like assets

= Tax cost setting amounts for the joining entity's reset cost base assets

Calculating the entry ACA

1. Start with cost of membership interests
2. Add liabilities and certain interests treated as liabilities for the purpose of this calculation
3. Add undistributed frankable profits accrued to the group

3A. Adjust for certain pre-joining time rollovers from a foreign-resident company or the company that became the head company to an Australian-resident company

4. Subtract distributions of profits not accruing to the group, and those accruing to the group that recouped losses
5. Subtract unused losses accrued to the group, except those reducing step 3 profits
6. Subtract an amount equal to transferred losses that did not accrue to the group, multiplied by the general company tax rate
7. Subtract certain inherited deductions to avoid duplication of benefit
8. The ACA is the remaining amount (if positive) or nil (if negative)

Note

Background information

Ledger accounts, calculation of income tax and deferred tax liabilities are included in the background information at the back of this example.

Commentary

Under consolidation, assets are brought into a consolidated group by a subsidiary member according to the cost setting rules. Among other things, this means that when an entity joins a consolidated group, the total value of the entity's assets for tax purposes is based on the cost of acquiring the entity – the tax values of the entity's assets are aligned with the tax values of the membership interests in the entity. → 'Treatment of assets', C2-1

Example

Facts

On 1 July 2000, Beta Pty Ltd (Beta) is incorporated with issued capital of $1,000 (1,000 ordinary shares at $1.00 per share). Beta immediately borrows further funds and acquired assets to commence business. Beta's financial position is as follows:

Table 1: Beta Pty Ltd – financial position at 1 July 2000 ($)

Land 1	1,200	Capital	1,000
Plant	200	Liabilities (loan)	1,000
Cash	300		
Trading stock	300		
	2,000		2,000

On 1 August 2000, Beta incorporates Gamma Pty Ltd (Gamma) with issued capital of $200 (200 ordinary shares at $1.00 per share). Gamma immediately invests its capital in two blocks of land held for agistment. Gamma's financial position is as follows:

Table 2: Gamma Pty Ltd – financial position at 1 August 2000 ($)

Land 2	100	Capital	200
Land 3	100		
	200		200

On 1 July 2001, Alpha Pty Ltd (Alpha) acquires 60% of the shares in Beta for $765, i.e. 60% of $1,275 (the value of net assets).

Table 3: Value of net assets of Beta at 1 July 2001 ($)

	Market value	
Assets		
Land 1	1,300	
Plant	180	
Shares in Gamma	190	
Trading stock	400	
Cash	158	2,228
Liabilities		
Loan	950	
Deferred tax liability	3	953
Value of net assets		**1,275**

The land and shares are not revalued in Beta's accounts. Beta's financial position is as follows:

Table 4: Beta Pty Ltd – financial position at 30 June 2001 ($)

Land 1	1,200	Capital	1,000
Plant (cost $200)	180	Profits	185
Shares in Gamma	200	Liabilities	
Trading stock	400	– loan	950
Cash	158	– deferred tax liability	3
	2,138		**2,138**

During the income year ending 30 June 2001, Gamma sells Land 3 for $90, making a net capital loss of $10. The market value of Land 2 is unchanged. Gamma does not derive any income during the year.

Table 5: Gamma Pty Ltd – financial position at 30 June 2001 ($)

Land 2	100	Capital	200
Cash	90	Losses	(10)
	190		**190**

On 30 June 2002, Alpha acquires the remaining 40% of shares in Beta for $796 (i.e. 40% of net asset values).

Table 6: Value of net assets of Beta at 30 June 2002 and 1 July 2002

	Market value	
Assets		
Land 1	1,400	
Plant	162	
Shares in Gamma	197	
Trading stock	350	
Cash	481	
Goodwill	304	2,894
Liabilities		
Loan	900	
Deferred tax liability	5	905
Value of net assets		**1,989**

Beta's financial position is as follows:

Table 7: Beta Pty Ltd – financial position at 30 June 2002 ($)

Land 1	1,200	Capital	1,000
Plant	162	Profits (after tax $303)	488
Shares in Gamma	200	Liabilities	
Trading stock	350	– loan	900
Cash	481	– deferred tax liability	5
	2,393		**2,393**

During the year ended 30 June 2002, Gamma makes an after tax profit of $7. Its financial position is as follows:

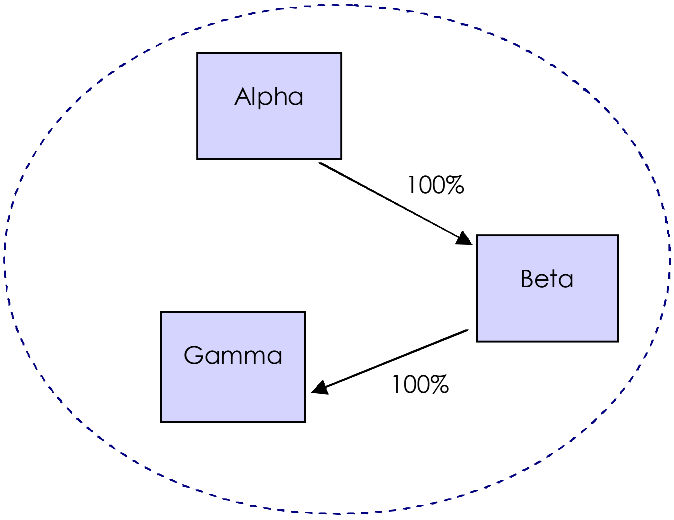
Table 8: Gamma Pty Ltd – financial position at 30 June 2002 ($)

Land 2	100	Capital	200
Cash	100	Net profit	
		– after tax profit	7
		– carry fwd loses	(10)
		Liabilities	
		– income tax	3
	200		200

Choice to consolidate

Alpha chooses to form a consolidated group with effect from 1 July 2002, and notifies the ATO within the time and manner specified. The consolidated group is structured as follows:

Figure 2: Structure of consolidated group



Application of cost setting rules

When a consolidated group is formed, no changes are made in relation to the assets of the head company (except that intragroup membership interests and debts are ignored after formation). The cost setting rules establish the tax cost setting amounts for assets of subsidiaries.

Alpha must first apply the cost setting rules to Beta, before applying them to Gamma. → section 705-145, *Income Tax Assessment Act 1997* (ITAA 1997)

Setting tax costs of Beta's assets

A: Calculate Beta's ACA

ACA step 1: Add up the cost of each membership interest

On 1 July 2001, Alpha acquires 60% of membership interests in Beta (Interest 1) for $765. On 1 July 2002, Interest 1 has a market value of $1,193, and Alpha acquires the remaining 40% of membership interests (Interest 2) for $796. There are no outstanding cost base adjustments for membership interests, such as for earlier value shifting or loss transfers. → subsection 705-65(3), ITAA 1997 and Explanatory Memorandum to New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraph 5.60

Worksheet: Step 1 – Add up the cost of each membership interest

		$ Interest 1	$ Interest 2	$ Interest 3	$
P	Cost base (CB) at the joining time or formation time (JT) (Note: cost of pre-CGT interests not indexed)	765	796		
Q	Reduced cost base (RCB) at JT (ignoring reductions for rebatable dividends: former section 160ZK(5) ITAA 1936 or section 110-55(7) ITAA 1997), and adding back any adjustments under section 165-115ZA(3) ITAA 1997 to the extent the relevant losses will reduce ACA under steps 5 & 6)	765	796		
R	CB (line P) as adjusted for value shifting or loss transfer	765	796		
S	RCB (line Q) as adjusted for value shifting or loss transfer, or section 165-115ZD ITAA 1997	765	796		
T	Market value (MV) at the joining time	1,193	796		
	Tests: If MV (line T) ≥ adjusted CB (line R), use line R If MV (line T) ≤ adjusted RCB (line S), use line S If adjusted RCB (line S) < MV (line T) < adjusted CB (line R), use line T				
	***Result* for each membership interest (sum is entry ACA step 1 amount)**	765	796		**1,561**

ACA step 2: Add liabilities of the joining entity at the joining time

The loan is shown as Liability 1 in the worksheet below. The deferred tax liability is shown as Liability 2. No reductions or adjustments are required. There are no employee shares, no non-membership equity interests issued by Beta and no debt interests that are regarded as equity for general accounting purposes.

Worksheet: Step 2 – Add liabilities etc.

	$ Liability 1	$ Liability 2	$ Subtotals	$
				Cfwd 1,561
Accounting liabilities				
Start with statement of financial position	900	5		
Adjust where liability valued differently for group – subsection 705-70(1A)				
This adjustment is not required for transitional entities, such as Beta is in this example – see section 701-32 of the IT(TP)A 1997 and 'Commentary' in C2-4-242.				
Reduce to $nil if attached to an asset				
Reduce for future income tax deductions				
Reduce for intra-group debt (add back reductions under section 165-115ZA(3) before comparison)				
Adjust for unrealised gains or losses				
Sum of reduced or adjusted amounts	900	5	905	
Add for employee shares				
MV of disregarded shares				
Reduce by reduction amount				
Add for non-membership equity interests				
Add amount received from third parties from the issue of non-membership equity interests				
Add equity treated as debt				
Add market value of equity for accounting purposes but debt for tax purposes (under debt/equity rules)				
Step 2 amount				
Sum of the sub-totals				905
Entry ACA result after step 2				**2,466**

ACA step 3: Add undistributed profits that accrued to the group

As Alpha elects to consolidate from 1 July 2002, in the first year of the two-year transitional period, and Beta is a wholly-owned subsidiary on that date, the transitional rule for ACA step 3 applies → former section 701-30, *Income Tax (Transitional Provisions) Act 1997*. All undistributed profits accrued to the group are included.

To apply the rule, calculate how much of the undistributed profits accrued to the group, how much did not accrue to the group and the extent to which they could be franked.

Beta's profit for the 2000–01 year is $185, of which $178 could have been distributed in a frankable form. None accrues to the group, as Alpha does not acquire an interest in Beta until 1 July 2001. Beta's profit for the 2001–02 year is $303, of which $296 could have been distributed in a frankable form (as per franking account → table 12). Alpha owns 60% of Beta during the year, so the amount that accrues to Alpha is $182, of which $178 ($296 x 60%) is in a frankable form. This $182 is included in step 3. The amount not accruing to the group is $121, of which $118 ($296 x 40%) is in a frankable form.

Worksheet: Step 3 – Add undistributed profits accrued to the group

	$	$
		Cfwd 2,466
<u>Ongoing rule</u>		
Add undistributed *frankable* profits accrued to group at the JT	178	
and		
<u>Transitional rule</u> For subsidiaries that are non-chosen transitional entities, and the transitional group has consolidated before 1 July 2003 or has consolidated on or before the first day of the head company's income year that started after 30 June 2003 and before 1 July 2004.		
Add *all* undistributed *unfrankable* profits accrued to group at the joining time	4	182
Entry ACA result after step 3		**2,648**

ACA steps 3A, 4, 5, 6 and 7

There are no rollovers or distributions of profits, so step 3A and 4 do not apply. Steps 5 and 6 are not applicable because there are no realised and unrecouped tax losses or net capital losses at the joining time. Step 7 is not applicable as the head company will not be entitled to any deductions because of acts or transactions of the joining entity before the joining time.

Entry ACA Step 8

The ACA is $2,648.

B: Subtract value of retained cost base assets

First determine the tax cost setting amounts for Beta's retained cost base assets. → section 705-25, ITAA 1997

Beta's retained cost base assets are Cash and Trading Stock.

The tax cost setting amount for the Cash asset equals the amount of Australian currency involved, $481. The tax cost setting amount for the Trading Stock equals the amount of its terminating value (on the basis that Beta used the cost base method to value its stock), i.e. $350. These amounts for retained cost base assets is subtracted from the ACA ($2,648), leaving $1,817. → section 705-35, ITAA 1997, and sections 701A-1 and 701A-5, IT(TP)A 1997

C: Apportion remaining ACA over reset cost base assets

The remainder of the ACA ($1,817) is then apportioned among Beta's remaining assets other than excluded assets (i.e. its reset cost base assets) according to their market values.

The market value of Beta's shares in Gamma will need to be adjusted where there is an adjustment at steps 3 or 5 of the ACA calculation for Gamma. (In this example, Gamma has a step 3 adjustment – i.e. the profit adjustment amount.)

Beta's interest in the profit adjustment amount is worked out by dividing the market value of Beta's shares in Gamma ($197) by the market value of all shares in Gamma ($197), and then multiplying the result by the amount to be included in Gamma's ACA calculation under step 3 ($4). The result – i.e. ($197/$197) x $4 = $4 – is subtracted from the $197 market value of Beta's shares in Gamma, which gives a revised market value of $193.
→ section 705-160, ITAA 1997

The profit adjustment amount for Gamma (step 3 amount) is based on the extent to which the profits have accrued to the head company. Alpha owns 60% of Beta (held continuously), and Beta owns 100% of Gamma (held continuously), so the adjustment is 60% of Gamma's profits (60% x $7 = $4). Therefore, the market value of shares in Gamma should be reduced by $4.

Table 9: Apportionment according to market value ($)

Reset cost base assets	Terminating value (TV)	Market value (MV)	Apportionment of remainder	Assets held on revenue account – excess over greater of TV or MV	Tax cost setting amount for asset
Land 1	1,200	1,400	1,233		1,233
Plant	144	162	143	0	143
Shares in Gamma	200	193	170		170
Goodwill	0	304	268		268
Totals	**1,544**	**2,059**	**1,814**	**0**	**1,814**

None of the tax cost setting amounts for assets held on revenue account exceed the greater of terminating value or market value of those assets, so no reduction in those tax cost setting amounts is necessary → section 705-40, ITAA 1997. Note that had it been necessary to reduce the tax cost setting amount for an asset held on revenue account, the amount of the reduction would have been allocated to the other assets in proportion to their market values.

→ 'Reduction for revenue-like assets (step C)', C2-4-530

Note also that part of the ACA is allocated to goodwill, notwithstanding that goodwill has not been shown in the accounts and has a nil terminating value.

D: Adjust for over-depreciated assets

Consider now whether a reduction (or further reduction) to the amount is required for over-depreciated assets. → former section 705-50, ITAA 1997

The over-depreciation provisions in the tax cost setting rules are modified for an entity that becomes a member of a consolidated group between 9 May 2007 and 30 June 2009. In this case, the head company need only look at five years of dividend history immediately before the joining time to determine whether an over-depreciation adjustment is required in relation to the joining entity's asset. From 1 July 2009, the over-depreciation adjustment in section 705-50 has been repealed, and it no longer applies to over-depreciated assets of entities that become subsidiary members of a consolidated group on or after that date. → *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010)

However, as Beta joined the consolidated group on 1 July 2002, these modifications will not apply. Therefore, for the purposes of this example, the depreciation status of Beta's plant will be examined.

Worksheet: Is an asset (Beta's plant) over-depreciated?

	At the joining time:	Test satisfied?	$ Excess amount
M	Does market value exceed adjustable value?	Yes	18
N	Does the cost exceed adjustable value?	Yes	56
	If the answer is YES to both questions, the asset is over-depreciated by the lesser of M and N		**18**

At the joining time the market value is $162 and the adjustable value $144. Therefore, the excess is $18. The cost is $200, an excess over the adjustable value of $56. Beta's plant is over-depreciated by $18 (the lesser of these two excesses).

Next, test to determine whether the tax cost setting amount needs to be reduced. → Worksheet: Over-depreciation reduction

The tax cost setting amount for an over-depreciated asset is reduced by the least of the over-depreciation amount (calculated above), the excess of the tax cost setting amount over its terminating value, and the tax deferral amount.

Worksheet: Over-depreciation reduction

			$ amount
	<u>**Test for each over-depreciated asset**</u>		
	Over-depreciation amount		
(a)	Over-depreciation amount from previous table		18
	Tax cost setting amount exceeds terminating value		
(b)	Excess of the tax cost setting amount over its terminating value		0
	Tax deferral amount		
(c)	*Start with* the amount of unfranked dividends paid by the joining entity before the joining time that were subject to the former section 46 or former section 46A rebate	0	
(d)	The amount of the profits paid as dividends in (c) above – (the *qualifying profits amount*) that was not subject to tax because of the over-depreciation of the asset – *but* counts only to the extent it was not counted in ACA step 4 and to the extent the deductions for over-depreciation did not form part of a loss that reduced the ACA under step 5, were not counted in ACA step 4 (but the depreciation did not generate a tax loss to be subtracted from the entry ACA at step 5)	0	
(e)	The extent to which the dividend in (c) – adjusted to amount in (d) – was *not* further distributed (directly or indirectly) to a taxpayer who was *not* entitled to such a rebate. This is the *tax deferral amount*	0	
	Transitional rule on formation		
(f)	*Add* – The tax deferral amount is increased to include any unfrankable **undistributed** profits accrued to head company and included in ACA step 3 (under transitional rules) to the extent that those profits were not subject to tax because of deductions for depreciation representing over-depreciation, and the deductions did not form part of a loss that reduced the ACA under step 5 (former subsection 701-30(3) IT(TP)A)	4	
(g)	Is there a tax deferral amount? How much?	Yes	4
	Reduction of tax cost setting amount is the lesser of (a), (b) and (g)		0

Note: The amount of $4 against test (f) above is the amount of undistributed unfrankable profits in the 2001–02 year that accrue to the group. That amount is unfrankable because of over-depreciation of the item of plant. This amount was included in Step 3 of the ACA calculation under the transitional rules.

The tax cost setting amount for the plant will not be reduced. (Note the tax cost setting amount, $143, is less than terminating value, $144.)

This test must be applied for each depreciating asset.

Choice of retaining accelerated depreciation rate

The head company may choose under section 705-45 to reduce the tax cost setting amount of a depreciating asset (acquired before 21 September 1999) to equal its terminating value. Where a depreciating asset's tax cost setting amount does not exceed its terminating value, section 701-80 permits the head company to use the accelerated depreciation provisions. In this example the tax cost setting amount for the plant is less than its terminating value. Therefore, the head company can retain the existing accelerated depreciation rate.

→ sections 705-45 and 701-80, ITAA 1997

Choice of replacing tax cost setting amounts with terminating values

Under the transitional provisions, Alpha may choose to use existing tax values (known as 'terminating values') instead of the amounts calculated under the cost setting rules. This choice is available on a subsidiary-by-subsidiary basis. This is in contrast with the choice of retaining the accelerated depreciation rate, which is available on an asset-by-asset basis. → sections 701-1 and 701-5, IT(TP)A 1997

It is assumed Alpha does not choose to use the terminating values and uses the tax cost setting amounts calculated above.

Setting tax costs of Gamma's assets

A: Calculate Gamma's ACA

ACA step 1: Add up the cost of each membership interest

The tax cost setting amount for the shares Alpha indirectly holds in Gamma via Beta (calculated above as $170) is treated as the cost base and reduced cost base for step 1 of the ACA for Gamma.

Worksheet: Step 1 – Add up the cost of each membership interest

		$ Interest 1	$ Interest 2	$ Interest 3	$
P	Cost base (CB) at the joining time or formation time (JT) (note: cost of pre-CGT interests not indexed)	170			
Q	Reduced cost base (RCB) at JT (ignoring reductions for rebatable dividends: former section 160ZK(5) ITAA 1936 or section 110-55(7) ITAA 1997), and adding back any adjustments under section 165-115ZA(3) ITAA 1997 to the extent the relevant losses will reduce the ACA under steps 5&6)	170			
R	CB (line P) as adjusted for value shifting or loss transfer	170			
S	RCB (line Q) as adjusted for value shifting or loss transfer, or section 165-115ZD ITAA 1997	170			
T	Market value (MV) at the joining time	197			

Tests: If MV (line T) ≥ adjusted CB (line R), use line R
If MV (line T) ≤ adjusted RCB (line S), use line S
If adjusted RCB (line S) < MV (line T) < adjusted CB (line R), use line T

	Interest 1	Interest 2	Interest 3	$
Result **for each membership interest (sum is entry ACA step 1 amount)**	170			**170**

ACA step 2: Add liabilities of the joining entity at the joining time

Gamma's only liability is for income tax. No reductions or adjustments are required. There are no employee shares, no non-membership equity interests issued by Gamma and no debt interests that are regarded as equity for general accounting purposes.

Worksheet: Step 2 – Add liabilities etc.

	$ Liability 1	$ Liability 2	$ Subtotals	$
				Cfwd 170
Accounting liabilities				
Start with statement of financial position	3			
Adjust where liability valued differently for group – subsection 705-70(1A)				
Reduce to $nil if attached to an asset				
Reduce for future income tax deductions				
Reduce for intragroup debt (add back reductions under section 165-115ZA(3) before comparison)				
Adjust for unrealised gains or losses				
Sum of reduced or adjusted amounts	3		3	
Add for employee shares				
MV of disregarded shares				
Reduce by reduction amount				
Add for non-membership equity interests				
Add amount received from third parties from the issue of non-membership equity interests				
Add equity treated as debt				
Add market value of equity for accounting but debt for tax purposes (under debt/equity rules)				
Step 2 amount				
Sum of the sub-totals				3
Entry ACA result after step 2				**173**

ACA step 3: Add undistributed profits which accrued to the group

As Alpha elects to consolidate from 1 July 2002 (i.e. in the transitional period and before 1 July 2003), and Gamma is a wholly-owned subsidiary on that date, the transitional rule for ACA step 3 applies → former section 701-30, IT(TP)A 1997. All accrued undistributed profits are included.

Gamma has a profit of $7 in the latest year that it is entitled to distribute in a fully franked form. No losses are recouped. During that year, Alpha indirectly owns 60% of Gamma, so the amount that accrues to Alpha is $4.

Worksheet: Step 3 – Add undistributed profits accrued to the group

	$	$
		Cfwd 173
Ongoing rule		
Add undistributed *frankable* profits accrued to group at the JT	4	
and		
Transitional rule For subsidiaries that are non-chosen transitional entities and the transitional group has consolidated before 1 July 2003 or has consolidated on or before the first day of the head company's income year that started after 30 June 2003 and before 1 July 2004.		
Add *all* undistributed *unfrankable* profits accrued to group at the joining time	0	4
Entry ACA result after step 3		**177**

ACA step 3A: Adjust for pre-joining time rollovers from a foreign resident company or the company that became the head company

Step 3A is not applicable as there have not been any rollovers.

ACA step 4: Subtract certain distributions and certain undistributed profits

Step 4 is not applicable. There are no actual distributions of profits and no undistributed unfrankable profits on hand at the joining time.

ACA step 5: Subtract unused tax losses that accrued to the head company

Step 5 is not applicable, as the unused net capital loss accrued before Alpha acquired an indirect interest in Gamma.

ACA step 6: Subtract for tax benefit from transferred tax losses not accrued to the group

For the purposes of the case study, it is assumed that Gamma satisfies the modified same business test for the purpose of transferring losses to the head company. Accordingly, $10 in net capital losses is transferred to the head company.

Worksheet: Step 6 – Subtract for tax benefit from transferred losses not accrued to group

			Cfwd $177
Transferred losses of any sort that did not accrue to the group	$10		
Less those losses to the extent that their transfer has been cancelled	$0	$10	
Multiply by the general company tax rate		30%	$3
Entry ACA result after Step 6			**$174**

ACA step 7

There are no inherited deductions so no amount is subtracted at step 7.

ACA step 8

The entry ACA is $174.

Steps B, C and D

First determine the tax cost setting amount for the retained cost base assets. Cash is Gamma's only retained cost base asset. The amount is $100.

The remainder of the ACA, after deducting the sum of the tax cost setting amounts for retained cost base assets, is $74. This is allocated to Land 2, which is the only reset cost base asset. There are no excluded assets.

Intragroup transactions ignored

After consolidation, the group decides to sell 40% of its interest in Land 2, by having Beta sell 40% of its shares in Gamma. Before doing so, Gamma pays its income tax debt of $3, and then transfers its remaining cash of $97 to Beta. The latter transaction is ignored for income tax purposes.

Exit from a consolidated group

Beta sells 40% of its shares in Gamma for $40, reflecting the $100 market value of the underlying asset, Land 2. As Gamma is no longer a wholly-owned member of the group it is treated as having left the group. Alpha is taken to have acquired all of the membership interests in Gamma just before the leaving time, for an amount equal to the cost of the assets leaving the group with Gamma, reduced by Gamma's liabilities. Section 711-20 of the ITAA 1997 lists other adjustments that are relevant in more complex cases. See also the high-level worked example of the cost setting process on exit → C2-2-210.

The only asset leaving with Gamma is Land 2, with a cost base of $74 (calculated above). There are no liabilities. Alpha is taken to have acquired the membership interests (200 shares) for a total of $74 (37 cents per share). The cost base of the 40% sold is $30 (80 shares x 37 cents, rounded), and Alpha has made a net capital gain of $10 ($40 less $30).

As a consequence of the exit history rule, the asset that Gamma takes with it from Alpha (the head company) will have the same cost for tax purposes as it did for Alpha at the time Gamma leaves the group – that is, the cost base of Land 2 will still be $74.

Background information

Beta Pty Ltd

Table 10: Beta – profit & loss ($)

30.6.01	Plant depreciation	20	30.6.01	Trading account	500
30.6.01	Running expenses	200			
30.6.01	Income tax expense	92			
30.6.01	Deferred tax liability	3			
	Net profit	185			
		500			500
30.6.02	Plant depreciation	18	30.6.02	Trading account	700
30.6.02	Running expenses	250			
30.6.02	Income tax expense	127			
30.6.02	Deferred tax liability	2			
	Net profit	303			
		700			700

Table 11: Beta – income tax expense ($)

30.6.01	Cash	92	30.6.01	P&L	92
		92			92
30.6.02	Cash	127	30.6.02	P&L	127
		127			127

Note: Income tax expense for 2000–01 calculated as follows:

Assessable income		
Sales		800
Increase in trading stock		400
		1,200
Less: allowable deductions		
Purchases	700	
Running expenses	200	
Plant depreciation	30	930
Taxable income		**270**

Depreciation plant: cost $200 x 15% = 30

(Adjustable value cfwd = $170)

Income tax payable for 2000–01 is $92 ($270 x 34%).

Note: Income tax expense for 2001–02 calculated as follows:

Assessable income		
Sales		1,100
		1,100
Less: allowable deductions		
Purchases	350	
Decrease in trading stock	50	
Running expenses	250	
Plant depreciation	26	676
Taxable income		**424**

Depreciation plant: adjustable value $170 x 15% = 26

(Adjustable value cfwd = $144)

Income tax payable for 2001–02 is $127 ($424 x 30%).

Table 12: Beta – franking account for imputation purposes

		Debit $	Credit $	Balance
1 July 2000	Opening balance			0
30 June 2001	Payment of tax for 2000-01 (tax 92 x 66/34)		178	178 CR
30 June 2001	Closing balance			178 CR
1 July 2001	Opening balance			178 CR
1 July 2001	**Conversion of Class C A/C to new 30% tax rate**		317	317 CR
	Cancelling existing balance	178		
	Reinstating credit at new rate (178 x 34/66 x 70/30)		214	214 CR
30 June 2002	Payment of tax for 2001-02 (tax 127 x 70/30)		296	510 CR
30 June 2002	Closing balance (actual)			510 CR

Table 13: Beta – deferred tax liability ($)

30.6.01	Balance cfwd	3	30.6.01	P&L	3
		3			3
			1.7.01	Balance bfwd	3
30.6.02	Balance cfwd	5	30.6.02	P&L	2
		5			5
			1.7.02	Balance bfwd	5

***Note*: Deferred tax liability 2000–01.** The temporary difference between the carrying value of plant ($180) and its tax base ($170) multiplied by the tax rate (34%) results in a deferred tax liability of $3.

Deferred tax liability 2001–02. The temporary difference between the carrying value of plant ($162) and its tax base ($144) multiplied by the tax rate (30%) results in a deferred tax liability of $5. The liability needs to be increased by $2.

For the sake of simplicity, changes in the market value of other assets have not been reflected in the accounts for the purposes of this worked example.

Gamma Pty Ltd

Table 14: Gamma – profit & loss ($)

30.6.01	Loss on sale of asset	10	30.6.01	Net loss for year	10
		10			10
30.6.02	Running costs	10	30.6.02	Agistment income	20
30.6.02	Income tax	3			
	Net profit	7			
		20			20

Note: There is no tax effect accounting for the loss on sale of Land 3, as Land 2 still has a market value of $100, so we cannot say it is probable that there will be a future taxable amount against which this entity could offset the net capital loss.

Note**: Income tax expense for 2001–02 calculated as follows:**

Assessable income		
Agistment income		20
		20
Less: allowable deductions		
Running expenses	10	10
Taxable income		**10**

Income tax payable for 2001–02 is $3 ($10 x 30%).

References

Income Tax Assessment Act 1997, section 701-80; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2

Income Tax Assessment Act 1997, sections 705-35, 705-45, 705-50 and 995-1; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2
- *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 6

Income Tax Assessment Act 1997, section 705-145; as amended by *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 3

Income Tax Assessment Act 1997, section 705-160; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003)

Income Tax Assessment Act 1997, section 711-20; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2

Income Tax (Transitional Provisions) Act 1997, former section 701-30; as amended by:

- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 7
- *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 5
- *Tax Laws Amendment (2010 Measures No.1) Act 2010* (No.56 of 2010), Schedule 5, Part 15

Income Tax (Transitional Provisions) Act 1997, sections 701A-1 & 701A-5; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 9

Income Tax (Transitional Provisions) Act 1997, sections 701-1 and 701-5; as amended by *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 7

Explanatory Memorandum to New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraph 5

Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, paragraphs 5.61 to 5.71

Income Tax (Transitional Provisions) Act 1997, section 701-32; as inserted by *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1, Part 9

Income Tax Assessment Act 1997, subsection 705-90(6); as substituted by *Tax Laws Amendment (2004 Measures No. 7) Act 2005* (No. 41 of 2005), Schedule 6, Part 3

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004, paragraphs 1.156 – 1.162

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 7) Bill 2004, paragraphs 6.24 – 6.29

Income Tax Assessment Act 1997, sections 705-60, 705-93, 705-147, 705-227 and subsection 995-1(1) as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 5

Income Tax Assessment Act 1997, subsection 705-70(1); as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 8

Income Tax Assessment Act 1997, subsection 705-85(3); as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 20

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5

Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006 (No. 101 of 2006), which repealed:

- section 701-30 of the *Income Tax (Transitional Provisions) Act 1997*, and
- sections 46, 46A and 160ZK of the *Income Tax Assessment Act 1936*

Revision history

Section C2-2-110 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on recent and proposed changes to consolidation rules, p. 2.	Recent and proposed legislative amendments.
26.10.05	Changes to figure 1, worksheets for steps 2 and 3 and references, pp. 1, 7, 15, 16.	Legislative amendments.
12.9.06	Change to worksheet step 3 for Betta, p. 8.	Legislative amendment.
15.11.06	Updated references to inoperative provisions.	Legislative amendment.
26.6.07	Note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used, and to the cost setting rules to phase out over-depreciation deductions, p. 22.	Reflect announcement on 8 May 2007 by Assistant Treasurer in media release no. 50.
6.5.11	References to non-membership equity interests, figure 1. Minor changes to reflect new wording regarding the recognition of liabilities. Removal of note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used, and to the cost setting rules to phase out over-depreciation deductions. Minor changes to reflect changed wording in former section 705-50. Changes made to reflect changes to the transitional concession for substituted accounting periods made to former subsection 701-30(1) of the IT(TP)A 1997.	Legislative amendments.

High-level worked example

Consolidated group joins another consolidated group

Description

This high-level example shows how a consolidated group joining another consolidated group (group to group) is treated like a single entity joining a consolidated group. It also illustrates one of the more complex group-to-group modifications to the basic case cost setting process, for over-depreciated assets (step D).

Commentary

When a consolidated group is acquired by another consolidated group the core rules provide that the head company of the acquired group is treated as a single entity joining the acquiring consolidated group → Subdivision 705-C, *Income Tax Assessment Act 1997* (ITAA 1997). The subsidiary members of the acquired group are treated as parts of the head company of that group, and their assets (other than intragroup membership interests) as assets of that head company. This is achieved by way of modifications to the basic case. → section 705-185, ITAA 1997

One of the more complex modifications to the basic rules relates to the adjustment for over-depreciation of assets in joining entities (step D of the cost setting process). This ensures that the tax cost setting amount is not inappropriately reduced for over-depreciated assets brought into the acquired group by an entity on joining. There is no reduction for over-depreciation to the extent that rebatable dividends paid out of profits sheltered from tax by the over-depreciation have not left the acquired group. → section 705-190, ITAA 1997

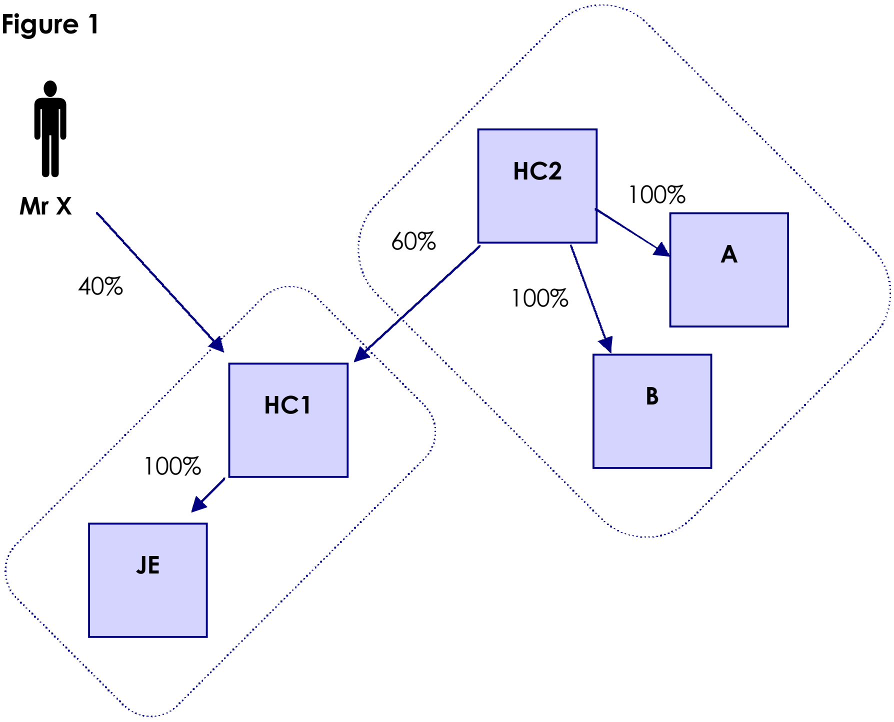
There is no modification where an over-depreciated asset was, just before the acquired group's time of consolidation, held by the head company of that group, and is still over-depreciated at the time the acquired group becomes part of the acquiring group. This is because section 705-50 of the ITAA 1997 applies appropriately to such assets.

Note, however, that the over-depreciation provisions in the tax cost setting rules have been modified for an entity that becomes a member of a consolidated group between 9 May 2007 and 30 June 2009. In this case the head company will only need to look at five years of dividend history immediately before the joining time to determine whether an over-depreciation adjustment is required in relation to the joining entity's asset. Effective from 1 July 2009, the over-depreciation adjustment in section 705-50 has been repealed so it will no longer apply to over-depreciated assets of entities that become subsidiary members of a consolidated group on or after that date.
→ *Tax Laws Amendment (2010 Measures No.1) Act 2010* (No.56 of 2010)

Example

Facts

Figure 1



On 1 July 2000, HC1 and JE are incorporated, with JE as a wholly-owned subsidiary of HC1. HC2 owns 60% of the shares in HC1. Mr X (an unrelated 3rd party) owns the other 40% of shares. Just after incorporation on 1 July 2000 the companies' financial positions are as follows:

Table 1: HC1 – financial position at 1 July 2000

Cash	200	Equity	800
Asset 1 (MV 200, AV 200)	200		
Shares in JE (MV 400)	400		
	800		800

Table 2: JE – financial position at 1 July 2000

Asset 2 (MV 400, AV 400)	400	Equity	400
	400		400

During the first year, HC1 makes a net profit after tax of $53. Of this an amount of $20 is sheltered from income tax due to over-depreciation. No provision is made for any future tax liability. HC1's taxable income is $50. Its financial position is as shown in table 3.

Table 3: HC1 – financial position at 30 June 2001

Cash	290	Equity	800
Asset 1 (MV 180, AV 160)	180	Provision for dividend	53
Shares in JE (MV 780)	400	Provision for income tax	17
	870		870

After a year of trading, JE makes a net profit after tax of $364. Of this an amount of $100 is sheltered from income tax due to over-depreciation. JE's taxable income is $400. No provision is made for future tax liability. JE's financial position is as follows:

Table 4: JE – financial position at 30 June 2001

Cash	600	Equity	400
Asset 2 (MV 300, AV 200)	300	Provision for dividend	364
		Provision for income tax	136
	900		900

During the year ending 30 June 2002, HC1 pays all of its profits for the previous year ($53) as a dividend to its shareholders. The dividend consists of a franked component of $40 and $13 paid as an unfranked dividend that relates solely to profits sheltered from tax due to over-depreciation. HC2 retains the unfranked portion of the dividend it receives. HC1's financial position at 30 June 2002 is as follows:

Table 5: HC1 – financial position at 30 June 2002

Cash	684	Equity	800
Asset 1 (MV 160, AV 120)	160	Accumulated profits	426
Shares in JE (MV 640)	400	Provision for income tax	18
	1,244		1,244

During the year ending 30 June 2002, JE pays all of its profits for the previous year ($364) as a dividend to HC1. The dividend consists of a franked component of $317 and $47 paid as an unfranked rebatable dividend that relates solely to profits sheltered from tax due to over-depreciation. HC1 retains this dividend. JE's financial position at 30 June 2002 is as follows:

Table 6: JE – financial position at 30 June 2002

Cash	500	Equity	400
Asset 2 (MV 200, AV 0)	200	Profit after income tax	240
		Provision for income tax	60
	700		700

HC1 and JE form a consolidated group

HC1 forms a consolidated group with JE on 1 July 2002. The group's financial position is unchanged from 30 June 2002. JE held an over-depreciated asset with a market value (MV) of $200 but a nil adjustable value (AV) at the formation time.

When a consolidated group forms, the tax costs of assets owned by the head company are not set. However, the tax costs of assets of subsidiaries are set under the asset cost setting rules, unless the head company is eligible to choose to retain existing tax costs and chooses to do so. HC1 chooses not to retain existing tax costs for JE, and the tax cost setting rules will apply.

HC1 begins by calculating the entry allocable cost amount (ACA) for JE as shown in the following section.

Calculation – setting the tax costs of JE's assets

A: Calculate entry ACA for JE

ACA step 1: Add up the cost of each membership interest

HC1 owns 100% of membership interests in JE from the date of incorporation to date of formation. JE is incorporated for $400 on 1 July 2000, and the market value of HC1's interests at 1 July 2002 is $640 (Interest 1 in the following worksheet). There are no outstanding cost base adjustments for membership interests, such as for earlier value shifting or loss transfers.

→ subsection 705-65(3), ITAA 1997; and Explanatory Memorandum to New Tax System (Consolidation) Bill (No.1) 2002, paragraph 5.60

Worksheet: Step 1 – Add up the cost of each membership interest

		$ Interest 1	$ Interest 2	$ Interest 3	$
P	Cost base (CB) at the joining time or formation time (JT) (Note: cost of pre-CGT interests not indexed)	400			
Q	Reduced cost base (RCB) at JT (ignoring reductions for rebatable dividends: former section 160ZK(5) ITAA 1936 or section 110-55(7) ITAA 1997), and adding back any adjustments under section 165-115ZA(3) ITAA 1997 to the extent the relevant losses will reduce ACA under steps 5 & 6)	400			
R	CB (line P) as adjusted for value shifting or loss transfer	400			
S	RCB (line Q) as adjusted for value shifting or loss transfer, or section 165-115ZD ITAA 1997	400			
T	Market value (MV) at the joining time	640			
	Tests: If MV (line T) ≥ adjusted CB (line R), use line R If MV (line T) ≤ adjusted RCB (line S), use line S If adjusted RCB (line S) < MV (line T) < adjusted CB (line R), use line T				
	Result **for each membership interest (sum is entry ACA step 1 amount)**	400			**400**

ACA step 2: Add liabilities of the joining entity at the joining time

The provision for income tax is shown as Liability 1. No reductions or adjustments are required. There are no employee shares, no non-membership equity interests issued by JE and no debt interests that are regarded as equity for general accounting purposes.

Worksheet: Step 2 – Add liabilities etc.

	$ Liability 1	$ Liability 2	$ Subtotals	$
				Cfwd 400
Accounting liabilities				
Start with statement of financial position	60			
Reduce where liability valued differently for group				
Reduce to $nil if attached to an asset				
Reduce for future income tax deductions				
Reduce for intra-group debt (add back reductions under section 165-115ZA(3) before comparison)				
Adjust for unrealised gains or losses				
Sum of reduced or adjusted amounts	60		60	
Add for employee shares				
MV of disregarded shares				
Reduce by reduction amount				
Add for non-membership equity interests				
Add amount received from third parties from the issue of non-membership equity interests				
Add equity treated as debt				
Add market value of equity for accounting purposes but debt for tax purposes (under debt/equity rules)				
Step 2 amount				
Sum of the sub-totals				60
Entry ACA result after step 2				**460**

ACA step 3: Add undistributed profits which accrued to the group

As HC1 elects to consolidate from 1 July 2002, in the first year of the two-year transitional period, and JE is a wholly-owned subsidiary on that date, the transitional rule for ACA step 3 applies → former section 701-30, *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A 1997). All undistributed profits accrued to the group are included.

JE has a total of $240 in undistributed profits that would accrue to HC1, of which $100 is unfranked and relates solely to profits sheltered from income tax due to over-depreciation. The balance relates to trading profit that is fully frankable and for which a provision of income tax of $60 is recognised in the accounts.

Worksheet: Step 3 – Add undistributed profits accrued to the group

	$	$
		Cfwd 460
<u>Ongoing rule</u>		
Add undistributed *frankable* profits accrued to group at the JT	140	
and		
<u>Transitional rule</u> For subsidiaries that are non-chosen transitional entities, and the transitional group has consolidated before 1 July 2003 or has consolidated on or before the first day of the head company's income year that started after 30 June 2003 and before 1 July 2004.		
Add *all* undistributed *unfrankable* profits accrued to group at the joining time	100	240
Entry ACA result after step 3		**700**

ACA steps 3A, 4, 5, 6 and 7

Steps 3A, 4, 5, 6 and 7 do not apply.

ACA Step 8

The ACA is $700.

B: Subtract value of JE's retained cost base assets

The ACA amount ($700) less retained cost base assets ($500) results in an ACA balance of $200.

C: Apportion remainder of ACA over remaining assets other than excluded assets

The remainder of the ACA of $200 is to be allocated to the reset cost base asset (Asset 2). However, a further reduction of this amount may be required if the asset is over-depreciated.

D: Adjust the amount for over-depreciated assets

Is the asset over-depreciated?

Worksheet: Is Asset 2 over-depreciated?

	Is an asset over-depreciated? Test for each depreciable asset At the joining time:	Test satisfied?	$ Excess amount
M	Does market value exceed adjustable value?	Yes	200
N	Does the cost exceed adjustable value?	Yes	400
	If the answer is YES to both questions, the asset is over-depreciated by the lesser of M and N		**200**

The market value of $200 exceeds the adjustable value of $0 by $200. The cost of $400 exceeds the adjustable value of $0 by $400. Under both tests for over-depreciation, Asset 2 is over-depreciated.

The tax cost setting amount for an over-depreciated asset is reduced by the lesser of the over-depreciation amount (calculated above), the excess of the tax cost setting amount over its terminating value, and the tax deferral amount (calculated in the following worksheet).

Worksheet: Asset 2 – over-depreciation reduction

			$ amount
	<u>**Test for each over-depreciated asset**</u>		
	Over-depreciation amount		
(a)	Over-depreciation amount from previous table		200
	Tax cost setting amount exceeds terminating value		
(b)	Excess of the tax cost setting amount over its terminating value		200
	Tax deferral amount		
(c)	*Start with* the amount of unfranked dividends paid by the joining entity before the joining time that were subject to the former section 46 or former section 46A rebate	47	
(d)	The amount of the profits paid as dividends in (c) above – (the *qualifying profits amount*) that was not subject to tax because of the over-depreciation of the asset – *but* counts only to the extent it was not counted in ACA step 4 and to the extent the deductions for over-depreciation did not form part of a loss that reduced the ACA under step 5, were not counted in ACA step 4 (but the depreciation did not generate a tax loss to be subtracted from the entry ACA at step 5)	47	
(e)	The extent to which the dividend in (c) – adjusted to amount in (d) – was *not* further distributed (directly or indirectly) to a taxpayer who was *not* entitled to such a rebate. This is the *tax deferral amount*	47	
	Transitional rule on formation		
(f)	*Add* – The tax deferral amount is increased to include any unfrankable *undistributed* profits accrued to head company and included in ACA step 3 (under transitional rules) to the extent that those profits were not subject to tax because of deductions for depreciation representing over-depreciation, and the deductions did not form part of a loss that reduced the ACA under step 5 (former subsection 701-30(3) IT(TP)A)	100	
(g)	Is there a tax deferral amount? How much?	yes	147
	Reduction of tax cost setting amount is the lesser of (a), (b) and (g)		147

The tax cost setting amount for Asset 2 of $200 must be further reduced by $147 to $53.

Further facts

On consolidation, HC1 and JE enter into a tax sharing agreement. JE agrees to pay to HC1 an annual amount based on an estimate of the tax that would have been payable had JE continued to be liable for tax on its income after deductions.

The financial positions of HC1 and JE at 30 June 2003 are as shown in tables 7 and 8.

Table 7: HC1 – financial position at 30 June 2003

Cash	766	Equity	800
Tax sharing agreement right	102	Accumulated profits	488
Asset 1 (MV 140, AV 80)	140	Provision for income tax	120
Shares in JE (MV 831)	400		
	1,408		1,408

Table 8: JE – financial position at 30 June 2003

Cash	833	Equity	400
Asset 2 (MV 100, AV 0)	100	Accumulated profits	431
		Provision for tax sharing	102
	933		933

Group consisting of HC1 and JE is acquired by another consolidated group

HC2 is the head company of an existing consolidated group consisting of itself and A and B (see figure 1). On 1 July 2003, HC2 acquires the remaining 40% of shares from Mr X for $687.60. HC1 is now ineligible to be a head company of a consolidated group as it is now a wholly-owned subsidiary of another company eligible to be a head company. Both HC1 and JE become members of HC2's consolidated group.

However, the cost setting rules are modified to operate as if only the head company of the acquired group joins, and all assets of the acquired group are treated as assets of the old head company for the purpose of setting tax costs of assets. → section 705-185, ITAA 1997

HC2 begins by calculating the entry ACA for HC1 as shown in the following section.

Calculation – setting tax costs of HC1's assets (and those of its member parts as a single entity)

A: Calculate entry ACA for HC1

ACA step 1: Add up the cost of each membership interest

HC2 acquired 60% of membership interests in HC1 on 1 July 2000 when it was incorporated, for an amount of $480 (Interest 1 in the worksheet below). This membership interest has a market value of $1,031 on 1 July 2003. HC2 acquires the remaining 40% on 1 July 2003 for $687.60 (Interest 2 in the worksheet below rounded to $688). There are no outstanding cost base adjustments for membership interests, such as for earlier value shifting or loss transfers.

Worksheet: Step 1 – Add up the cost of each membership interest

		$ Interest 1	$ Interest 2	$ Interest 3	$
P	Cost base (CB) at the joining time or formation time (JT) (Note: cost of pre-CGT interests not indexed)	480	688		
Q	Reduced cost base (RCB) at JT (ignoring reductions for rebatable dividends: former section 160ZK(5) ITAA 1936 or section 110-55(7) ITAA 1997), and adding back any adjustments under section 165-115ZA(3) ITAA 1997 to the extent the relevant losses will reduce ACA under steps 5 & 6)	480	688		
R	CB (line P) as adjusted for value shifting or loss transfer	480	688		
S	RCB (line Q) as adjusted for value shifting or loss transfer, or section 165-115ZD ITAA 1997	480	688		
T	Market value (MV) at the joining time	1,031	688		

Tests: If MV (line T) ≥ adjusted CB (line R), use line R
If MV (line T) ≤ adjusted RCB (line S), use line S
If adjusted RCB (line S) < MV (line T) < adjusted CB (line R), use line T

	Interest 1	Interest 2	Interest 3	
***Result* for each membership interest (sum is entry ACA step 1 amount)**	**480**	688		**1,168**

ACA step 2: Add liabilities of the joining entity at the joining time

The provision for income tax is shown as Liability 1. No reductions or adjustments are required. There are no employee shares, no non-membership equity interests issued by HC1 or JE and no debt interests that are regarded as equity for general accounting purposes.

Worksheet: Step 2 – Add liabilities etc.

	$ Liability 1	$ Liability 2	$ Subtotals	$
				Cfwd 1,168
Accounting liabilities				
Start with statement of financial position	120			
Reduce where liability valued differently for group				
Reduce to $nil if attached to an asset				
Reduce for future income tax deductions				
Reduce for intra-group debt (add back reductions under section 165-115ZA(3) before comparison)				
Adjust for unrealised gains or losses				
Sum of reduced or adjusted amounts	120		120	
Add for employee shares				
MV of disregarded shares				
Reduce by reduction amount				
Add for non-membership equity interests				
Add amount received from third parties from the issue of non-membership equity interests				
Add equity treated as debt				
Add market value of equity for accounting purposes but debt for tax purposes (under debt/equity rules)				
Step 2 amount				
Sum of the sub-totals				120
Entry ACA result after step 2				**1,288**

ACA step 3: Add undistributed profits which accrued to the group

From HC1's franking account, it can be seen that, as at 30 June 2003, $499 is franked and a further $280 would be frankable (provision for income tax $120). (Subsections 705-90(3) and (4) require that a hypothetical adjustment be made to the franking account on the basis that the tax would have been paid by 30 June 2003.) Therefore, HC1's undistributable, frankable profits at the joining time would be $779, of which only $467 (rounded) would accrue to the acquiring group, as HC2 only held 60% interest in HC1 continuously until 1 July 2003.

Worksheet: Step 3 – Add undistributed profits accrued to the group

	$	$
		Cfwd 1,288
Ongoing rule		
Add undistributed *frankable* profits accrued to group at the JT	467	
and		
Transitional rule For subsidiaries that are non-chosen transitional entities, and the transitional group has consolidated before 1 July 2003 or has consolidated on or before the first day of the head company's income year that started after 30 June 2003 and before 1 July 2004.		
Add *all* undistributed *unfrankable* profits accrued to group at the joining time		
Entry ACA result after step 3		**1,755**

ACA steps 3A, 4, 5, 6 and 7

Steps 3A, 4, 5, 6 and 7 do not apply.

ACA Step 8

The ACA is $1,755.

B: Subtract value of JE's retained cost base assets

The ACA amount ($1,755) less the retained cost base asset (Cash $1,599 – i.e. $766 for HC1 and $833 for JE) results in an ACA balance of $156.

C: Apportion remainder of ACA over remaining assets other than excluded assets

The remainder ($156) is then apportioned amongst the reset cost base assets according to their market values. (The intragroup arrangement for tax sharing is ignored as the group is treated as a single taxpayer.)

Table 9: Apportionment according to market value ($)

Reset cost base assets	Terminating value (TV)	Market value (MV)	Apportionment of remainder	Assets held on revenue account - excess over greater of TV or MV	Tax cost setting amount for asset
Asset 1	80	140	91	0	91
Asset 2	0	100	65	0	65
Totals	**80**	**240**	**156**	**0**	**156**

There is no reduction to the tax cost setting amounts under section 705-40 for assets held on revenue account as the amounts do not exceed the greater of the assets' MV or TV.

D: Adjust the amount for over-depreciated assets

The tax cost setting amount for depreciation assets may be further reduced for over-depreciation. Note that no reduction occurred for Asset 1 when HC1 consolidated its group, as the tax costs of HC1's assets were not reset. The tax cost of Asset 2 was reduced when the first group formed; however, now that its tax cost has been reset, it needs to be tested again. → section 705-190, ITAA 1997

Is Asset 1 over-depreciated?

Worksheet: Is Asset 1 over-depreciated?

	Is an asset over-depreciated? Test for each depreciable asset At the joining time:	Test satisfied?	$ Excess amount
M	Does market value exceed adjustable value?	Yes	60
N	Does the cost exceed adjustable value?	Yes	120
	If the answer is YES to both questions, the asset is over-depreciated by the lesser of M and N		**60**

The market value of $140 exceeds the adjustable value of $80 by $60. The cost of $200 exceeds the adjustable value of $80 by $120. Under both tests for over-depreciation, asset 1 is over-depreciated.

The tax cost setting amount for an over-depreciated asset is reduced by the lesser of the over-depreciation amount (calculated above), the excess of the tax cost setting amount over its terminating value, and the tax deferral amount (calculated in the following worksheet).

Worksheet: Asset 1 – over-depreciation reduction

			$ amount
	Test for each over-depreciated asset		
	Over-depreciation amount		
(a)	Over-depreciation amount from previous table		60
	Tax cost setting amount exceeds terminating value		
(b)	Excess of the tax cost setting amount over its terminating value		11
	Tax deferral amount		
(c)	*Start with* the amount of unfranked dividends paid by the joining entity before the joining time that were subject to the former section 46 or former section 46A rebate	0	
(d)	The amount of the profits paid as dividends in (c) above – (the *qualifying profits amount*) that was not subject to tax because of the over-depreciation of the asset – *but* counts only to the extent it was not counted in ACA step 4 and to the extent the deductions for over-depreciation did not form part of a loss that reduced the ACA under step 5, were not counted in ACA step 4 (but the depreciation did not generate a tax loss to be subtracted from the entry ACA at step 5)	0	
(e)	The extent to which the dividend in (c) – adjusted to amount in (d) – was *not* further distributed (directly or indirectly) to a taxpayer who was *not* entitled to such a rebate. This is the *tax deferral amount*	0	
	Transitional rule on formation		
(f)	*Add* – The tax deferral amount is increased to include any unfrankable *undistributed* profits accrued to head company and included in ACA step 3 (under transitional rules) to the extent that those profits were not subject to tax because of deductions for depreciation representing over-depreciation, and the deductions did not form part of a loss that reduced the ACA under step 5 (former subsection 701-30(3) IT(TP)A)	0	
(g)	Is there a tax deferral amount? How much?	0	0
	Reduction of tax cost setting amount is the lesser of (a), (b) and (g)		0

Note: Although the HC1 had made a distribution of unfranked dividends before the joining time, that amount was not subject to the former section 46 or former 46A rebate and would therefore not be counted at (c) above.

Asset 1's tax cost setting amount of $91 is accordingly not reduced.

Is Asset 2 over-depreciated?

Worksheet: Is Asset 2 over-depreciated?

	Is an asset over-depreciated? Test for each depreciable asset At the joining time:	Test satisfied?	$ Excess amount
M	Does market value exceed adjustable value?	Yes	100
N	Does the cost exceed adjustable value?	Yes	400
	If the answer is YES to both questions, the asset is over-depreciated by the lesser of M and N		**100**

The market value of $100 exceeds the adjustable value of $0 by $100. The cost of $400 exceeds the adjustable value of $0 by $400. Under both tests for over-depreciation, asset 2 is over-depreciated.

The tax cost setting amount for an over-depreciated asset is reduced by the lesser of the over-depreciation amount (calculated above), the excess of the tax cost setting amount over its terminating value, and the tax deferral amount (calculated in the following worksheet).

Worksheet: Asset 2 – over-depreciation reduction

			$ amount
	Test for each over-depreciated asset		
	Over-depreciation amount		
(a)	Over-depreciation amount from previous table		100
	Tax cost setting amount exceeds terminating value		
(b)	Excess of the tax cost setting amount over its terminating value		65
	Tax deferral amount		
(c)	*Start with* the amount of unfranked dividends paid by the joining entity before the joining time that were subject to the former section 46 or former section 46A rebate	0	
(d)	The amount of the profits paid as dividends in (c) above – (the *qualifying profits amount*) that was not subject to tax because of the over-depreciation of the asset – *but* counts only to the extent it was not counted in ACA step 4 and to the extent the deductions for over-depreciation did not form part of a loss that reduced the ACA under step 5, were not counted in ACA step 4 (but the depreciation did not generate a tax loss to be subtracted from the entry ACA at step 5)	0	
(e)	The extent to which the dividend in (c) – adjusted to amount in (d) – was *not* further distributed (directly or indirectly) to a taxpayer who was *not* entitled to such a rebate. This is the *tax deferral amount*	0	
	Transitional rule on formation		
(f)	*Add* – The tax deferral amount is increased to include any unfrankable *undistributed* profits accrued to head company and included in ACA step 3 (under transitional rules) to the extent that those profits were not subject to tax because of deductions for depreciation representing over-depreciation, and the deductions did not form part of a loss that reduced the ACA under step 5 (former subsection 701-30(3) IT(TP)A)	0	
(g)	Is there a tax deferral amount? How much?	0	0
	Reduction of tax cost setting amount is the lesser of (a), (b) and (g)		0

Note: Although JE paid an unfranked rebatable dividend of $47 to HC1 on 31 October 2001, this dividend is not counted at step (d) above, because it was not distributed outside the first consolidated group and the modification in section 705-190 applies.

Asset 2's tax cost setting amount of $65 is accordingly not reduced.

Income tax calculations for HC1

Income tax depreciation schedule for asset 1

Year ended 30 June	Cost	Adjustable value at beginning	Method	Remainder of effective life in years	Tax deduction	Adjustable value at year end
2001	200	200	prime cost	5	40	160
2002	–	160	prime cost	4	40	120
2003	–	120	prime cost	3	40	80
Total	**200**				**120**	

Income tax payable by HC1

Year ended 30 June 2001

Assessable income		100
Allowable deductions		
Expenses	10	
Depreciation of Asset 1	40	50
Taxable income		50

Tax payable $17 ($50 x 34%)

Year ended 30 June 2002

Assessable income	120	
Dividend received	364	484
Allowable deductions		
Expenses	20	
Depreciation of Asset 2	40	60
Taxable income		424

Tax on taxable income $127 (424 x 30%) less dividend rebate $109 (364 x 30%)

Tax payable $18

Year ended 30 June 2003

Assessable income (group income)			
HC1		120	
JE		1,000	1,120
Allowable deductions			
Expenses	of HC1	20	
	of JE	607	
Depreciation:	of Asset 1	40	
	of Asset 2 (AV 0)	53	720
Taxable income			400

Tax payable $120 ($400 x 30%)

General journal entries

DR	Tax sharing agreement right	102	
DR	Income tax expense	18	
	CR Provision for tax		120

HC1's franking account for imputation purposes

		Debit $	Credit $	Balance
1 July 2000	Opening balance			0
30 June 2001	Closing balance			0
1 July 2001	Opening balance			0
31 Aug 2001	Payment of tax for 2000-01 (tax 17 x 70/30)		40	40 CR
30 Sept 2001	Payment of dividend	40		0
31 Oct 2001	Receipt of franked dividend		317	317 CR
30 June 2002	Closing balance			317 CR
1 July 2002	Opening balance			317 CR
31 Aug 2002	Payment by HC1 of tax for 2001-02 (18 x 70/30)		42	359 CR
31 Aug 2002	Payment by JE of tax for 2001–02 (60 x 70/30)		140	499 CR
30 June 2003	Closing balance			499 CR
30 June 2003	Actual balance			499 CR
30 June 2003	**Hypothetical payment** by 30.6.03 of tax for group for 2002–03 (120 x 70/30)		280	779 CR
30 June 2003	**Hypothetical closing balance**			779 CR

Income tax calculations for JE

Income tax depreciation schedule for asset 2

Year ended 30 June	Cost	Adjustable value at beginning	Method	Remainder of effective life in years	Tax deduction	Adjustable value at year end
2001	400	400	prime cost	2	200	200
2002	–	200	prime cost	1	200	0
2003	53*	0	prime cost	0	53	0
Total	**400**				**453**	

* NOTE: Depreciation for 2002-03 would be based on new tax cost for the asset on consolidation. The tax cost setting amount for Asset 2, after reducing for over-depreciation, was $53.

Income tax payable by JE

Year ended 30 June 2001

Assessable income		1,000
Allowable deductions		
Expenses	400	
Depreciation of Asset 2	200	600
Taxable income		400

Tax payable $136 ($400 x 34%)

Year ended 30 June 2002

Assessable income		1,100
Allowable deductions		
Expenses	700	
Depreciation of Asset 2	200	900
Taxable income		200

Tax payable $60 ($200 x 30%)

Year ended 30 June 2003

Notional assessable income		1,000
Notional allowable deductions		
Expenses	607	
Depreciation of Asset 2	53	660
Notional taxable income		340

Notional tax payable $102 ($340 x 30%)

JE's franking account for imputation purposes

		Debit $	Credit $	Balance
1 July 2000	Opening balance			0
30 June 2001	Closing balance			0
1 July 2001	Opening balance			0
31 Aug 2001	Payment of tax for 2000-01 (tax 136 x 70/30)		317	317 CR
31 Oct 2001	Payment of franked dividend	317		0
30 June 2002	Closing balance (actual)			0
30 June 2002	Closing balance (actual)			0
30 June 2002	**Hypothetical payment** by 30/6/02 of tax for 2001–02 (60 x 70/30)		140	140 CR
30 June 2002	**Hypothetical closing balance**			140 CR

References

Income Tax Assessment Act 1997, section 705-50 and subsection 705-65(3); as amended by

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2

Explanatory Memorandum to New Tax System (Consolidation) Bill (No.1) 2002, paragraph 5.60

Income Tax Assessment Act 1997, Subdivision 705-C; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 4

Income Tax (Transitional Provisions) Act 1997, former section 701-30; as amended by:

- New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002 (No. 90 of 2002), Schedule 7
- *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 5

Income Tax Assessment Act 1997, former subsection 701-30 of the IT(TP)A 1997, as amended by *Tax Laws Amendment (2010 Measures No.1) Act 2010* (No.56 of 2010), Schedule 5, Part 15

Income Tax Assessment Act 1997, subsection 705-90(6) as substituted by *Tax Laws Amendment (2004 Measures No. 7) Act 2005* (No. 41 of 2005), Schedule 6, Part 3

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 7) Bill 2004, paragraphs 6.24 – 6.29

Income Tax Assessment Act 1997, section 705-50 and subsection 995-1(1) as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 6

Income Tax Assessment Act 1997, subsection 705-70(1); as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 8

Income Tax Assessment Act 1997, subsection 705-85(3); as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 20

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5

Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006 (No. 101 of 2006), which repealed:

- section 701-30 of the *Income Tax (Transitional Provisions) Act 1997*, and
- sections 46, 46A and 160ZK of the *Income Tax Assessment Act 1936*

Revision history

Section C2-2-120 first published 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
26.10.05	Changes to worksheets pp. 7 and 13, and references.	Legislative amendments.
	Changes to worksheet p. 17	To correct error.
15.11.06	Updated references to inoperative provisions.	Legislative amendment.
26.6.07	Note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used, and to the cost setting rules to phase out over-depreciation deductions, p. 21.	Reflect announcement on 8 May 2007 by Assistant Treasurer in media release no. 50.
6.5.11	References to non-membership equity interests.	Legislative amendments.
	Minor changes to reflect changed wording in 705-70(1).	
	Removal of note regarding proposed changes to clarify both the valuation of liabilities and the accounting principles to be used, and to the cost setting rules to phase out over-depreciation deductions.	
	Minor changes to reflect changed wording in 705-50.	
	Revisions to reflect changes to the transitional concession for substituted accounting periods made to former subsection 701-30(1) of the IT(TP)A 1997.	

High-level worked example

Linked entities join a consolidated group

Description

This high-level example shows how the cost setting rules apply when entities linked by ownership become subsidiary members of an existing consolidated group at the same time. The cost setting process is similar to that on formation. → 'Treatment of assets', C2-1

Commentary

When linked entities join a consolidated group, the basic case cost setting rules are modified in a similar way as in the formation of a consolidated group → Subdivision 705-D, *Income Tax Assessment Act 1997* (ITAA 1997). The modifications illustrated in this case study include:

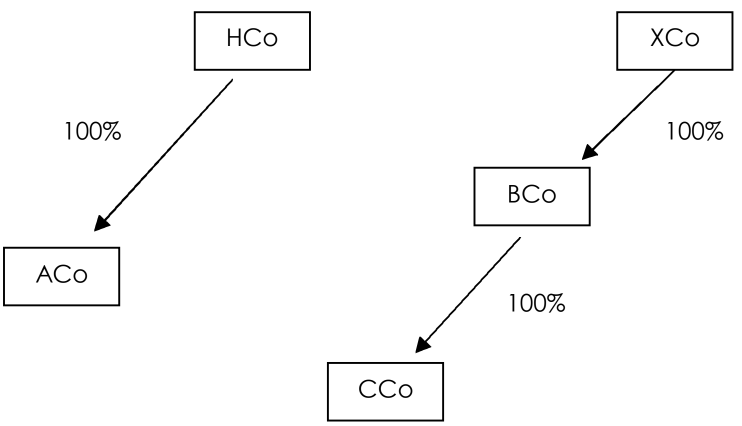
- top-down application of cost setting rules
- adjustment to entry ACA step 4, and
- adjustment to market value of an asset reflecting certain membership interests, for the purpose of allocating the ACA to reset cost base assets.

Example

Facts

On 1 July 2001, XCo capitalises BCo with $200 and BCo capitalises CCo with $200. The only asset in BCo is shares in CCo. The assets in CCo are $100 Cash, as well as Land purchased by CCo on that date for $100.

Figure 1: HCo and other entities



During the year ending 30 June 2002, CCo makes an after tax profit of $100 and distributes a fully franked dividend of $100 to BCo on 30 June 2002.

Table 1: BCo – financial position at 30 June 2002

Cash asset	$100	Equity	$200
Shares in CCo	$200	Profit (after tax)	$100
	$300		$300

Table 2: CCo – financial position at 30 June 2002

Cash asset	$100	Equity	$200
Land	$100		
	$200		$200

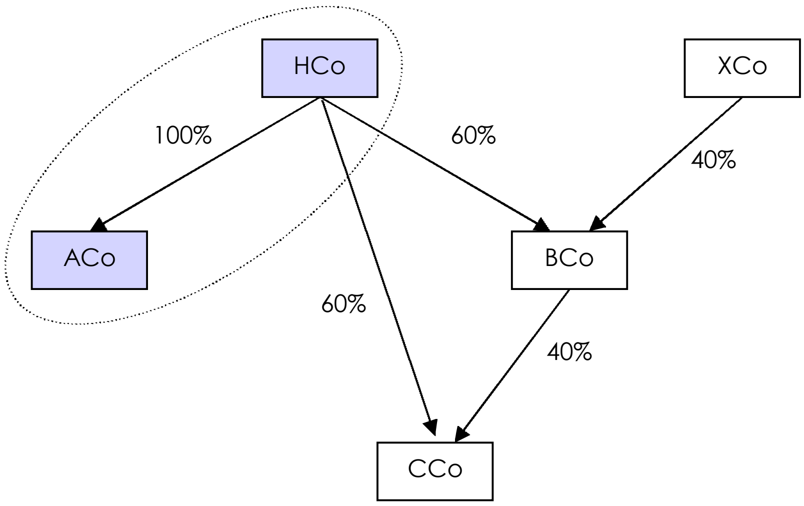
Note: the fully franked dividend of $100 has been paid out to BCo.

Table 3: HCo – financial position at 30 June 2002

Cash asset	$400	Equity	$500
Shares in ACo	$100		
	$500		$500

On 1 July 2002, HCo forms a consolidated group with ACo. At that time, HCo purchases, from BCo, 60 of the 100 ordinary shares in CCo for $120 (market value of $2 per share). On the same day, HCo purchases, from XCo, 60 of the 100 ordinary shares in BCo for $180 (market value of $3 per share).

Figure 2: HCo consolidated group and other entities



On 2 July 2002, BCo distributes its dividend income of $100 (from CCo) to HCo and XCo ($100 for 100 shares = $1 per share). In line with ownership, HCo receives a fully franked dividend of $60 ($1 per share x 60 shares) and XCo receives $40.

Table 4: BCo – financial position at 2 July 2002

Cash asset	$120	Equity	$200
Shares in CCo	$80	Retained Profit	$0
	$200		$200

Note: Cash asset of $120 is the receipt from sale of 60 shares in CCo to HCo. Under the equity method of accounting, BCo's asset reflecting shares in CCo is reduced by $120 to $80.

Table 5: CCo – financial position at 2 July 2002

Cash asset	$100	Equity	$200
Land	$100		
	$200		$200

Table 6: HCo – financial position at 2 July 2002

Cash asset	$160	Equity	$500
Shares in ACo	$100	Profit	$60
Shares in BCo	$120	Loss	($60)
Shares in CCo	$120		
	$500		$500

Note: The Cash asset of $160 includes the $60 fully franked dividend received from BCo. Under the equity method of accounting, HCo's asset reflecting shares in BCo is reduced by $60 to $120.

On 30 June 2003, BCo purchases a machine priced at $40.

For year ended 30 June 2003, CCo makes a trading loss (also tax loss) of $100. Because HCo directly owns 60% of shares in CCo and indirectly owns 24% of shares in CCo (60% ownership of BCo multiplied by BCo's 40% ownership of CCo), $84 of the loss was accrued to the HCo consolidated group.

Table 7: BCo – financial position at 30 June 2003

Cash asset	$80	Equity	$200
Shares in CCo	$40	Loss	($40)
Machine	$40		
	$160		$160

Note: Under the equity method of accounting, BCo's asset reflecting shares in CCo is reduced by $40 to $40 to account for CCo's loss.

Table 8: CCo – financial position at 30 June 2003

Cash asset	$0	Equity	$200
Land	$100	Loss	($100)
	$100		$100

Table 9: HCo – financial position at 30 June 2003

Cash asset	$160	Equity	$500
Shares in ACo	$100	Loss	($60)
Shares in BCo	$120		
Shares in CCo	$60		
	$440		$440

Note: Under the equity method of accounting, HCo's asset reflecting shares in CCo is reduced by $60 to $60 to account for CCo's loss.

On 1 July 2003, HCo purchases 40 shares in BCo for $64 (market value of $1.60 per share x 40 shares) from XCo. Now BCo is 100% owned by HCo and joins HCo's consolidated group on that date. CCo is now also wholly owned by HCo because of HCo's purchase of shares in BCo, and joins the consolidated group at the same time.

Figure 3: HCo consolidated group

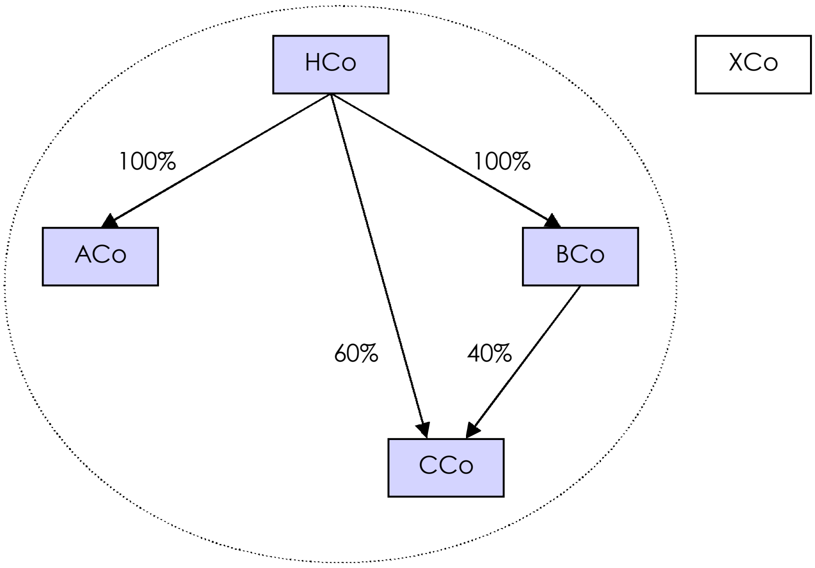


Table 10: BCo – financial position at 1 July 2003

Cash asset	$80	Equity	$200
Shares in CCo	$40	Loss	($40)
Machine	$40		
	$160		$160

Note: Under the equity method of accounting, BCo's asset reflecting shares in CCo is reduced by $40 to $40 to account for CCo's loss.

Table 11: CCo – financial position at 1 July 2003

Cash asset	$0	Equity	$200
Land	$100	Loss	($100)
	$100		$100

Table 12: HCo – financial position at 1 July 2003

Cash asset	$96	Equity	$500
Shares in ACo	$100	Loss	($60)
Shares in BCo	$184		
Shares in CCo	$60		
	$440		$440

Timeline

1.7.01	XCo capitalises BCo and CCo.
30.6.02	CCo distributes $100 fully franked dividend to BCo.
1.7.02	HCo forms a consolidated group. HCo acquires 60% of CCo and 60% of BCo.
2.7.02	BCo successively distributes $100 to XCo and HCo.
30.6.03	CCo makes tax loss of $100 for income year ending 30.6.03.
1.7.03	HCo purchases 40% of BCo from XCo. BCo and CCo join HCo consolidated group.

Calculation – setting tax costs of BCo's assets

Calculate entry ACA for BCo

ACA step 1: Add up the cost of each membership interest

On 1 July 2002, HCo acquires 60 shares in BCo for $3.00 per share. On 1 July 2003, HCo acquires the remaining 40 shares in BCo for $1.60 each. The market value of shares in BCo at the joining time is $1.60 each. → table 10

For the first 60 shares, the step 1 amount for each share is its reduced cost base ($3.00) because the market value is less than the reduced cost base at the joining time. For the next 40 shares, the step 1 amount for each share is its cost base ($1.60) because the market value is equal to the cost base. Assume no adjustment is required to the cost base or reduced cost base. → section 705-65, ITAA 1997

The step 1 amount is: ($3.00 x 60) + ($1.60 x 40) = $244.

ACA steps 2, 3 and 3A

These steps are not applicable in this example because BCo has no liability, undistributed profit or rollovers at the joining time.

ACA step 4

BCo distributes a fully franked dividend of $60 to HCo on 2 July 2002. The profit from which the dividend is paid did not accrue to the HCo consolidated group but instead reflects a return of capital. The amount is subtracted here at step 4 because it is a distribution directly to the head company. → section 705-230, ITAA 1997

The result of step 4 is $244 – $60 = $184

ACA steps 5 and 6

These steps are not applicable in this example because BCo has no tax losses. Therefore, the result after step 6 is $184.

ACA step 7

This step is not applicable as there are no inherited deductions.

ACA step 8

The ACA is $184.

Allocating the ACA to BCo's assets (cost setting process steps B to D)

BCo has a Cash asset of $80 at the joining time, which as a retained cost base asset has a tax cost setting amount of $80. After subtracting $80 from the ACA, the remainder ($104) is allocated to the reset cost base assets according to their market values. → table 13

Table 13: Apportionment to reset cost base assets according to market value

Assets	Market value	Apportionment	Allocated value
Machine	$40.00	40.00 / 114 x $104.00 =	$36
Shares in CCo	$74	74 / 114 x $104.00 =	$68
Total	$114	$104.00	$104.00

Note: The market value of Shares in CCo is increased by BCo's interest in the loss adjustment amount for CCo. BCo's interest in the loss adjustment amount is worked out by dividing the market value of BCo's shares in CCo ($40) by the market value of all shares in CCo ($100), and then multiplying the result by the amount to be included in CCo's ACA calculation under step 5 ($84). The result – i.e. ($40/$100) x $84 = $33.60 – is added to the $40 market value of BCo's shares in CCo = $73.60 (rounded to $74). → section 705-235, ITAA 1997

The cost setting amount for a revenue-like asset cannot exceed the greater of its terminating value or market value. Therefore the tax cost setting amount for the Machine cannot exceed $40 → section 705-40, ITAA 1997. As the tax cost setting amount is less than $40 there is no reduction required at step C. Accordingly there is no consequent excess to reallocate to the remaining reset cost base assets (i.e. the Shares in CCo).

No adjustment is required at step D as BCo has no over-depreciated asset. The tax cost setting amounts for the assets in BCo are $36 for the Machine and $68 for the Shares in CCo.

Calculation – setting tax costs of CCo's assets

Calculate entry ACA for CCo

ACA step 1: Add up the cost of each membership interest

For the 60 shares directly owned by HCo, the step 1 amount is the sum of their reduced cost bases ($2.00 per share x 60 shares = $120.00), because the market value at the joining time ($1.00 per share) is less than the reduced cost base ($2.00 each). → table 11

For the 40 shares owned by BCo, the step 1 amount is the tax cost setting amount just worked out for BCo's asset that reflects shares in CCo ($68).

Therefore, the step 1 amount is $188 ($120 + $68).

ACA steps 2, 3 and 3A

These steps are not applicable in this example because CCo has no liability or undistributed profit or rollovers at the joining time.

ACA step 4

CCo distributes a fully franked dividend of $100 to BCo on 30 June 2002. BCo successively distributes $60 of the dividend income to HCo on 2 July 2002. The profit from which the dividend is paid did not accrue to the HCo consolidated group but instead reflects a return of capital.

However, this amount was paid out of the amount to be deducted under entry ACA step 4 for BCo (BCo made a direct distribution to HCo). The $60 is not reduced under this step for CCo. → section 705-230, ITAA 1997

ACA step 5

CCo has a tax loss of $100. Of this, $84 accrued to HCo because HCo directly and indirectly held 84% – i.e. 60% + (60% x 40%) – of shares in CCo when CCo incurred the loss. Therefore, the step 5 amount is $84.

The result after step 5 is $104 ($188 – $84).

ACA step 6

Assume the tax loss of $100 is transferable to HCo at the joining time. Of this loss, $16 ($100 – $84) did not accrue to the group. Therefore, the step 6 amount is $5 ($16 x 30% company tax rate, rounded to the nearest dollar).

The result after step 6 is $99 ($104 – $5).

ACA step 7

This step is not applicable as there are no inherited deductions.

ACA step 8

The ACA is $99.

Allocating the ACA to CCo's assets

CCo has only one asset, Land, which is a reset cost base asset. Therefore, the tax cost setting amount for Land is $99.

References

Income Tax Assessment Act 1997, section 705-65; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2
- *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedules 3 and 5

Income Tax Assessment Act 1997, Subdivision 705-D, sections 705-210 to 705-235; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 4, and *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 1

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, paragraphs 1.30-1.42

Explanatory Memorandum to New Business Tax System (Consolidation and other measures) Bill (No. 2) 2002, paragraphs 5.53-5.60

Revision history

Section C2-2-130 first published 2 December 2002 and updated 28 May 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

High-level worked example

A trust joins a consolidated group

Description

This high-level example shows how the cost setting process applied to set the tax costs of the assets of an entity joining a consolidated group is modified for a trust, in particular a discretionary trust.

Commentary

Due to inherent differences between trusts and companies, the basic case rules that apply to entry into a consolidated group are modified for trusts so as to achieve a comparable outcome to other entry circumstances → Subdivision 713-A, *Income Tax Assessment Act 1997* (ITAA 1997). Specifically, there are modifications to steps 1 and 3 in the allocable cost amount (ACA) calculation.

Note

Proposed changes to consolidation rules

Proposed changes to the consolidation rules will ensure that cost is allocated to the assets of bare trusts and other trusts with absolutely entitled beneficiaries on joining a consolidated group – see Treasury Position Paper No. 30, *Minor technical amendments* at **www.treasury.gov.au**

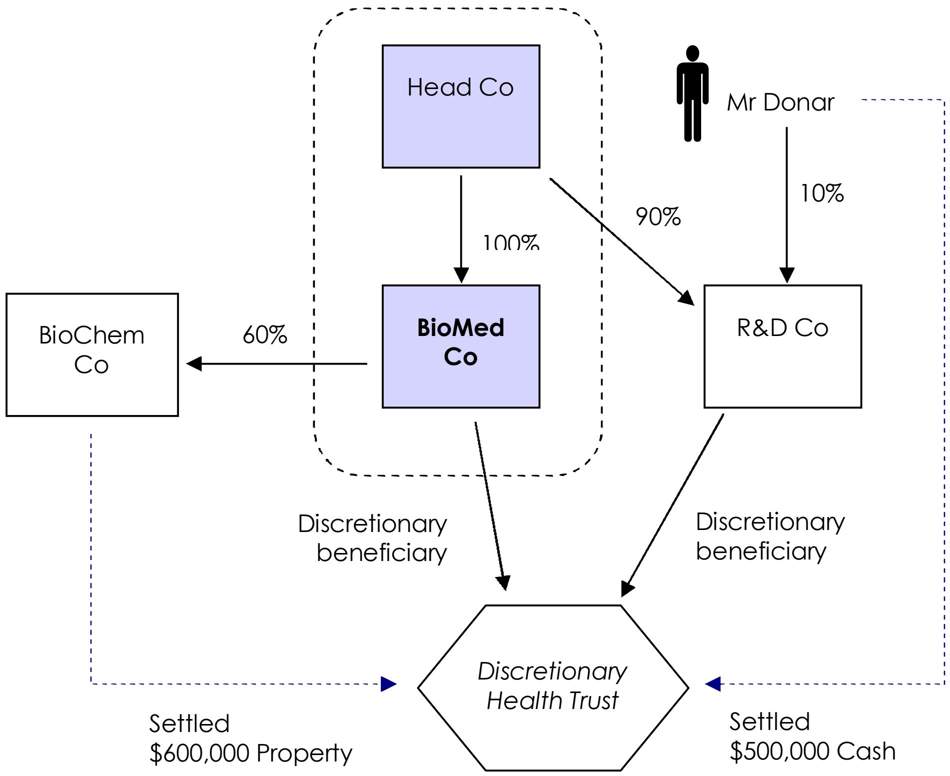
Example

Facts

Head Co is the head company of a consolidated group. BioMed Co is a member of that group. On 1 July 2004, Head Co acquires 90% of the membership interests in R&D Co for $450,000. The other 10% are held by an unrelated taxpayer, Mr Donar. In the same year BioMed Co acquires 60% of the interests in BioChem Co for $600,000.

On 1 July 2005 a discretionary trust known as the Discretionary Health Trust (DH Trust) is created by the settlement of $500,000 cash by Mr Donar and an item of property to the value of $600,000 by BioChem Co. The discretionary beneficiaries of this trust are BioMed Co and R&D Co. Neither company contributes any amount or property to the discretionary trust nor pays any consideration for its beneficial interest in the trust. The corporate structure after the settlement of the trust is shown in Figure 1.

Figure 1: Structure after settlement of Discretionary Health Trust



The trustee of DH Trust chooses to exercise its discretion and distribute all the income derived by the trust in the income year ending 30 June 2006. It distributes 60% of the income to BioMed Co and the remaining 40% to R&D Co. Following the income year ending 30 June 2007, the trustee does not exercise its discretion and so pays tax at the top marginal rate on the $93,458 of taxable income derived by the trust in that year. The trust's realised undistributed profits net of tax amount to $50,000.

R&D Co and DH Trust join the consolidated group

On 1 July 2007, Head Co acquires the remaining 10% of the membership interests in R&D Co for $96,000. As a result, both R&D Co and DH Trust are consolidated into the group, because Head Co now indirectly owns all the membership interests in DH Trust.

When linked entities are joining a consolidated group, the cost setting process is first applied to the top entity in the chain of linked entities (the top-down approach) → section 705-225, ITAA 1997. The tax cost setting amount allocated to the assets that are membership interests in the next entity is included at step 1 of the entry ACA for that entity. → 'Modifications to entry cost setting rules', C2-1-040, and worked example: 'Linked entities join a consolidated group', C2-2-130.

Consequently, the tax cost setting amounts for R&D Co's assets must be determined before DH Trust's ACA can be calculated.

Calculation – setting the tax costs of R&D Co's assets

R&D Co joined the group after it became a discretionary beneficiary of DH Trust. This means a tax cost setting amount will be allocated to the membership interest the company holds in the trust, as follows:

Calculate ACA

For the purpose of this example assume R&D Co has no liabilities, undistributed profits or losses at the joining time. The amount added at step 1 of the entry ACA calculation is $546,000, i.e. $450,000 + $96,000 (10% of $500,000 in assets and $460,000 in market value of discretionary beneficial interests). As no adjustments are made at steps 2 to 7 of the ACA calculation, the ACA for R&D Co is $546,000.

Allocate ACA

R&D Co's assets consist of its interest in the trust and another reset cost base asset with a market value of $500,000. For the purposes of this example assume the market value of R&D Co's membership interest in DH Trust at the joining time is $460,000 – i.e. 40% of the trust's value of $1,150,000 ($500,000 cash + $600,000 property item + $50,000 undistributed after tax profits). The total market value of R&D Co's reset cost base assets is therefore $960,000.

The tax cost setting amount of R&D Co's discretionary membership interest is therefore $261,625 ($460,000/$960,000 x $546,000). The tax cost setting amount for the other reset cost base asset is $284,375 ($500,000/$960,000 x $546,000).

Allocating a tax cost setting amount to R&D Co's membership interest in DH Trust effectively gives the membership interest a cost base. Consequently, the modification to step 1 for trusts does not apply. Instead the amount of $261,625 is added to the DH Trust's ACA step 1 amount under section 705-65 (step 1 of the entry ACA calculation for the basic case).

Calculation – setting the tax costs of DH Trust's assets

Calculate ACA

Step 1 amount

BioMed Co is already a member of the consolidated group when it becomes a discretionary beneficiary of DH Trust. It did not contribute any amount or property to the discretionary trust nor pay any consideration for its beneficial interest. Therefore, the group's membership interest in the trust through BioMed has a nil cost base. Also, BioMed Co acquired the membership interest in the trust because cash and property were settled on the trust. Consequently, the step 1 modification for trusts applies in relation to this membership interest.

The adjustment at step 1 of DH Trust's ACA calculation is determined using the discretionary trust method statement in section 713-20 of the ITAA 1997.

1. Determine the amounts and property settled on the trust at or before the joining time. Exclude those settled amounts and property forming part of the cost base of a membership interest in the trust that have already been added at step 1 under section 705-65 of the ITAA 1997.

   This amount is $838,375 ($500,000 cash + $600,000 property item – $261,625 cost base of R&D Co's membership interest).

2. Determine how much of the amount calculated at 1 would be distributed to BioMed Co if the entire capital and income of the trust had been realised and the trust ended.

   Given the trustee's sole prior pattern of distribution, it is assumed BioMed Co would receive 60% of the cash and property item settled on the trust. This amounts to $660,000 ($1,100,000 x 60%).

3. Reduce the amount from 2 by any amount that would have been included in the assessable income or has been taken into account in working out a capital gain or capital loss of Head Co because BioMed Co was a beneficiary in the discretionary trust.

   The distribution of the capital would not trigger CGT event E4 and the income has already been taxed to the trustee. Accordingly, there is no reduction and the amount remains $660,000.

4. Determine the amounts and market value (as at settlement time) of property settled on DH Trust by the head company and by parties independent of and unconnected to the group.

   – Nothing was settled by the head company.
   – BioMed Co owned 60% of BioChem Co at the time of settlement so could control the company for value shifting purposes → section 727-355, ITAA 1997. Section 713-20(3) therefore requires the property settled by BioChem Co to be excluded when making this calculation.
   – The amount settled by independent parties was $500,000 in cash settled by Mr Donar.

   The amount counted at step 4 of the discretionary trust method statement is therefore $500,000.

5. The amount by which step 1 of DH Trust can be increased is the lesser of the amounts determined at 3. or 4. which is $500,000.

The amount that is added at step 1 of DH Trust's ACA calculation is therefore $761,625 ($261,625 + $500,000).

Step 3 amount

The trust also has $50,000 of realised, taxed, undistributed profits at the joining time. If these profits had been distributed by the trust at the time at which they arose, and assuming the previous pattern of distribution had been maintained, $30,000 would have been distributed to BioMed Co, which was wholly-owned by the group for the whole time in which the profits accrued. R&D Co, however, was only 90% owned by the group during that period. So of the $20,000 that would have been distributed to R&D Co, only $18,000 accrued to the group. The amount added at step 3 is therefore $48,000.

For the purpose of this example assume DH Trust has no liabilities or losses at the joining time. The ACA that can be allocated to DH Trust's assets is therefore:

Step 1	$761,625
Step 2	0
Step 3	$48,000
Step 3A	0
Step 4	0
Step 5	0
Step 6	0
Step 7	0
ACA	$809,625

Assets held by Head Co as a consequence of R&D Co and DH Trust joining the consolidated group are shown in table 1:

Table 1: Assets held by Head Co at 2 July 2007

Asset	Tax value	Market value
Shares in BioChem Co	$600,000	$240,000*
Assets from R&D Co	$284,375	$500,000
Cash from DH Trust	$550,000	$550,000
Other Assets DH Trust	$259,625	$600,000

* 60% of ($1,000,000 capital less $600,000 settled on trust)

References

Income Tax Assessment Act 1997, Subdivision 713-A; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 5

Income Tax Assessment Act 1997, section 705-225; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 4

Income Tax Assessment Act 1997, section 705-65; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2
- *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedules 3 and 5

Income Tax Assessment Act 1997, section 727-355; as amended by *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 15

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No 1) 2002, Chapter 1, paragraphs 1.47 to 1.86

Revision history

Section C2-2-140 first published 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on proposed changes to consolidation rules, p. 1.	Proposed legislative amendments.
28.2.08	Minor corrections to calculations.	Amend calculation errors.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

High-level worked example

Partnership – *all* partners join consolidated group

Description

The cost setting process for a partner joining a consolidated group depends on whether:

- at least one (but not all) of the partners in the partnership joins a particular consolidated group → 'Partnership – *not all* partners join consolidated group', C2-2-155, or
- all partners in the partnership join the same consolidated group.

This high-level example shows how the cost setting process applies to set the tax costs of the partnership assets when all partners in the partnership join the same consolidated group.

Commentary

Due to the characteristics of a partnership, the basic case rules that apply to entry into a consolidated group are modified in the case of a partnership to achieve a comparable outcome to other entry circumstances → Subdivision 713-E, *Income Tax Assessment Act 1997* (ITAA 1997). Specifically:

- A 'partnership cost pool' (PCP) replaces the allocable cost amount (ACA) in the tax cost setting process for the partnership assets. The PCP is worked out based on the sum of all the cost bases or tax costs for all of the partners' fractional interests in the partnership → section 713-210, ITAA 1997. These fractional interests are known as partnership cost setting interests (PCSI) → section 713-210, ITAA 1997.
- If a partner in the partnership joins the consolidated group at the same time as the partnership, the tax cost setting amounts (TCSA) are worked out for the assets of the partner (including PCSIs) before TCSAs are worked out for the assets of the partnership. C2-2-155 'Partnership – *not all* partners join consolidated group' shows how to work out the TCSAs for a partner's assets including the partnership cost setting interests.
- PCSIs in the partnership held by the head company cease to be recognised once the partnership joins the group. Tax costs are set for the partnership's underlying assets, which become the only partnership assets recognised by the head company.

Example

Facts

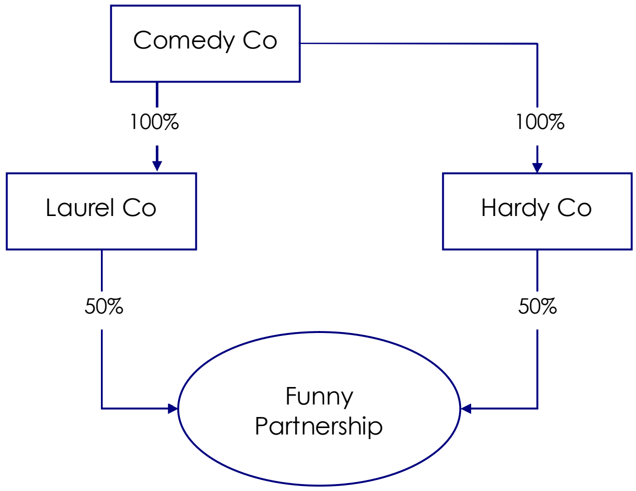
On 1 July 2002, Comedy Co acquires:

- 100% of the shares in Laurel Co, and
- 100% of the shares in Hardy Co.

Comedy Co forms a consolidated group on 1 July 2003. On that date, Laurel Co and Hardy Co each have a 50% interest in the assets of Funny Partnership. As a consequence, all three entities join Comedy Co's consolidated group.

→ figure 1

Figure 1



Funny Partnership has the following assets on 1 July 2003:

- $1,800 cash
- recording studio with a market value and an opening adjustable value at the joining time of $1,500 and a cost of $1,900
- recording equipment with a market value of $700, an opening adjustable value of $500, and a cost of $700.

Before setting the tax costs for Funny Partnership's assets it is necessary to calculate TCSAs for the assets of Laurel Co and Hardy Co (including their PCSIs) by applying the general cost setting rules and the modifications in Subdivision 713-E of the ITAA 1997. This process is required even though the PCSIs in Funny Partnership will not be recognised by Comedy Co and ultimately only the underlying assets of Funny Partnership will be recognised as assets of Comedy Co. C2-2-155 'Partnership – *not all* partners join consolidated group' demonstrates how to calculate the tax costs for Laurel Co and Hardy Co's assets. The TCSA and market value of Laurel Co and Hardy Co's PCSIs in Funny Partnership at the joining time are shown in table 1.

Table 1: TCSAs of the PCSIs of Laurel Co and Hardy Co

Partnership cost setting interest	Market value at 1 July 2003 ($)	TCSA ($)
Laurel Co		
Cash	900	900
Recording studio	750	750
Recording equipment	350	250
Hardy Co		
Cash	900	900
Recording studio	750	750
Recording equipment	350	250

The tax cost of each of Laurel Co and Hardy Co's PCSIs in the assets of Funny Partnership at the joining time is set at the asset's tax cost setting amount → subsection 701-10(4), ITAA 1997.

Calculating the TCSAs for the partnership assets

The tax cost of the partnership assets is set by applying the general cost setting provisions of section 701-10 and Subdivision 705-A of the ITAA 1997 (including any provisions that modify Subdivision 705-A) – as modified by Subdivision 713-E, which contains the special cost setting rules for partners and partnerships. Although this is a formation case, for the purposes of this example the modifications to the basic case for a group formation in Subdivision 705-B of the ITAA 1997 have been disregarded.

The TCSAs for Funny Partnership's assets are worked out as follows:

Step 1

The partnership cost pool (PCP) is worked out by adding up all of the subsection 713-240(2) amounts for all of the partnership cost setting interests in the partnership at the joining time.

Table 2: Working out the subsection 713-240(2) amount

Item	If the market value of the partnership cost setting interest is ...	the subsection (2) amount for the partnership cost setting interest is ...
1	equal to or greater than its cost base	its cost base
2	less than its cost base but greater than its reduced cost base	its market value
3	less than or equal to its reduced cost base	its reduced cost base

In this example, because both the partners join the consolidated group at the same time as the partnership, the cost base of each of the PCSIs in Funny Partnership's assets will equal its TCSA calculated at the joining time.

The PCP calculation is set out in table 3.

Table 3: Working out the partnership cost pool (PCP)

Asset	Market value ($)	Cost base ($)	Subsection 713-240(2) amount ($)
Laurel Co			
PCSI in cash	900	900	900
PCSI in recording studio	750	750	750
PCSI in recording equipment	350	250	250
Hardy Co			
PCSI in cash	900	900	900
PCSI in recording studio	750	750	750
PCSI in recording equipment	350	250	250
Partnership cost pool			**3,800**

The PCP ($3,800) is the sum of all of the subsection 713-240(2) amounts for Laurel Co and Hardy Co.

Note: Where it is necessary to determine the cost base and reduced cost base of a PCSI that the head company held before the partnership joined the group, so as to determine the subsection 713-240(2) amount, it should be assumed for the purposes of that comparison that a CGT event happens at that time → sections 110-25 and 110-55, ITAA 1997.

Step 2

Work out the tax cost setting amounts for the retained cost base assets in accordance with section 705-25 of the ITAA 1997.

The TCSA of Funny Partnership's cash is equal to the amount of Australian currency concerned ($1,800) → subsection 705-25(2), ITAA 1997. This is subtracted from the PCP amount ($3,800). The remaining PCP ($2,000) is allocated to the reset cost base assets.

Step 3

Work out the TCSA for the reset cost base assets in accordance with sections 705-35, 705-40 and 705-45 – as modified by subsection 713-240(3).

Funny Partnership has two reset cost base assets (the recording studio and recording equipment), both of which are depreciating assets.

The remaining PCP ($2,000) is apportioned to the reset cost base assets according to the following formula:

$$\text{PCP} \times \frac{\text{market value of asset}}{\text{total market value of reset cost base assets}}$$

Table 4: Allocation of PCP to Funny Partnership's assets

Asset	Terminating value (TV) ($)	Market value (MV) ($)	PCP apportioned ($)	Assets held on revenue account – excess over greater of TV or MV	TCSA ($)
Recording studio	1,500	1,500	1,364	0	1,364
Recording equipment	500	700	636	0	636
Total	2,000	2,200	2,000	0	2,000

The recording studio and the recording equipment are both depreciating assets. The TCSA for a reset cost base asset that is a depreciating asset must not exceed the greater of its market value and its terminating value → section 705-40, ITAA 1997.

References

Income Tax Assessment Act 1997, Subdivision 713-E; as inserted by *Taxation Law Amendment Act (No. 6) 2003* (No. 67 of 2003)

Revision history

Section C2-2-150 first published 14 July 2004.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

High-level worked example

Partnership – *not all* partners join consolidated group

Description

The cost setting process for a partner joining a consolidated group depends on whether:

- at least one (but not all) of the partners in a partnership joins a particular consolidated group, or
- all partners in the partnership join the same consolidated group

  → 'Partnership – *all* partners join consolidated group', C2-2-150.

This high-level example shows how the cost setting process applies to set the tax costs of the assets of a partner, including interests in the partnership, when *not all* partners join the consolidated group.

Commentary

Due to the characteristics of a partner's interests in the assets of a partnership, the basic case rules that apply to entry into a consolidated group are modified in the case where not all partners join the consolidated group, to achieve a comparable outcome to other entry circumstances → Subdivision 713-E, *Income Tax Assessment Act 1997* (ITAA 1997). Those modifications include:

- The tax cost setting amount is calculated for the partner's fractional interests in the partnership assets. These fractional interests are known as partnership cost setting interests (PCSI) → section 713-210, ITAA 1997. The tax costs for the underlying assets of the partnership are not reset.
- The adjustment for the partnership's over-depreciated assets is made to the allocable cost amount (ACA), *not* to the tax cost setting amount (TCSA) of the PCSI (unlike non-partnership over-depreciation cases, where the adjustment is made to the TCSA of the asset). → subsection 713-225(5), ITAA 1997
- The TCSA of a PCSI in a partnership asset that is trading stock or a depreciating asset is equal to the interest's individual share of the terminating value of the partnership asset (unlike non-partnership trading stock or depreciating assets, which are reset cost base assets). → subsection 713-225(4), ITAA 1997

Example

Facts

On 1 July 2002, Comedy Co acquires 100% of the shares in Laurel Co for $3,050 (the value of net assets). The assets of Laurel Co include a 50% interest in the assets of Funny Partnership. The market value of the net assets of Laurel Co and Funny Partnership at the time of acquisition are:

Table 1: Value of net assets of Laurel Co at 1 July 2002 ($)

	Market value	
Assets		
Cash	50	
Land	500	
Motor vehicle	600	
Interest in partnership	1,900	3,050
Liabilities		nil
Value of net assets		**3,050**

Table 2: Value of net assets of Funny Partnership at 1 July 2002 ($)

	Market value	
Assets		
Cash	2,100	
Recording studio	1,700	3,800
Liabilities		nil
Value of net assets		**3,800**

The financial position of Laurel Co and Funny Partnership at the time of acquisition is as follows:

Table 3: Laurel Co – financial position at 30 June 2002 ($)

Cash	50	Capital	3,050
Land	500		
Motor vehicle	600		
Investment in Funny Partnership	1,900		
	3,050		3,050

Table 4: Funny Partnership – financial position at 30 June 2002 ($)

Cash		2,100	Laurel Co capital	1,900
Studio	cost 1900		Hardy Co capital	1,900
	(acc depn 200)	1,700		
		3,800		3,800

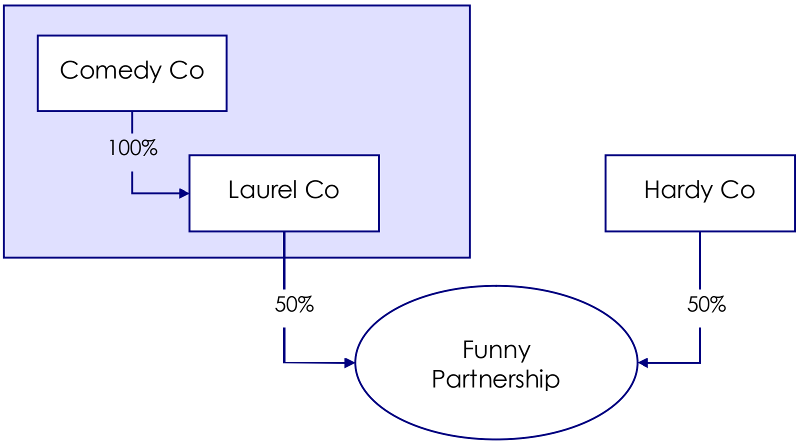
For tax purposes the land has a cost base and reduced cost base of $500 and the motor vehicle has an adjustable value of $600. Funny Partnership's recording studio has an adjustable value of $1,700.

On 1 July 2002 Funny Partnership purchased recording equipment for $700.

Division 40 of the ITAA 1997 (relating to depreciating assets) applies to the recording studio and recording equipment.

Comedy Co and its wholly-owned subsidiary Laurel Co form a consolidated group on 1 July 2003.

Figure 1: Structure of consolidated group



The value of the net assets and the financial position of Laurel Co and Funny Partnership at the formation time are as follows:

Table 5: Value of net assets of Laurel Co at 1 July 2003 ($)

	Market value	
Assets		
Cash	115	
Land	500	
Motor vehicle	500	
Investment in partnership	2,000	3,115
Liabilities	15	15
Value of net assets		**3,100**

Table 6: Value of net assets of Funny Partnership at 1 July 2003 ($)

	Market value	
Assets		
Cash	1,800	
Recording studio	1,500	
Recording equipment	700	4,000
Liabilities		nil
Value of net assets		**4,000**

Table 7: Laurel Co – financial position at 30 June 2003 ($)

Cash	115		
Land	500	Deferred tax liability	15
Motor vehicle	500		
Investment in Funny Partnership	1,950	Capital	3,050
	3,065		3,065

Table 8: Laurel Co – profit & loss for year ended 30 June 2003 ($)

30.6.03	Depreciation expense	100	30.6.03	Income	100
30.6.03	Income tax expense	15	30.6.03	Share of net profit – Funny Partnership	50
30.6.03	Profit cfwd	35			
		150			150
			30.6.03	Profit bfwd	35
30.6.03	Provision for dividend	35			
		35			35

Table 9: Funny Partnership – financial position at 30 June 2003 ($)

Cash		1,800	Laurel Co capital	1,900
Studio	cost 1900		Hardy Co capital	1,900
	(acc depn 400)	1,500	Laurel Co ret. profit	50
Equipment	cost 700		Hardy Co ret. profit	50
	(acc depn 100)	600		
		3,900		3,900

Table 10: Funny Partnership – profit & loss for year ended 30 June 2003 ($)

30.6.03	Depn expense	300	30.6.03	Income	400
30.6.03	Profit cfwd	100			
		400			400
30.6.03	Profit distribution	100	30.6.03	Profit bfwd	100
		100			100

Table 11: Funny Partnership – Profit distribution for year ended 30 June 2003 ($)

30.6.03	Laurel Co ret. profits	50	30.6.03	P&L	100
30.6.03	Hardy Co ret. profits	50			
		100			100

For tax purposes, Funny Partnership's gross income for the year ending 30 June 2003 was $400. The tax deductions claimed for the decline in value of the recording studio and the recording equipment were $200 for each. Funny Partnership's net partnership income for the year ended 30 June 2003 is nil.

For accounting purposes, Funny Partnership's income is also $400 and the depreciation expenses for the recording studio and the recording equipment are $200 and $100 respectively. Net accounting profit before tax is $100.

None of the assets of Laurel Co or Funny Partnership have been revalued in the accounts.

At the formation time, the land has a tax cost base and reduced cost base of $500 and the motor vehicle has an adjustable value for tax purposes of $500. The recording studio and the recording equipment have adjustable values of $1,500 and $500 respectively. The depreciation for tax and accounting purposes is as shown in table 12.

Table 12: Funny Partnership – depreciation schedule ($)

Studio	TAX (effective life = 9.5yrs)		ACCOUNTING (useful life 9.5yrs)	
	cost 1.7.01	1,900	cost 1.7.01	1,900
	y/e 30.6.02	–200	y/e 30.6.02	–200
	adjustable value	1,700	carrying amount	1,700
	y/e 30.6.03	–200	y/e 30.6.03	–200
	adjustable value	1,500	carrying amount	1,500
Equipment	**TAX (effective life = 3.5yrs)**		**ACCOUNTING (useful life 7yrs)**	
	cost 1.7.02	700	cost 1.7.02	700
	y/e 30.6.03	–200	y/e 30.6.03	–100
	adjustable value	500	carrying amount	600

Note: These effective and useful lives have been selected for demonstration purposes only.

Laurel Co paid $35 out as an unfranked dividend to its shareholder, Comedy Co, on 30 June 2003. This dividend was paid out of the $50 profits Laurel Co received from Funny Partnership. Comedy Co received an intercorporate dividend rebate on the unfranked dividend.

Setting the tax cost for the joining partner

The tax cost of the partner's assets is set by applying the general cost setting provisions of section 701-10 and Subdivision 705-A of the ITAA 1997 (including any provisions that modify Subdivision 705-A) – as modified by Subdivision 713-Eof the ITAA 1997, which contains the special cost setting rules for partners and partnerships. Although this is a formation case, for the purposes of this example the modifications to the basic case for a group formation in Subdivision 705-B of the ITAA 1997 have been disregarded.

Calculating the tax cost of partnership cost setting interests

The tax cost of Laurel Co's partnership cost setting interests is worked out as follows:

Working out the ACA for the joining partner

The ACA for a joining partner is allocated among its assets (including those consisting of PCSIs) in accordance with the general cost setting rules, subject to modification to reflect the nature of the joining entity. It has been assumed for this example that Laurel Co is not a chosen transitional entity.

Laurel Co's ACA is worked out using the 8 step process. → figure 1: Cost setting process on formation and entry in C2-1

Step 1 – cost of membership interests: $3,050

For the purposes of this example it is assumed that the market value of Comedy Co's membership interests in Laurel Co is greater than its cost base for the membership interests. The step 1 amount is therefore the cost base of the interests → section 705-65, ITAA 1997.

Step 2 – add liabilities: $15

The temporary difference between the carrying value of Funny Partnership's recording equipment ($600) and its tax base ($500) multiplied by the tax rate (30%) results in a deferred tax liability of $30. Laurel Co, as an equal partner in Funny Partnership, therefore has a deferred tax liability of $15.

The costs that are relevant in determining the net income or loss of the partnership are the tax costs of the underlying assets of the partnership. As the tax costs (tax base) of the underlying assets of the partnership are not reset, the amount of the liability will not be different when it becomes a liability of the group and there is no adjustment under subsection 705-70(1A) of the ITAA 1997.

(No steps 3 to 7 amounts)

Step 8 – total: $3,065

The group's ACA for Laurel Co of $3,065 is allocated to all of its assets, including its PCSIs in the partnership assets.

Determining the terminating value of the PCSI

The terminating value of each of Laurel Co's PCSIs at the joining time is its individual share of the terminating value of each of the partnership's assets → subsection 713-215(2), ITAA 1997. The terminating value of the assets is worked out as if Funny Partnership had joined the consolidated group at the joining time → subsection 713-215(3), ITAA 1997.

Funny Partnership's terminating value for the depreciable assets is equal to their adjustable value just before the joining time. → subsection 705-30(3), ITAA 1997

As the joining time is the beginning of an income year, the opening adjustable value for both depreciating partnership assets will be the adjustable value at the end of the previous income year (that is, just before joining time).
→ section 40-85, ITAA 1997

The terminating values for the PCSIs are:

- for the recording studio, $750 ($1500 x 50% share)
- for the recording equipment, $250 ($500 x 50% share).

Working out the TCSA for PCSIs in a partnership asset that is a depreciating asset

The TCSA for a partnership asset that is a depreciating asset has a special character and its calculation reflects this → Division 705, ITAA 1997. The TCSA:

- is worked out as if the PCSI relating to the asset were a retained cost base asset, and
- is equal to its terminating value (as worked out above).

→ subsection 713-225(4), ITAA 1997

Adjustment to ACA if partnership asset is over-depreciated

Where the joining entity is a partner in a partnership, its ACA is reduced if one or more of the partnership assets are over-depreciated at the joining time → subsection 713-225(5), ITAA 1997. The reduction is worked out in relation to the joining entity's PCSIs in depreciating assets (the reduction interests) → section 713-230, ITAA 1997.

An asset is over-depreciated if it is a depreciating asset to which Division 40 of the ITAA 1997 applies and its:

- market value exceeds its adjustable value, and
- cost exceeds its adjustable value.

→ former subsection 705-50(6), ITAA 1997

The over-depreciation of the asset is the *lesser* of the two excesses (or either of them if they are the same).

→ former subsection 705-50(6), ITAA 1997

The adjustable value of the reduction interest is equal to the partner's individual share of the adjustable value of the underlying partnership asset to which it relates. The cost of the reduction interest is equal to the partner's individual share of the cost of the asset to which it relates → section 713-230, ITAA 1997.

Note: if Laurel Co's non-partnership assets were over-depreciated, the TCSAs of those assets would be reduced – not the ACA.

Note, however, that the over-depreciation provisions in the tax cost setting rules have been modified for an entity that becomes a member of a consolidated group between 9 May 2007 and 30 June 2009. In this case a head company will only need to look at five years of dividend history immediately before the joining time to determine whether an over-depreciation adjustment is required in relation to the joining entity's asset. Effective from 1 July 2009, the over-depreciation adjustment in section 705-50 has been repealed, so it will no longer apply to over-depreciated assets of entities that become subsidiary members of a consolidated group on or after that date. → *Tax Laws Amendment (2010 Measures No.1) Act 2010* (No. 56 of 2010)

First it is necessary to determine whether any of the partnership assets are over-depreciated. As Laurel Co became a member of the group on 1 July 2003, the above-mentioned modifications do not apply.

Worksheet 1: For PCSI in recording studio – is the asset over-depreciated?

	Test for each depreciable asset At the joining time:	Test satisfied? Yes/No	Excess amount ($)
M	Does market value ($750) exceed adjustable value ($750)?	No	0
N	Does the cost ($950) exceed adjustable value $(750)?	Yes	200
	If the answer is YES to both questions, the asset is over-depreciated by the lesser of M and N.		0

The adjustable value of the PCSI in the recording studio is equal to Laurel Co's individual share of the adjustable value of the recording studio, and the cost of the PCSI in the recording studio is equal to Laurel Co's individual share of the cost of the recording studio → section 713-230, ITAA 1997. As the market value does not exceed the adjustable value, the recording studio is not over-depreciated.

Worksheet 2: For PCSI in recording equipment – is the asset over-depreciated?

	Test for each depreciable asset At the joining time:	Test satisfied? Yes/No	Excess amount ($)
M	Does market value ($350) exceed adjustable value ($250)?	Yes	100
N	Does the cost ($350) exceed adjustable value ($250)?	Yes	100
	If the answer is YES to both questions, the asset is over-depreciated by the lesser of M and N.		100

As Funny Partnership's recording equipment is an asset to which Division 40 applies, and both the market value and the cost of the interest exceed its adjustable value, it is an over-depreciated asset. The amount of over-depreciation is $100 (the amount by which either the asset's market value, or the asset's cost, exceeds its adjustable value) → section 713-230, ITAA 1997.

Reduction amount

The amount of the reduction is worked out in accordance with section 705-50 of the ITAA 1997. The cost setting rules are applied without reducing the

ACA for the over-depreciated partnership assets and ignoring the operation of subsection 713-225(4) (PCSIs in depreciating assets of the partnership are treated as reset cost base assets) → section 713-230, ITAA 1997. The sum of all of the over-depreciation adjustments that would otherwise have been deducted from the TCSAs of the PCSIs in over-depreciated assets is subtracted from the ACA to arrive at the final ACA.

TCSAs for partnership cost setting interests are worked out as if the PCSI were an asset of the same kind as the underlying partnership asset → section 713-225, ITAA 1997. The PCSI in the partnership's cash has a TCSA equal to the amount of Australian currency concerned, $900 → section 705-25, ITAA 1997.

Laurel Co's cash is a retained cost base asset with a TCSA equal to the amount of Australian currency concerned, $115 → section 705-25, ITAA 1997.

The TCSAs of the two retained cost base assets ($900 + $115) are subtracted from the ACA ($3,065), leaving $2,050 → section 705-35, ITAA 1997.

The remainder of the ACA ($2,050) is then apportioned among Laurel Co's remaining assets other than excluded assets in proportion to their market values.

Table 13: Initial apportionment of ACA to Laurel Co's reset cost base assets

Asset	Terminating value (TV) ($)	Market value (MV) ($)	ACA apportioned ($)	Assets held on revenue account – excess over greater of TV or MV	TCSA ($)
PCSI - Recording studio	750	750	732	0	732
PCSI - Recording equipment	250	350	342	0	342
Land	500	500	488		488
Motor vehicle	500	500	488	0	488
Total		**2,100**	**2,050**	**0**	**2,050**

The TCSA of a depreciating asset must not exceed the greater of the asset's market value (MV) and the joining entity's terminating value (TV) for that asset. → section 705-40, ITAA 1997

The terminating value for the motor vehicle, a depreciating asset, is equal to its adjustable value just before the joining time ($500) → section 705-40, ITAA 1997. As the TCSA of the motor vehicle ($488) does not exceed the greater of the MV ($500) and the TV ($500), there is no adjustment to the TCSA.

The PCSI in the recording studio and the PCSI in the recording equipment are treated as being depreciating assets → subsection 713-225(2), ITAA 1997. As the TCSA of the PCSI in the recording studio ($732) does not exceed the greater of its MV ($750) and its TV ($750 as worked out above), no adjustment is required under section 705-40 of the ITAA 1997. The greater of the MV ($350) and the TV ($250 as worked out above) of the PCSI in the recording equipment exceeds the TCSA ($342), so there is no adjustment under section 705-40 of the ITAA 1997.

The reduction amount is the least of the over-depreciation amount (calculated above), the excess of the TCSA over its terminating value, and the tax deferral amount (worksheet 3).

Worksheet 3: For recording equipment – over-depreciation reduction of ACA

	Test for each over-depreciated asset	**$**	**$ amount**
	Over-depreciation amount		
(a)	Over-depreciation amount from previous calculation		**100**
	Tax cost setting amount exceeds terminating value		
(b)	Excess of the tax cost setting amount ($342) over its value ($250)		**92**
	Tax deferral amount		
(c)	*Start with* the amount of unfranked dividends paid by the joining entity before the joining time that were subject to the former section 46 or former section 46A rebate	**35**	
(d)	The amount of the profits paid as dividends in (c) above (the *qualifying profits amount*) that were not subject to tax because of the over-depreciation of the asset, *but* count only to the extent they were not counted in ACA step 4 and to the extent the deductions for over-depreciation did not form part of a loss that reduced the ACA under step 5, were not counted in ACA step 4 (but the depreciation did not generate a tax loss to be subtracted from the entry ACA at step 5)	**35**	
(e)	The extent to which the dividend in (c) – adjusted to amount in (d) – was *not* further distributed (directly or indirectly) to a taxpayer who was *not* entitled to such a rebate. This is the *tax deferral amount*	**35**	
	Transitional rule on formation		
(f)	*Add* – The tax deferral amount is increased to include any unfrankable undistributed profits accrued to head company and included in ACA step 3 (under transitional rules) to the extent that those profits were not subject to tax because of deductions for depreciation representing over-depreciation, and the deductions did not form part of a loss that reduced the ACA under step 5 (former subsection 701-30(3), *Income Tax (Transitional Provisions) Act 1997*).	**0**	
(g)	**Is there a tax deferral amount?** How much?	**Yes**	**35**
	Reduction of the ACA is the lesser of (a), (b) and (g).		**35**

The final ACA available for all of Laurel Co's assets (including its interest in the partnership assets) is:

$3,065 – $35 = $3,030

ACA allocation

The final ACA is allocated to Laurel Co's assets (including PCSIs).

The PCSI in the partnership's cash has a TCSA equal to the amount of Australian currency concerned, $900. → section 705-25, ITAA 1997

Laurel Co's cash will also be a retained cost base asset with a TCSA equal to the amount of Australian currency concerned, $115. → section 705-25, ITAA 1997

The PCSIs in the recording studio and in the recording equipment are also retained cost base assets. Each will have a TCSA equal to its terminating value (worked out above) → section 713-225, ITAA 1997. The PCSIs in the recording studio and in the recording equipment will have TCSAs of $750 and $250 respectively.

The amounts of the retained cost base assets ($900 + $115 + $750 + $250 = $2,015) are subtracted from the ACA ($3,030) leaving $1,015. → section 705-35, ITAA 1997

The remainder of the ACA ($1,015) is then apportioned among Laurel Co's remaining assets other than excluded assets in proportion to their market values.

Table 14: Allocation of ACA to Laurel Co's assets ($)

Asset	Terminating value (TV)	Market value (MV)	ACA apportioned	Assets held on revenue account – excess over greater of TV or MV	TCSA
Land	500	500	507.50		515
Motor vehicles	500	500	507.50	7.50	500
Total		**1,000**	**1,015.00**	**7.50**	**1,015**

The TCSA for a depreciating asset is limited to the greater of the asset's market value and the joining entity's terminating value for the asset → section 705-40, ITAA 1997. The TCSA for the motor vehicle, a depreciating asset, is therefore limited to $500. The amount of the reduction ($7.50) is reallocated to the land, which is the only remaining reset cost base asset, to give it a TCSA of $515.

Background information

Table 15: Laurel Co – income tax expense for year ended 30 June 2003 ($)

Funny Partnership net income		
Assessable income		400
Less: allowable deductions		
Depreciation – studio	200	
Depreciation – equipment	200	400
Net partnership income		nil
Laurel Co taxable income		
Assessable income	100	
Less: allowable deductions		
Depreciation – motor vehicle	100	
Taxable income		nil

Note: Deferred tax liability 2002-03

The temporary difference between the carrying value of Funny Partnership's recording equipment ($600) and its tax base ($500) multiplied by the tax rate (30%) results in a deferred tax liability of $30. Laurel Co, as an equal partner in Funny Partnership, therefore has a deferred tax liability of $15.

References

Income Tax Assessment Act 1997, Subdivision 713-E; as inserted by *Taxation Law Amendment Act (No. 6) 2003* (No. 67 of 2003)

Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006 (No. 101 of 2006); which repealed:

- section 701-30 of the *Income Tax (Transitional Provisions) Act 1997*, and
- sections 46 and 46A of the *Income Tax Assessment Act 1936*

Income Tax Assessment Act 1997, section 705-50 and subsection 995-1(1); as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 6

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5

Revision history

Section C2-2-155 first published 14 July 2004.

Further revisions are described below.

Date	Amendment	Reason
15.11.06	Updated references to inoperative provisions.	Legislative amendment.
26.6.07	Note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used, and to phase out over-depreciation deductions, p. 13.	Reflect announcement on 8 May 2007 by Assistant Treasurer in media release no. 50.
30.6.09	Correction to legislative reference.	Correct error.
6.5.11	Removal of note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used, and to phase out over-depreciation deductions. Minor changes to reflect changed wording in former section 705-50.	Legislative amendments.

High-level worked example

The cost setting process on exit

Description

This high-level example shows how the cost setting rules apply when a subsidiary member of a consolidated group leaves the group. The process is shown in the figure below. Some steps in the process are expanded on in worked examples included in this section of the Reference Manual.

Figure 1: Cost setting process on exit

A Calculate leaving entity's ACA (allocable cost amount)

↓

B Allocate the result to each of the membership interests by dividing the result by the number of those membership interests

↓

C If there is more than one class of membership interest in the leaving entity, allocate the ACA to each class in proportion to the market value of all of the membership interests in the class

Market valuation

↓

D Allocate the result to each of the membership interests in the class by dividing the result by the number of those membership interests in the class

↓

= Tax cost setting amounts for the leaving entity's membership interests

Calculating the exit ACA

1. Start with terminating values of the leaving entity's assets just before the leaving time
2. Add certain inherited deductions not reflected in the terminating value of the assets leaving the group
3. Add intragroup liabilities owed to the leaving entity at the leaving time
4. Subtract liabilities and certain interests treated as liabilities for the purpose of this calculation
5. The ACA is the remaining amount (if positive) or nil (if negative)

Commentary

When a subsidiary member (the leaving entity) leaves a consolidated group, the head company recognises for tax purposes, just before the leaving time, the membership interests in the leaving entity. These membership interests are not recognised while the entity is a member of the group. The cost for the membership interests equals the head company's cost for the net assets in the leaving entity just before the leaving time. This preserves the alignment between the costs for membership interests in the entity and its assets.

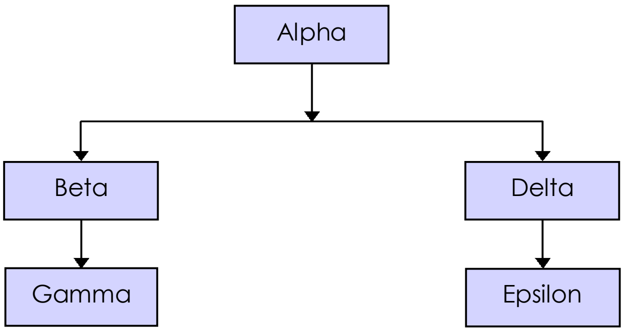
→ 'Treatment of assets', C2-1

Example

Facts

Alpha consolidated group, consisting of Alpha as the head company and Beta and Gamma as subsidiary members, is formed on 1 July 2002. On 30 June 2009, Alpha acquires 100% of Delta (and its wholly-owned subsidiary Epsilon) by paying $10,000 for 1,000 shares, and the consolidated group is structured as follows:

Figure 2: Alpha consolidated group



The financial position of Delta and Epsilon on joining the group is shown in tables 1 and 2.

Table 1: Delta – financial position at 30 June 2009

	Book value	Market value	Cost base	Terminating value
Assets				
Cash	$1,000	$1,000	$1,000	$1,000
Trading stock	$2,000	$2,000	$2,000	$2,000
Land 1	$3,000	$3,000	$3,000	$3,000
Shares in Epsilon	$4,000	$4,000	$4,000	$4,000
Liabilities	$0	$0		
Equity				
500 class A shares	$5,000	$5,000	$5,000	
500 class B shares	$5,000	$5,000	$5,000	

Table 2: Epsilon – financial position at 30 June 2009

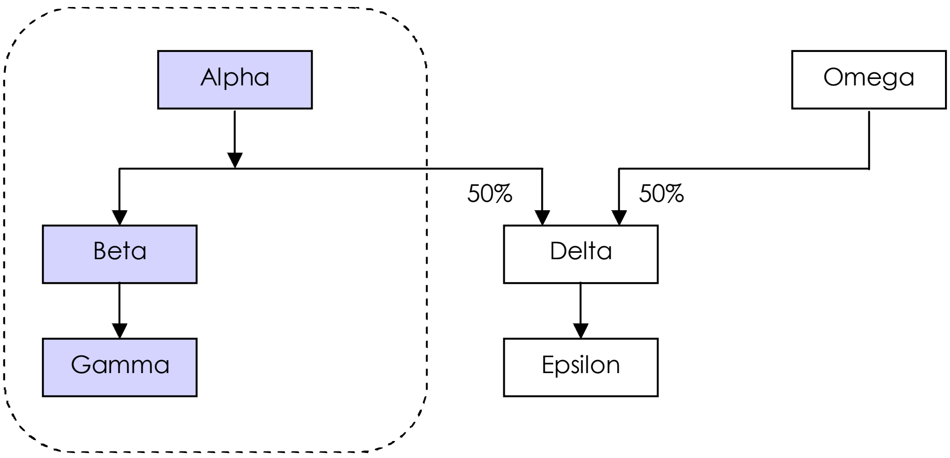
	Book value	Market value	Cost base	Terminating value
Assets				
Cash	$1,000	$1,000	$1,000	$1,000
Land 2	$2,000	$2,000	$2,000	$2,000
Land 3	$1,000	$1,000	$1,000	$1,000
Liabilities	$0	$0		
Equity				
100 shares	$4,000	$4,000	$4,000	

During the 2009–10 income year:

- Delta and Epsilon do not trade
- Delta loans $1,000 to Beta
- Delta borrows $2,000 from Omega on 1 July 2009 (immediately after joining Alpha's consolidated group) and incurs $200 borrowing expenses, and
- Gamma transfers an asset (Land 4) to Delta on 20 August 2009.

On 30 June 2010, Alpha sells 50% of its investment in Delta to Omega, which pays $14.80 for each of 250 Class A shares and $12.80 for each of 250 Class B shares. After the sale, Delta is 50% owned by Alpha and 50% by Omega. As Delta is no longer a wholly-owned subsidiary of Alpha it does not meet the criteria to be a member of the consolidated group. Therefore, Delta leaves the consolidated group on 30 June 2010, along with its wholly-owned subsidiary Epsilon, which (because of the part sale of its sole parent) is no longer wholly owned by the group.

Figure 3: Alpha's consolidated group after part sale of Delta



The financial position of Delta and Epsilon at the time of Delta's part sale is shown in tables 3 and 4.

Table 3: Delta – financial position at 30 June 2010

	Book value	Market value	Cost base	Terminating value
Assets				
Cash	$1,800	$1,800	$1,800	$1,800
Receivables	$1,000	$1,000	–	–
Trading stock	$2,000	$2,000	$2,000	$2,000
Land 1	$3,000	$5,000	$3,000	$3,000
Land 4	$2,000	$2,000	$2,000	$2,000
Shares in Epsilon	$4,000	$4,000	$4,000	$4,000
Liabilities	$2,000	$2,000		
Equity				
500 class A shares	$5,900	$7,400	$5,000	
500 class B shares	$5,900	$6,400	$5,000	

Table 4: Epsilon – financial position at 30 June 2010

	Book value	Market value	Cost base	Terminating value
Assets				
Cash	$1,000	$1,000	$1,000	$1,000
Land 2	$2,000	$2,000	$2,000	$2,000
Land 3	$1,000	$1,000	$1,000	$1,000
Liabilities	$0	$0	$0	
Equity				
100 shares	$4,000	$4,000	$4,000	

Order of application of cost setting

The cost of the membership interests in each of the leaving subsidiaries must be worked out on a 'bottom up' basis, as the membership interests in the lower level entity (which represent an asset of the higher level entity) must be given a cost which is used in turn to calculate the cost of membership interests in the higher level entity → section 711-55, *Income Tax Assessment Act 1997* (ITAA 1997) and Explanatory Memorandum to New Business Tax System (Consolidation) Bill No. 1, paragraph 5.142. Therefore, Alpha must first apply the cost setting rules to Epsilon, before applying them to Delta.

Setting the tax costs of membership interests in Epsilon

A: Calculate exit ACA for Epsilon

ACA step 1: Add up the terminating values of assets in Epsilon just before the leaving time.

Epsilon has three assets just before the leaving time (table 5).

Table 5: Epsilon assets just before the leaving time

	Terminating value
Cash	$1,000
Land 2	$2,000
Land 3	$1,000
	$4,000

ACA step 2: Add certain inherited deductions

As Epsilon does not inherit any deduction from Alpha, no amount is added.

ACA step 3: Add intragroup liabilities owed to Epsilon

As members do not owe any liability to Epsilon, no amount is added.

ACA step 4: Subtract liabilities of Epsilon

As Epsilon has no liability, no amount is subtracted.

Exit ACA Step 5

The ACA is $4,000.

B: Apportion ACA to each class of membership interest

There is only one class of membership interests in Epsilon.

C: Divide ACA by number of membership interests in each class

The tax cost for each share in Epsilon is calculated as:

$$\frac{\$4{,}000}{100 \text{ shares}} = \$40 \text{ per share}$$

Setting tax costs of membership interests in Delta

A: Calculate Delta's exit ACA

ACA step 1: Add up the terminating values of assets in Delta just before the leaving time.

Delta has five assets just before the leaving time (table 6).

Table 6: Delta assets just before the leaving time

	Terminating value
Cash	$1,800
Trading stock	$2,000
Land 1	$3,000
Land 4	$2,000
Shares in Epsilon	$4,000
	$12,800

Note: the receivables of $1,000 is an intragroup debt and is not recognised within a consolidated group.

ACA step 2: Add certain inherited deductions

The borrowing expenditure of $200 incurred by Delta before the leaving time is allowable to the head company Alpha as an income tax deduction apportioned over five years; that is, $40 per year. Alpha claims $40 for the income year ended 30 June 2010, and the remaining $160 of borrowing expenses as yet unclaimed by Alpha becomes available to Delta on leaving the group to be claimed as a tax deduction over the remaining four years.

The step 2 amount is worked out by multiplying all the deductions covered by subsection 711-35(2) by the corporate tax rate.[7] → subsection 711-35(1), ITAA 1997

The deductions included in this step are deductions to which the leaving entity becomes entitled under section 701-40 of the ITAA 1997 as a result of it ceasing to be a subsidiary member of the group, other than a deduction for expenditure:

- that is, forms part of or reduces, the cost of an asset that becomes an asset of the leaving entity because subsection 701-1(1) (the single entity rule) ceases to apply, or

[7] For exits that occurred before 10 February 2010, the step 2 amount is worked out using the formula: Owned deductions + (Acquired deductions x Corporate tax rate). Acquired deductions are those that were acquired deductions at step 7 of the entry ACA when an entity became a subsidiary member of a consolidated group → Adjustment for certain inherited deductions (ACA step 7), C2-4-340. Owned deductions are deductions that are not acquired deductions.

- to which section 110-40 of the ITAA 1997 (expenditure on assets acquired before 7.30 pm on 13 May 1997) applies.

→ subsection 711-35(2)

Therefore, the step 2 amount calculation is:

$160 x 30% = $48

This is then added to the step 1 amount of $12,800 to give a result of $12,848 after the application of step 2.

ACA step 3: Add intragroup liabilities owed to Delta

The intragroup liability of $1,000 owed to Delta is not recognised for income tax purposes while Delta is a member of the group. In this step, the liability is identified and its market value of $1,000 is added to the result of step 2:

$12,848 + $1,000 = $13,848

ACA step 4: Subtract liabilities of Delta

Delta has a $2,000 liability owed to an external party. The amount of the liability is subtracted from the result of step 3:

$13,848 – $2,000 = $11,848

Exit ACA Step 5

The ACA is $11,848.

B: Apportion ACA to each class of membership interest

Table 7: Apportion ACA to each class of membership interest

	Market value	Proportion to the market values	ACA	Apportionment
Class A	$7,400	$7,400 / ($7,400 + $6,400)	x $11,848	= $6,353.28
Class B	$6,400	$6,400 / ($7,400 + $6,400)	x $11,848	= $5,494.72

C: Divide ACA by number of membership interests in each class

The tax cost for class A shares is calculated as:

$$\frac{\$6{,}353.28}{500 \text{ shares}} = \$12.71 \text{ per share}$$

The tax cost for class B shares is calculated as:

$$\frac{\$5{,}494.72}{500 \text{ shares}} = \$10.99 \text{ per share}$$

The head company Alpha's capital gains from the sale of Delta shares are shown in table 8.

Table 8: Alpha capital gains from sale of Delta shares

	Proceeds – cost base		Number of shares sold	Total capital gains from the sale
Class A shares	$14.80 – $12.71	= $2.09	x 250 shares	= $522.50
Class B shares	$12.80 – $10.99	= $1.81	x 250 shares	= $452.50
				$975.00

References

Income Tax Assessment Act 1997, section 701-1; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *Tax Laws Amendment (2007 Measures No. 4) Act 2007* (No. 143 of 2007), Schedule 1

Income Tax Assessment Act 1997, section 701-40; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 11

Income Tax Assessment Act 1997, section 711-20; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2
- *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 21
- *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 7- Division 1

Income Tax Assessment Act 1997, section 711-25; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (No. 83 of 2004), Schedule 2
- *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 7- Division 1

Income Tax Assessment Act 1997, section 711-35; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 7, Division 1 and Part 9

Income Tax Assessment Act 1997, section 711-45; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2
- *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1

- *Tax Laws Amendment (2004 Measures No. 7) Act 2005* (No. 41 of 2005), Schedule 6
- *Financial Sector Legislation Amendment (Restructures) Act 2007* (No. 117 of 2007), Schedule 3
- *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Parts 7, 8, 9, and 20.

Income Tax Assessment Act 1997, sections 711-40 and 711-55; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Income Tax (Transitional Provisions) Act 1997, sections 701-1 and 701-40; as amended by *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 7

Income Tax Assessment Act 1997, section 110-40

Explanatory Memorandum to New Business Tax System (Consolidation) Bill No. 1, paragraph 5.142

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5

Revision history

Section C2-2-210 first published (excluding drafts) 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on proposed changes to consolidation rules.	Proposed legislative amendments.
26.10.05	Removal of note on proposed change to rules.	Legislative amendment.
26.6.07	Note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used, p. 9.	Reflect announcement on 8 May 2007 by Assistant Treasurer in media release no. 50.
6.5.11	'certain membership interests' changed to 'certain interests', at step 4 in calculating the exit ACA in figure 1. Changes to the example to reflect modifications to the calculation of the step 2 amount and to clarify the facts. Removal of note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used.	Legislative amendments.

Entry ACA worksheet

This worksheet can be used where an entity joins a consolidated group and the cost setting rules apply.

Step 1: Add up the cost of each membership interest* – section 705-65, *Income Tax Assessment Act 1997* (ITAA 1997)

		$ Interest 1	$ Interest 2	$ Interest 3	$
P	Cost base (CB) at the joining time or formation time (JT) (note: cost of pre-CGT interests not indexed)				
Q	Reduced cost base (RCB) at JT (ignoring reductions for rebatable dividends: section 160ZK(5), ITAA 1936 / section 110-55(7), ITAA 1997, and adding back any adjustments under section 165-115ZA(3), ITAA 1997 to the extent the relevant losses will reduce the ACA under steps 5 & 6)				
R	CB (line P) as adjusted for value shifting or loss transfer				
S	RCB (line Q) as adjusted for value shifting or loss transfer, or section 165-115ZD, ITAA 1997				
T	Market value (MV)				
	Tests If MV (line T) ≥ adjusted CB (line R), use line R If MV (line T) ≤ adjusted RCB (line S), use line S If adjusted RCB (line S) < MV (line T) < adjusted CB (line R), use line T				
	Sum is entry ACA step 1 result				

* A non-membership equity interest in the joining entity held by a member of the joined group is treated as a membership interest for the purposes of step 1 of the ACA.

Step 2: Add accounting liabilities and other things

	$ Liability 1	$ Liability 2	$ Subtotals	$
				bfwd
<u>Accounting liabilities</u> **(sections 705-70 to 705-80, ITAA 1997)**				
Start with statement of financial position				
Reduce where liability valued differently for group				
Reduce to $nil if attached to an asset				
Reduce for future income tax deductions				
Reduce for intra-group debt (add back reductions under section 165-115ZA(3), ITAA 1997 before comparison)				
Adjust for unrealised gains or losses				
Sum of reduced or adjusted liabilities				
<u>Add for employee shares</u> **(section 705-85, ITAA 1997)**				
Market value of disregarded employee shares				
Reduce by reduction amount				
<u>Add amount received from third parties from the issue of non-membership equity interests</u> (section 705-85)				
<u>Add market value of any approved deposit-taking institution (ADI) restructure preference shares in the joining entity that were disregarded under section 703-37 for the purpose of the entity being considered a wholly-owned subsidiary of the head company at the joining time</u> (section 705-85)				
<u>Add equity for accounting but debt for tax purposes</u>				
MV of equity being debt under debt/equity rules				
Result (sum of the subtotals)				
Entry ACA result after step 2				

Step 3: Add undistributed profits accrued to the group (section 705-90, ITAA 1997)

	$	$	$ bfwd
Ongoing rule (section 705-90)			
Undistributed *frankable* profits accrued to group at the JT			
Transitional rule (applies to non-chosen transitional entities where a transitional group has formed before 1 July 2003 or has consolidated on or before the first day of the head company's income year that started after 30 June 2003 and before 1 July 2004)			
Undistributed *unfrankable* profits accrued to group at JT			
***Add* the sum of these net amounts**			
Entry ACA result after step 3			

Step 3A: Adjust for prior CGT rollovers from a foreign-resident company or a company that became the head company (sections 705-93, 705-147 & 705-227, ITAA 1997)

Adjust for previous rollovers from a foreign-resident company under Subdivision 126-B or section 160ZZO, ITAA 1936	$	$ bfwd
Adjustment		
Start with rollover adjustments that increase the ACA (deferred rollover losses)		
Subtract rollover adjustments that decrease the ACA (deferred rollover gains)		
Add the net amount if positive/subtract if negative		
Entry ACA adjusted result after step 3A		

Step 4: Subtract certain distributions and certain undistributed profits (section 705-95, ITAA 1997)

		$	$
			bfwd
	Subtract all of the following		
A	Distributions from profits that did not accrue to group		
B	Distributions from profits that accrued to the group to the extent that those profits recouped losses of any sort that accrued to the group before the JT		
	Formation rule Do not count subsequent distributions of profits adjusted at ACA step 4 for the entity below that actually made the profits from which the first distribution up the chain was made (just count in the first entity making the profit): section 705-155, ITAA 1997		
	Entry ACA result after step 4		

Step 5: Subtract unused losses that accrued to the group (section 705-100, ITAA 1997)

		$
		bfwd
Subtract all unused losses of any sort that accrued to the group (including losses that cannot be transferred to the head company) before the JT		
less those amounts to the extent that they reduced the undistributed profits from an earlier year that would otherwise have been included in the step 3 amount (to avoid double counting)		
Entry ACA result after step 5		

Step 6: Subtract for tax benefit from transferred losses not accrued to group (section 705-110, ITAA 1997)

	$	$	$
			bfwd
Transferred losses of any sort that did not accrue to the group			
less those losses to the extent that their transfer has been cancelled			
Multiply by the general company tax rate		**30%**	
Entry ACA result after step 6			

Step 7: Subtract inherited deductions (section 705-115, ITAA 1997)

		$	$	$
	(*Other than* deductions where expenditure becomes part of, or reduces the cost of the relevant asset or is precluded from becoming part of the cost of the asset because of section 110-40, ITAA 1997, or where the expenditure reduced the amount of step 3 undistributed frankable owned profits)			**bfwd**
J	*Owned deductions* (if deduction was instead a profit, how much could have been distributed to group as a profit that accrued to the group)			
	Acquired deductions (balance of the inherited deductions)			
K	***Multiply acquired deductions by general company tax rate***	**30%**		
	Subtract the sum of J and K			
	Entry ACA result after step 7			

Step 8: Entry ACA result (section 705-60, ITAA 1997)

	$
ACA equals result after step 7 or nil, whichever is greater	

Revision history

Section C2-3-110 first published 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on recent and proposed changes to consolidation rules.	Recent and proposed legislative amendments.
26.10.05	Change to step 3 and update of note on foreign loss of a partnership, p. 3.	Legislative amendment.
30.6.09	Removal of note at step 6 to reflect new rules for treatment of foreign losses.	Legislative amendments.
6.5.11	Change to include market value of ADI restructure preference shares in step 2. Removal of table for adjustments to the result of step 3A following the repeal of section 705-150. Reference to non-membership equity interests at step 1 and step 2. Revisions to reflect changes to the transitional concession for substituted accounting periods (former subsection 701-30(1) of the IT(TP)A 1997).	Legislative amendments.

Over-depreciation worksheet

After testing depreciating assets for reduction of the tax cost setting amount because they are revenue-like assets (→ 'Reduction for revenue-like assets (step C)', C2-4-530), consider whether a reduction (or further reduction) to the amount is required for each over-depreciated asset → 'Reduction for over-depreciated assets (step D)', C2-4-610; section 705-50, *Income Tax Assessment Act 1997* (ITAA 1997); Explanatory Memorandum to New Business Tax System (Consolidation) Bill (No.1) 2002, paragraph 5.44.

The first step is to ascertain whether each item of plant is over-depreciated.

Is an asset over-depreciated?

	Test for each depreciating asset At the joining time:	Test satisfied? yes/no	$ excess amount
M	Does market value exceed adjustable value?		
N	Does cost exceed adjustable value?		
	If the answer is YES to both questions, the asset is over-depreciated by the lesser of M and N		

The tax cost setting amount for an over-depreciated asset is reduced by the least of the over-depreciation amount (calculated above), the excess of the tax cost setting amount over its terminating value, and the tax deferral amount.

→ calculation following page

Over-depreciation reduction

			$ amount
	Test for each over-depreciated asset		
	Over-depreciation amount		
(a)	Over-depreciation amount from previous table		
	Tax cost setting amount exceeds terminating value		
(b)	Excess of the tax cost setting amount over its terminating value		
	Tax deferral amount		
(c)	*Start with* the amount of unfranked dividends paid by the joining entity before the joining time, that were subject to section 46 or 46A rebate		
(d)	The amount of the profits paid as dividends in (c) above – (the *qualifying profits amount*) that were not subject to tax because of the over-depreciation of the asset – *but* count only to the extent they were not counted in ACA step 4 and to the extent the deductions for over-depreciation did not form part of a loss that reduced the ACA under step 5, were not counted in ACA step 4 (but the depreciation did not generate a tax loss to be subtracted from the entry ACA at step 5)		
(e)	The extent to which the dividend in (c) – adjusted to amount in (d) – was *not* further distributed (directly or indirectly) to a taxpayer who was *not* entitled to such a rebate. This is the *tax deferral amount*		
(f)	**Transitional rule on formation**		
	Add – The tax deferral amount is increased to include any unfrankable *undistributed* profits accrued to head company and included in ACA step 3 (under transitional rules) to the extent that those profits were not subject to tax because of deductions for depreciation representing over-depreciation, and the deductions did not form part of a loss that reduced the ACA under step 5 (subsection 701-30(3) IT(TP)A)		
(g)	**Tax deferral amount (result after (c), (d), (e) and (f)**		
	Reduction of tax cost setting amount is the lesser of (a), (b) and (g)		

Note

Changes to the over-depreciation provisions

The over-depreciation provisions in the tax cost setting rules have been modified for an entity that becomes a member of a consolidated group between 9 May 2007 and 30 June 2009. In this case a head company will only need to look at five years of dividend history immediately before the joining time to determine whether an over-depreciation adjustment is required in relation to the joining entity's asset. Effective from 1 July 2009, the over-depreciation adjustment in section 705-50 has been repealed, so it will no longer apply to over-depreciated assets of entities that become subsidiary members of a consolidated group on or after that date. → *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010)

References

Income Tax Assessment Act 1997, section 705-50 and subsection 995-1(1); as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 6

Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5

Revision history

Section C2-3-210 first published 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
6.5.11	Minor changes to reflect the repeal of section 705-50, effective 1 July 2009.	Legislative amendment.

Worked example

Transitional entities and chosen transitional entities

Description

When a member of a consolidated or multiple entry consolidated (MEC) group qualifies as a transitional entity, the head company of the group may choose not to set the tax costs for the assets of that entity on the group's formation. Instead, the head company will inherit the existing tax cost of the assets. This example explains when a member can qualify as a transitional entity.

Commentary

Generally, when a consolidated or MEC group forms, the head company sets the tax cost for the assets of the subsidiary members (the 'spread' method). However, if the group forms during the transitional period (1 July 2002 to 30 June 2004), the head company may choose instead to retain the existing tax costs of a member that qualifies as a transitional entity (the 'stick' method). Such an entity is a chosen transitional entity.

Permitting the head company of a consolidated or MEC group to retain a chosen transitional entity's tax costs is a concession allowed to reduce compliance costs. For example, the head company need not obtain market values for the assets of a chosen transitional entity.

Note

Transitional foreign-held subsidiaries in MEC and consolidated groups and eligible tier-1 companies in MEC groups do not have the tax cost of their assets set. Therefore, it is not necessary to consider whether transitional foreign-held subsidiaries and eligible tier-1 companies are transitional entities.

→ 'Transitional provisions for foreign-held, Australian-resident subsidiaries to be members of a MEC group', C10-2-120

→ section 701C-30 of the *Income Tax Assessment (Transitional Provisions) Act 1997* (IT(TP)A) (on transitional foreign-held subsidiaries) and subsection 719-160(2) of the *Income Tax Assessment Act 1997* (on eligible tier-1 companies).

→ Taxation Determination 2005/43

The conditions an entity must satisfy to qualify as a transitional entity will depend on the date the group formed, as follows:

A consolidated group formed on 1 July 2002:

Each entity that became a subsidiary member of the group on that day is a transitional entity. → subsection 701-1(1) of the IT(TP)A

A MEC group formed on 1 July 2002:

Each entity that became a subsidiary member of the group on that day is a transitional entity. → subsection 701-1(1) of the IT(TP)A as modified by section 719-2

A consolidated group formed after 1 July 2002 and before 1 July 2003:

- An entity must have been a wholly-owned subsidiary of the prospective head company on the formation date, *and*
- during the period 1 July 2002 to the formation date, the entity must not have ceased to be a wholly-owned subsidiary of the prospective head company and then again become its wholly-owned subsidiary.

→ subsection 701-1(2) of the IT(TP)A

A MEC group formed after 1 July 2002 and before 1 July 2003:

- An entity, on the formation date, must have been a wholly-owned subsidiary of the entities that became members of the MEC group as eligible tier-1 companies at the time the group formed, *and*
- during the period 1 July 2002 to the formation date, the entity must not have ceased to be a wholly-owned subsidiary of these entities and then again become their wholly-owned subsidiary.

In applying this test, the entity is treated as a wholly-owned subsidiary, at a particular time, of the entities that became members of the MEC group as eligible tier-1 companies if all of the membership interests in the entity were directly or indirectly held by one or more of these entities at that time.

→ subsection 701-1(2) of the IT(TP)A as modified by subsection 719-161(2)

A consolidated group formed during the financial year starting 1 July 2003:

- The entity must have been a wholly-owned subsidiary of the prospective head company just before 1 July 2003, *and*
- during the period 1 July 2002 to the formation date, the entity must not at any time have ceased to be a wholly-owned subsidiary of the prospective head company and then again become its wholly-owned subsidiary.

→ subsection 701-1(3) of the IT(TP)A

A MEC group formed during the financial year starting 1 July 2003:

- The entity must have been, just before 1 July 2003, a wholly-owned subsidiary of the entities that became members of the MEC group as eligible tier-1 companies at the time the group formed, *and*
- during the period 1 July 2002 to the formation date, the entity must not at any time have ceased to be a wholly-owned subsidiary of these entities and then again become their wholly-owned subsidiary.

In applying this test, the entity is treated as a wholly-owned subsidiary, at a particular time, of the entities that became members of the MEC group as eligible tier-1 companies if all of the membership interests in the entity were directly or indirectly held by one or more of these entities at that time.

→ subsection 701-1(3) of the IT(TP)A as modified by subsection 719-161(2)

A MEC group formed during the financial year starting 1 July 2003 where the membership interests in an eligible tier-1 company have been transferred to another eligible tier-1 company before formation:

An eligible tier-1 company of a potential MEC group whose membership interests were transferred to one or more other eligible tier-1 companies of the group at a particular time (the transfer time) so that it was a wholly-owned subsidiary of those eligible tier-1 companies when the MEC group formed may still qualify as a transitional entity. The transferred entity will be a transitional entity if it satisfies the following conditions:

- it and one or more other entities must have been members of the potential MEC group as eligible tier-1 companies continuously from just before 1 July 2003 until the transfer time, *and*
- after the transfer, it remained a wholly-owned subsidiary of one or more of the eligible tier-1 companies until the formation time, *and*
- the other eligible tier-1 companies remained members of the potential MEC group as eligible tier-1 companies continuously from just before 1 July 2003 until the formation time, *and*
- the other eligible tier-1 companies became members of the MEC group as eligible tier-1 companies when the group formed.

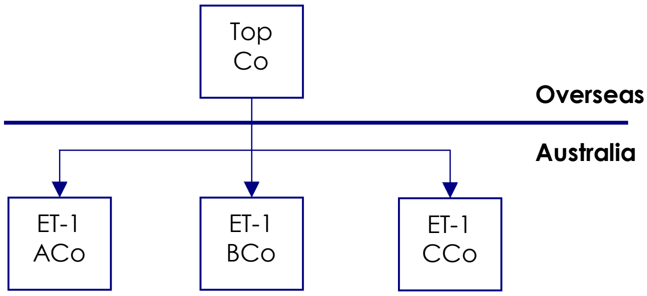
→ subsection 719-161(3) of the IT(TP)A

Subsection 719-161(3) of the IT(TP)A was also intended to achieve the following outcomes:

- An eligible tier-1 company whose membership interests are transferred in the circumstances described above remains a transitional entity if the choice to consolidate is made under section 703-50 (concerning consolidated groups) rather than section 719-50 (concerning MEC groups).
- Whether the choice to consolidate is made under section 703-50 (concerning consolidated groups), or section 719-50 (concerning MEC groups), a wholly-owned subsidiary of an eligible tier-1 company transferred in the circumstances described above will also be a transitional entity if:
  - the subsidiary was a wholly-owned subsidiary of the transferred eligible tier-1 company just before 1 July 2003, and
  - it remained a wholly-owned subsidiary of the eligible tier-1 company continuously from the earliest time it became a wholly-owned subsidiary of the eligible tier-1 company after 1 July 2002 until the time the election to consolidate is made.

Example

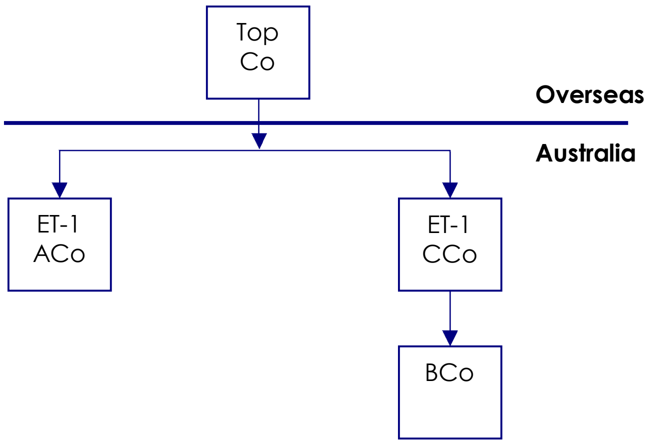
Figure 1



ACo, BCo and CCo are eligible tier-1 companies of the top company Top Co (Figure 1). Just before 1 July 2003, ACo, BCo and CCo are members of a potential MEC group.

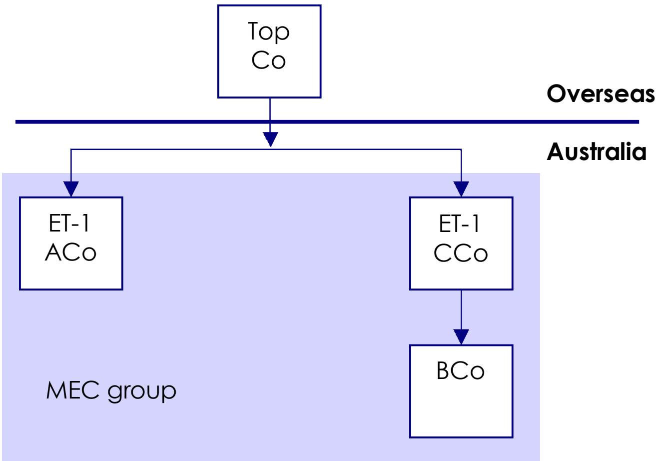
On 30 September 2003, Top Co transfers all its membership interests in BCo to CCo. After the transfer, BCo is a wholly-owned subsidiary of CCo (Figure 2).

Figure 2



On 1 December 2003, ACo and CCo, as eligible tier-1 companies, choose to form a MEC group. The members of the MEC group are ACo, BCo and CCo. ACo is the provisional head company (PHC).

Figure 3



BCo qualifies as a transitional entity in the MEC group. ACo may choose for BCo to be a chosen transitional entity. → section 701-5 of the IT(TP)A as modified by section 719-2 of the IT(TP)A

References

Income Tax Assessment (Transitional Provisions) Act 1997, sections 701-1 and 719-161

Explanatory Memorandum to the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, paragraphs 1.75 to 1.87

Explanatory Memorandum to the Tax Laws Amendment (2004 Measures No. 2) Bill 2004, paragraphs 2.107 to 2.117

Revision history

Section C2-4-105 first published 16 December 2005.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Calculating the ACA for non-chosen subsidiary partly held by chosen transitional entity

Description

Where a chosen transitional entity[8] holds interests in one or more non-chosen subsidiaries in a consolidated group, the chosen transitional entity is treated as a head company for the purpose of calculating the allocable cost amount (ACA) for the non-chosen subsidiaries. This example shows how, at formation, the head company and sub-groups headed by chosen transitional entities calculate the ACA under section 701-20 of the IT(TP)A 1997 for a non-chosen subsidiary in which they hold the membership interests.

→ Taxation Determination TD 2004/73

Commentary

The head company and each sub-group headed by a chosen transitional entity calculate separate notional ACAs (in the case of the head company, the 'adjusted allocable amount') for the non-chosen subsidiary, each disregarding the interests held by the other.

The head company's adjusted allocable amount is the amount that would be the non-chosen entity's ACA if the interests held by the head company at formation (excluding interests held by any chosen transitional entity) were the only interests in the non-chosen entity, with the amount calculated by multiplying each of the ACA step 2 to step 7 amounts by the following fraction:

$$\frac{\text{Market value of the head company's interest in the non-chosen subsidiary (excluding interests held by any chosen transitional entity)}}{\text{Market value of the consolidated group's total interests in the non-chosen subsidiary}}$$

The sub-group's 'notional allocable cost amount' is the amount that would be the non-chosen entity's ACA if the chosen transitional entity were the head company of a smaller consolidated group that included the non-chosen subsidiary, and the interests held by the chosen transitional entity and its sub-group at formation (i.e. of the larger group) were the only interests in the non-chosen subsidiary, with the amount calculated by multiplying each of the ACA step 2 to step 7 amounts by the following fraction:

$$\frac{\text{Market value of the chosen transitional entity's interest in the non-chosen subsidiary}}{\text{Market value of the consolidated group's total interests in the non-chosen subsidiary}}$$

[8] That is, a subsidiary for which the head company has chosen the transitional option of retaining the existing tax values for its assets instead of applying the cost setting rules.

The consolidated group's ACA for the non-chosen subsidiary is the sum of the head company adjusted allocable amount and the sub-group's notional allocable cost amount.

Example

Facts

ACo is a wholly-owned subsidiary of HeadCo. ACo in turn owns all the shares in two further subsidiary companies, BCo and CCo.

DCo is incorporated on 1 July 2000 with issued capital of $100,000 and with 20% of its shares issued to CCo and the remaining 80% issued to an unrelated company, XCo.

DCo immediately borrows $50,000 and acquires assets to commence a business. DCo's financial position is as follows:

Table 1: DCo – financial position at 1 July 2000 ($)

Land	110,000	Capital	100,000
Cash	40,000	Liabilities (loan)	50,000
	150,000		150,000

During the first year DCo makes a trading loss of $20,000 which is also a tax loss. Assume the value of the land remains unchanged.

Table 2: DCo – financial position at 30 June 2001 ($)

Land	110,000	Capital	100,000
Cash	20,000	Liabilities (loan)	50,000
		Loss	(20,000)
	130,000		130,000

On 1 July 2001, CCo purchases a further 40% of the shares in DCo from XCo. CCo pays $34,400 for the shares ($32,000 for the assets and $2,400 for the losses). During the year ending 30 June 2002 the value of the land is again constant but DCo makes a further trading loss (which is also a tax loss) of $10,000.

Table 3: DCo – financial position at 30 June 2002 ($)

Land	110,000	Capital	100,000
Cash	10,000	Liabilities (loan)	50,000
		Accumulated losses	(30,000)
	120,000		120,000

On 1 July 2002, HeadCo and BCo together purchase the shares XCo still holds in DCo, each taking a 20% interest in DCo. HeadCo and BCo each pay $15,800 for their 20% interest ($14,000 for the assets and $1,800 for the losses).

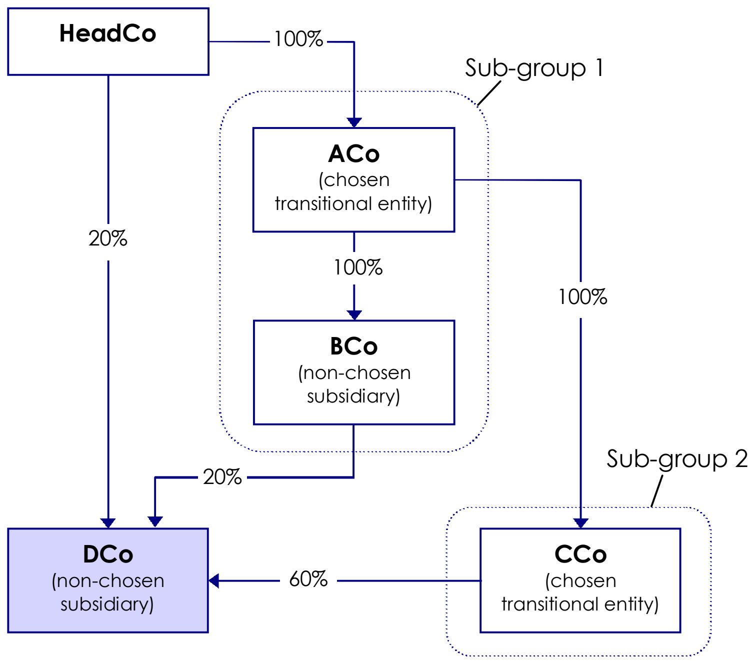
HeadCo, ACo, BCo, CCo and DCo form a consolidated group on 1 July 2002 and HeadCo chooses that ACo and CCo be chosen transitional entities. BCo's financial position at formation is as follows:

Table 4: BCo – financial position at 1 July 2002 ($)

Cash	34,200	Capital	50,000
Shares in D	15,800		
	50,000		50,000

For the purpose of working out the ACA for DCo there are two sub-groups: ACo and its non-chosen subsidiary BCo form one sub-group, and CCo constitutes a second sub-group.

Figure 1: HeadCo's consolidated group at formation



Calculation – HeadCo's adjusted allocable amount for DCo

For HeadCo's 20% interest in DCo the step 1 amount is $15,800.

Steps 2 and 6 of the ACA calculation are also relevant. The step 2 and step 6 amounts are first calculated disregarding interests held in DCo by any sub-group; i.e. treating HeadCo's 20% interest as if it were a 100% interest in DCo acquired on 1 July 2002. On this basis the step 2 amount is $50,000 (the loan owed by DCo) and the step 6 amount is $9,000 (30% of DCo's tax losses of $30,000).

The step 2 and step 6 amounts are then multiplied by the fraction obtained by dividing the market value (at the time the consolidated group comes into existence) of HeadCo's membership interests in DCo, excluding the interests it holds through the sub-groups, by the market value of the consolidated group's total membership interests in DCo. This fraction is $15,800/$79,000. The step 2 and step 6 amounts are therefore reduced to $10,000 and $1,800 respectively.

The head company adjusted allocable amount is therefore:

$15,800 + $10,000 – $1,800 = $24,000

Calculation – sub-group 2's notional ACA for DCo

CCo paid $54,400 ($20,000 + $34,400) for its 60% interest in DCo. The step 1 amount in its sub-group's notional ACA calculation is therefore $54,400.

In this sub-group's case, the amounts at steps 2 to 7 are calculated as if the 60% of DCo's shares it held at 1 July 2002 were 100% of the issued shares in DCo. On this basis the step 2 amount is again $50,000.

Assuming for this calculation that the 60% of DCo's shares held by CCo at 1 July 2002 were 100% of the issued shares in DCo, one-third of the loss that DCo incurred in the year ending 30 June 2001 would have accrued to shares held by CCo and all of the loss it incurred in the year ending 30 June 2002 would have accrued to the shares held by CCo. That is, the 20% interest CCo held in 2000-01 and the 40% interest it acquired in 2001-02 would each be increased by 100/60. On this basis, sub-group 2 calculates a step 5 amount, in relation to DCo's tax losses, as follows:

(20% × 100/60 × $30,000) + (40% × 100/60 × $10,000) = $16,667

There is also a step 6 amount, calculated as if two-thirds of DCo's loss in the year ending 30 June 2001 had accrued to shares not held at that time by CCo. The step 6 amount is calculated as follows:

40% × 100/60 × $20,000 × 30% = $4,000

Each of these step 2, 5 and 6 amounts is then multiplied by the fraction obtained by dividing the market value (at formation time) of sub-group 2's membership interests in DCo by the market value of the consolidated group's total membership interests in DCo; i.e. $47,400/$79,000. The step 2, 5 and 6 amounts are reduced to $30,000, $10,000 and $2,400 respectively.

The sub-group's notional ACA is:

$54,400 + $30,000 – ($10,000 + $2,400) = $72,000

Calculation – sub-group 1's notional ACA for DCo

Before sub-group 1's notional ACA for DCo can be calculated, the ACA for BCo (a non-chosen subsidiary) must be calculated, followed by the tax cost setting amounts for BCo's assets, including BCo's membership interests in DCo. Since ACo holds its entire interest in DCo indirectly through BCo, the notional ACA for sub-group 1's interest in DCo is based only on the membership interests held by BCo.

The cost base, reduced cost base and market value of ACo's 100% membership interests in BCo are all $50,000, so the step 1 amount is $50,000. As none of steps 2 to 7 apply in this case, BCo's ACA is $50,000.

The tax cost setting amount for BCo's retained cost base assets (cash) is $34,200. This amount is subtracted from the ACA. The remainder of the ACA of $15,800 is allocated to BCo's reset cost base assets – the shares it holds in DCo. This becomes the step 1 amount in BCo's notional ACA for DCo.

Next calculate BCo's notional ACA for DCo. The step 1 amount is the tax cost setting amount already calculated for the shares in DCo, i.e. $15,800. Steps 2 and 6, relating to DCo's borrowings and the accumulated tax losses, are also relevant. The amounts at these steps are calculated in the same way as for steps 2 and 6 in the calculation of HeadCo's adjusted allocable amount, and are equal to the amounts calculated by HeadCo.

Sub-group 1's notional ACA for DCo is therefore $24,000.

Consolidated group's ACA for DCo

The consolidated group's ACA for DCo is the sum of the head company adjusted allocable amount and the sub-groups' notional ACAs, i.e.:

$24,000 + $72,000 + $24,000 = $120,000

Allocating the ACA among DCo's assets

The tax cost setting amount for DCo's cash, a retained cost base asset, is $10,000. After subtracting this amount from the total ACA of $120,000, $110,000 remains for allocation to the land, a reset cost base asset.

References

Income Tax (Transitional Provisions) Act 1997, Division 701; as amended by:

- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 7
- *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003)

Taxation Determination TD 2004/73 – Income tax: consolidation: where the head company and a chosen transitional entity in a consolidated group hold separate membership interests in a non-chosen subsidiary, how does the group calculate the allocable cost amount for the non-chosen subsidiary?

Revision history

Section C2-4-205 first published 12 May 2004.

Revisions are described below.

Date	Amendment	Reason
26.10.05	Reference to new taxation determination.	
26.6.07	Note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used.	Reflect announcement on 8 May 2007 by Assistant Treasurer in media release no. 50.
6.5.11	Removal of note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used.	Legislative amendment.

Worked example

Amount to be used as cost for membership interests (ACA step 1)

Description

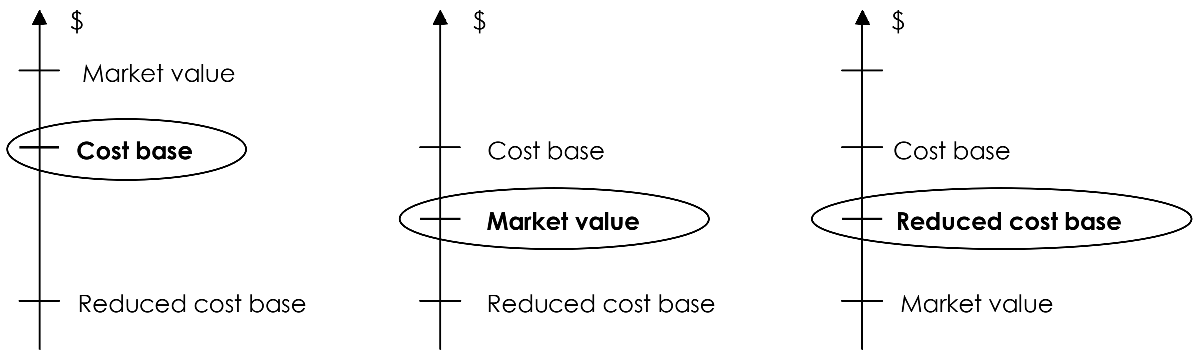
This example shows how the amount to be used as the cost for membership interests (ACA step 1) is determined where the market value of the membership interests differs from the cost base or reduced cost base.

Commentary

The first step in determining the allocable cost amount (ACA) for a joining entity is to add up the costs for all of the membership interests in it that are held by members of the consolidated group it is joining → section 705-65, *Income Tax Assessment Act 1997* (ITAA 1997). Subject to certain adjustments, the cost used for each membership interest (the relevant cost) is the cost amount that would be used in determining the CGT outcome if the membership interest were disposed of at the joining time. This amount reflects part of the group's cost of acquiring the joining entity's assets.

If, at the joining time, the market value of a membership interest is greater than or equal to its cost base, the relevant cost is the cost base. Otherwise, the relevant cost is the greater of the market value of the interest or the reduced cost base of the interest. The relevant cost is shown in bold in Figure 1.

Figure 1 The relevant cost in ACA step 1



Example

Facts

Company ACo has five issued shares on 1 June 1998.

On 1 June 1998, company HeadCo purchases a share (Interest 1 on the worksheet following) of ACo at $9.90.

On 8 June 1998, HeadCo purchases another share (Interest 2) of ACo at $10.00.

On 15 June 1998, HeadCo purchases another share (Interest 3) of ACo at $10.10.

On 22 June 1998, HeadCo purchases another share (Interest 4) of ACo at $10.20.

On 1 July 2003, ACo chooses to consolidate its group.

On 2 July 2003, HeadCo purchases the remaining share (Interest 5) of ACo at $10.30 and ACo joins HeadCo's consolidated group. At the joining time, the market value of ACo's shares is $10.20 each. (HeadCo is paying a premium for Interest 5.)

Incidental costs of acquiring those shares are nil. Since 1 June 1998, there has been no CGT event triggering resetting of the cost bases of the shares. There has been no event requiring value shifting or loss transfer adjustment. Also assume that Subdivision 165-CD of the ITAA 1997 does not apply to ACo.

Calculation

The indexation factor for each of shares 1 to 4 is 1.020 (123.4/121.0).

Table 1: ACA step 1: Add up the cost of each membership interest

		$ Interest 1	$ Interest 2	$ Interest 3	$ Interest 4	$ Interest 5
P	Cost base (CB) at the joining time (JT) or formation time (Note: cost of pre-CGT interests not indexed)	10.10	10.20	10.30	10.40	10.30
Q	Reduced cost base (RCB) at JT (ignoring reductions for rebatable dividends: former section 160ZK(5) ITAA 1936 or section 110-55(7) ITAA 1997), and adding back any adjustments under section 165-115ZA(3) ITAA 1997 to the extent the relevant losses will reduce the ACA under steps 5 & 6)	9.90	10.00	10.10	10.20	10.30
R	CB (line P) as adjusted for value shifting or loss transfer	10.10	10.20	10.30	10.40	10.30
S	RCB (line Q) as adjusted for value shifting or loss transfer or section 165-115ZD ITAA 1997	9.90	10.00	10.10	10.20	10.30
T	Market value (MV)	10.20	10.20	10.20	10.20	10.20
	Tests If MV (line T) ≥ adjusted CB (line R), use line R If MV (line T) ≤ adjusted RCB (line S), use line S If adjusted RCB (line S) < MV (line T) < adjusted CB (line R), use line T					
	***Result* for each share**	10.10	10.20	10.20	10.20	10.30

Therefore, **the step 1 amount is $51.00,** i.e.:
(10.10 x 1) + (10.20 x 1) + (10.20 x 1) + (10.20 x 1) + (10.30 x 1)

References

Income Tax Assessment Act 1997, section 705-65; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 5.56–64

Income Tax Assessment Act 1997, subsections 110-55(7) and 165-115ZA(3)

Income Tax Assessment Act 1936, former subsection 160ZK(5)

Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006 (No. 101 of 2006), which repealed section 160ZK of the Income Tax Assessment Act 1936

Revision history

Section C2-4-220 first published (excluding drafts) 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
15.11.06	Updated references to inoperative provisions.	Legislative amendment.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Reduction for intragroup liabilities on entry (in ACA step 2)

Description

This example shows how an amount added at step 2 of the allocable cost amount (ACA) calculation (which involves adding the joining entity's liabilities) is determined where the liability is owed by the joining entity to a member of the joined group (an intragroup liability).

Commentary

The second step in determining the ACA for a joining entity is to add all of its accounting liabilities at the joining time. → section 705-70, *Income Tax Assessment Act 1997* (ITAA 1997)

The amount taken into account for a joining entity's liability that is a debt or other liability owed to the joined group depends on the market value of the corresponding asset of the joined group.

If the market value of the corresponding asset is equal to or more than the group's cost base for the asset, the amount to be added is the group's cost base. If the market value is less than or equal to the group's reduced cost base for the asset, the amount to be added is the group's reduced cost base. If the market value falls between the group's cost base and reduced cost base, the amount to be added is the market value of the asset.

Example

Facts

ACo is acquired by HeadCo (the head company of a consolidated group) on 1 July 2002 for $200. The financial position of ACo on joining the group is:

- assets at a cost of $300 (market value)
- liability: $100 loan from BCo (100% subsidiary of HeadCo)

In the books of BCo, the asset (loan to ACo) shows a cost base of only $80. (This could arise where the liability has been assigned – market value is $100, purchased for $80.)

Calculation

The ACA after adding the ACA step 2 result will be $280 – the price paid for membership interests of $200 plus the liability of $80. In this example, the market value of the member's asset constituted by the accounting liability is greater than the asset's cost base. Therefore, the amount to be added will equal the member's cost base of $80. → subsection 705-75(2), ITAA 1997

Note: The liability of $80 is added at ACA step 2 (to determine the group's cost of acquiring ACo) → section 705-70. However, the intragroup debt to BCo does not become a liability of the joined group, and the group's asset (the $80 loan to ACo) will not be treated as an asset of the group for income tax purposes. This is because all intragroup transactions in a consolidated group are ignored.

Note

Proposed changes to consolidation rules

The tax cost setting rules will be modified to clarify both the valuation of liabilities, and that the accounting principles must be used consistently – see Assistant Treasurer's media release no. 50 of 8 May 2007.

References

Income Tax Assessment Act 1997, sections 705-70 and 705-75; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraph 5.71

Revision history

Section C2-4-240 first published (excluding drafts) 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on recent changes to consolidation rules, p. 1.	Legislative amendments.
26.6.07	Note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used, p. 2.	Reflect announcement on 8 May 2007 by Assistant Treasurer in media release no. 50.
28.2.08	Change to calculation description.	Clarification.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Adjustment for employee shares (in ACA step 2)

Description

This example shows how employee shares may be treated as a liability of the joining entity for the purposes of adding liabilities at step 2 of the allocable cost amount (ACA) calculation.

Commentary

Employee shares may be disregarded in determining whether a joining entity is a wholly-owned subsidiary of the head company → section 703-35, *Income Tax Assessment Act 1997* (ITAA 1997). However, for the purposes of adding liabilities at step 2 of the ACA calculation, those shares are treated as a liability of the joining entity at an amount equal to their market value.

That amount will be reduced where the employee shares were issued after the group acquired membership interests in the joining entity. These employee shares are not treated as liabilities to the extent that the membership interests held by members of the group are reduced in value as a result of the issue of the employee shares. This rule only applies if the market value of the employee share interests at the time of their issue exceeds the consideration paid for their acquisition by the employees.

The amount of the reduction is determined by first working out a factor using the following formula:

$$\frac{\text{Market value of head company's membership interest (just before the employee share interest is acquired by the employee)}}{\text{Market value of all membership interests (just before the employee share interest is acquired by the employee)}} \times \frac{\text{Market value of employee share interests at time of acquisition} - \text{Consideration paid or given for acquisition of employee share interest}}{\text{Market value of employee share interests at time of acquisition}}$$

This factor is then applied to the market value of the employee share at the time it was issued to work out the reduction amount for that share. The reduction amount is subtracted from the market value of the share at the joining time. The result is included at ACA step 2 as a liability.

Example

Facts

As a wholly owned subsidiary of XCo, BCo has 9,920 ordinary shares on issue at 30 May 2000. On the following day (31 May 2000), 40 employee shares are issued, with employees contributing 50 cents per share. Just before the employee shares are issued, the other ordinary shares each have a market value of $1.00.

On 30 June 2000, BCo has 9,960 ordinary shares on issue (including the 40 employee shares). On 1 July 2000, ACo acquires 5,976 ordinary shares (60% interest) in BCo from XCo.

On 31 May 2001, a further forty employee shares are issued, with employees contributing 60 cents per share. Just before these are issued, the ordinary shares each have a market value of $1.20.

On 1 July 2002, ACo chooses to form a consolidated group with its other subsidiaries.

On 31 July 2002, BCo has 10,000 ordinary shares on issue, comprising 9,920 shares owned by XCo and ACo, and 80 employee shares. The same day ACo acquires from XCo the remaining shares in BCo (3,944 ordinary shares). As a consequence, BCo joins ACo's consolidated group. The market value of employee shares at the joining time is $1.60 each.

Without the adjustment described in this example, the amount to be added at ACA step 2 for employee shares would be calculated as follows:

$1.60 x 80 employee shares = $128.00

However, this amount needs to be reduced because some employee shares are issued after the head company (ACo) acquires membership interests in the joining entity (BCo).

Calculations

Reduction amount for employee shares issued 31 May 2000

Table 1: Share details

	Just before 31 May 2000		After share issue 31 May 2000		Joining time 31 July 2002	
	Number of shares	Market value @ $1.00 each	Number of shares	Market value @ $0.9980[2] each	Number of shares	Market value @ $1.60 each
3rd party shares	9,920	$9,920	9,920	$9,900.08[3]	0	
Employee shares	0		40	$39.92[4]	80	$128
ACo's shares	0				9,920	$15,872
Totals	**9,920**	**$9,920**	**9,960**	**$9,940.00[1]**	**10,000**	**$16,000**

Notes:

[1] Total value of the assets (thus the shares) of BCo was increased as a result of the $20 contribution by employees to acquire 40 employee shares ($0.50 x 40).

[2] Total value of shares divided by number of shares outstanding ($9,940/9,960).

[3] 9,920 shares x $0.9980 (market value of each share).

[4] 40 shares x $0.9980 (market value of each share).

[5] In practice, issuing small numbers of employee shares (less than 1% of total ordinary shares) may not affect the market value of the ordinary shares.

Calculation of reduction amount factor for employee shares issued 31 May 2000

$$\frac{\overset{\text{Market value of head company's membership interest (just before the employee share interest is acquired by the employee)}}{0}}{\underset{\text{Market value of all membership interests (just before the employee share interest is acquired by the employee)}}{9{,}920}} \times \frac{\overset{\text{Market value of employee share interests at time of acquisition}}{39.92} - \overset{\text{Consideration paid or given for acquisition of employee share interest}}{20}}{\underset{\text{Market value of employee share interests at time of acquisition}}{39.92}}$$

The reduction amount factor is zero. (The amount is not reduced as these employee shares are issued before ACo acquires any membership interest in BCo.) Accordingly, the amount to be included in ACA step 2 for the employee shares issued on 31 May 2000 is their market value of $1.60 per share.

Reduction amount for employee shares issued 31 May 2001

Table 2: Share details

	Just before 31 May 2002		After share issue 31 May 2001		Joining time 31 July 2002	
	Number of shares	Market value @ $1.20 each	Number of shares	Market value @ $1.1976 each	Number of shares	Market value @ $1.60 each
3rd party shares	3,944	$4,733	3,944	$4,723.33	0	
Employee shares 2001	40	$48	40	$47.90	40	$64
Employee shares 2002			40	$47.90	40	$64
ACo's shares	5,976	$7,171	5,976	$7,156.87	9,920	$15,872
Totals	**9,960**	**$11,952**	**10,000**	**$11,976.00**	**10,000**	**$16,000**

Calculation of reduction amount factor for shares acquired 31 May 2001

Market value of head company's membership interest (just before the employee share interest is acquired by the employee) / Market value of all membership interests (just before the employee share interest is acquired by the employee)

x

(Market value of employee share interests at time of acquisition — Consideration paid or given for acquisition of employee share interest) / Market value of employee share interests at time of acquisition

$$\frac{\mathbf{7{,}171}}{\mathbf{11{,}952}} \times \frac{\mathbf{47.90} - \mathbf{24}}{\mathbf{47.90}}$$

The reduction amount factor is 0.2993653 ($7,171/$11,952 x 23.9/47.9). This factor is applied to the market value of the employee shares issued on 31 May 2001 ($1.1976) to determine the reduction amount of 36 cents per share. It follows that $1.24 ($1.60 less 36 cents) is included in ACA step 2 for each employee share issued on 31 May 2001.

Calculation of amount to be added at ACA step 2 for employee shares:

Employee shares issued 31 May 2000:

$1.60 x 40 = $64.00

Employee shares issued 31 May 2001:

$1.24 x 40 = $49.60

Total = **$114** ($64.00 + $49.60 rounded)

References

Income Tax Assessment Act 1997, sections 705-35 and 705-85; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 5.75 to 5.77

Revision history

Section C2-4-241 first published (excluding drafts) 2 December 2002.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Determining the amount of a deferred tax liability to be used at ACA step 2, including use of administrative short cuts

Description

This example shows how to work out, for the purposes of subsection 705-70(1A), the amount of a deferred tax liability (DTL) to be used at ACA step 2 where the DTL for the joined group can be assumed to be less than it was for the joining entity. Administrative short cuts are available for this purpose in certain circumstances.

Commentary

Generally the liability to be added at step 2 is the amount that would be recognised in the joining entity's notional financial statement at the joining time, determined in accordance with the entity's accounting principles for tax cost setting. The entity's accounting principles for tax cost setting are the accounting standards or authoritative pronouncements of the Australian Accounting Standards Board, just before the joining time. → subsection 705-70 (1), subsection 705-70(3), section 995-1, ITAA 1997.

However, if, in accordance with the joining entity's accounting principles, the amount of the accounting liability of the joining entity would be different when it became an accounting liability of the joined group, the latter amount is treated as the amount of the liability. → subsection 705-70 (1A), ITAA 1997

An example of an accounting liability that would be affected by this rule is a deferred tax liability (DTL).

When determining the value of a DTL, the amount recognised in the notional statement of financial position should be the amount that would have been recognised if the deferred tax assets (DTA) and DTL had not been set off in accordance with AASB112 (previously AASB 1020, AAS 3) 'Income Taxes'.

The purpose of subsection 705-70(1A) is to ensure that the appropriate amount of ACA is allocated to reset cost base assets. Where a head company of a consolidated group acquires another entity to bring into the group, it is assumed that the head company will pay only the market value for the net assets of the entity. In deciding what it is willing to pay, the head company will factor in the value of DTL in the joining entity that will be recognised by the consolidated group at the joining time. Without an adjustment, the resulting higher acquisition price, together with the existing value of DTL in the joining entity, would effectively create a double count in the ACA. By replacing the joining entity's value for DTL with the amount that would be the accounting liability of the joined group, this double counting is negated.

Subsection 705-70(1A) therefore requires the value of the joining entity's DTL when it becomes a DTL of the group to be used at step 2 of the ACA calculation, rather than the DTL included in the joining entity's financial statements immediately before the joining time.

Determining the most accurate value for what will become the DTL of the group may require several iterations of the ACA calculation. For example, the correct amount for DTL to be used at step 2 can be worked out using a process of trial and error. The ACA is first calculated based on a particular value of DTL. This could be the DTL carried by the joining entity before the joining time, or a considered estimate of what that value might be. This ACA amount is then allocated to the reset cost base assets of the joining entity to determine their tax cost setting amounts (TCSAs). This in turn allows an amount for the DTL to be determined for the head company based on the TCSAs. If this new DTL is different to the DTL used in the first ACA calculation, a second ACA calculation is required using the new DTL. This process is repeated until the DTL determined for the head company is the same as that used in the last iteration; that is, until there is no longer any variation in the value of the DTL between iterations. It is this amount of the DTL in the joining entity that becomes the DTL of the joined group, and the amount that should be used for the purposes of ACA step 2.

In view of the compliance costs of such an iterative process, the subsection 705-70(1A) adjustment is not required for transitional entities. For similar reasons, no capital loss needs be worked out where CGT event L7 applies in respect of a DTL for a transitional entity. → sections 701-32 and former 701-34, IT(TP)A 1997; paragraphs 1.156 – 1.162 of the Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004; 'Transitional rules' in C2-1-010

Where subsection 705-70(1A) is relevant, compliance costs may be reduced by applying one of the three administrative short cut methods outlined below. If these short cut methods are not suitable for your circumstances and you would like to use another administrative approach, contact the ATO for guidance.

Administrative short cuts

1. You can perform two or three ACA iterations and then make an informed judgement to estimate the final result, and then redo the calculation using that estimate, so as to shorten the iterative process required to produce a result.

2. You can apply a 'materiality' factor to the change in value at each iteration to limit the number of iterations required – i.e., you do not need to do another iteration provided the change in value of the DTL between iterations is 2% or less and less than $1 million dollars → 'Short cut method 2: applying the materiality factor', p. 8.

3. You can stop the process at any point in the iterative cycle provided the value of the DTL at that point is less than the DTL used in the previous iteration.

The short cut methods are illustrated in Example 1.

In some cases, applying section 705-70(1A) may not require numerous iterations and thus consideration of the short cut methods is not required. See Example 2, where the correct DTL was determined by the second iteration.

Note: In cases where an existing consolidated group acquires all of the membership interests in a joining entity for a price reflecting the full market value of its assets, and it is expected that no adjustment will be needed for over-depreciation, so that no discount has been allowed in the purchase price for DTL of the joining entity, the starting value for DTL in the iterative process could be zero. This should reduce the number of iterations required.

Example 1

Facts

Sub Co is incorporated by head company HCo for $200,000 on 1 July 2004. At that time Sub Co acquires property for $100,000 and a depreciating asset for $100,000. For the year ending 30 June 2005, Sub Co derives accounting income (also assessable income) of $100,000. No dividends were paid. The asset is depreciated 20% for accounting purposes and 50% for tax purposes.

HCo forms a consolidated group with Sub Co on 1 July 2005. Its financial performance and financial position at the joining time is as follows:

Table 1: Sub Co – financial performance for year ending 30 June 2005 ($)

	A/Cs	Tax
Sales	100,000	100,000
Depreciation	20,000	50,000
Profit	80,000	50,000
Tax at 30%	24,000	15,000
Tax Expense	24,000	
Provision for Tax	15,000	
DTL	9,000	

Table 2: Sub Co – financial position at 30 June 2005 ($)

Cash	100,000	Equity	200,000
Property	100,000	Profit	56,000
Asset	80,000	Provision for Tax	15,000
		DTL	9,000
	280,000		280,000

Sub Co's franking account has a credit balance on 30 June 2005 of $15,000 (on a tax paid basis, under the Simplified Imputation System). The converted balance is then grossed-up under subsection 705-90(3) to $35,000. After adjusting for hypothetical payments etc. under subsection 705-90(4), the step 3 amount is limited to $35,000.

Sub Co's book value for the depreciating assets is $80,000 and adjustable value is $50,000. In this case the market value of the depreciating asset is equal to its book value at the joining time.

Calculation

The following calculation shows how the value of the DTL to be used at step 2 of the ACA calculation is determined, starting, for convenience, with the joining entity's DTL amount.

Table 3: ACA calculation – 1st iteration ($)

Step 1	Add cost of membership interests		200,000
Step 2	Add Liabilities		
	– Provision for Tax	15,000	
	– DTL to be carried by HCo	9,000	24,000
Step 3	Add undistributed taxed profits		35,000
Step 8	Total ACA		259,000

Table 4: Tax cost setting amounts (TCSA) after 1st iteration ($)

Step A	ACA	259,000
Step B	*Less* retained cost base assets	
	— Cash	(100,000)
Step C	Allocate balance of ACA to reset cost base assets	159,000
	Market value	**TCSA**
Property	100,000	88,333
Asset	80,000	70,667
	180,000	159,000

Table 5: Value of DTL to head company after 1st ACA iteration ($)

	Book value	TCSA	Diff @30%
Asset	80,000	70,667	(9,333 x 30%) = 2,800
DTL in head coy			2,800

This does not match the DTL used in ACA step 2. This amount is used in the next iteration.

Table 6: ACA calculation – 2nd iteration ($)

Step 1	Add cost of membership interests		200,000
Step 2	Add Liabilities		
	– Provision for Tax	15,000	
	– DTL to be carried by HCo	2,800	17,800
Step 3	Add undistributed taxed profits		35,000
Step 8	Total ACA		252,800

Table 7: TCSAs after 2nd iteration ($)

Step A	ACA	252,800
Step B	*Less* retained cost base assets	
	– Cash	(100,000)
Step C	Allocate balance of ACA to reset cost base assets	152,800
	Market value	**TCSA**
Property	100,000	84,889
Asset	80,000	67,911
	180,000	152,800

Table 8: Value of DTL to head company after 2nd ACA iteration ($)

	Book value	TCSA	Diff @30%
Asset	80,000	67,911	(12,089 x 30%) = 3,627
DTL in head coy			3,627

After the second iteration the DTL is $3,627. This does not match the DTL used in step 2 in the second ACA iteration. This amount is used in the next ACA iteration.

Table 9: ACA calculation – 3rd iteration ($)

Step 1	Add cost of membership interests		200,000
Step 2	Add Liabilities		
	– Provision for Tax	15,000	
	– DTL to be carried by HCo	3,627	18,627
Step 3	Add undistributed taxed profits		35,000
Step 8	Total ACA		253,627

Table 10: TCSAs after 3rd iteration ($)

Step A	ACA		253,627
Step B	*Less* retained cost base assets		
	– Cash		(100,000)
Step C	Allocate balance of ACA to reset cost base assets		153,627
		Market value	**TCSA**
Property		100,000	85,348
Asset		80,000	68,279
		180,000	153,627

Table 11: Value of DTL to head company after 3rd ACA iteration ($)

	Book value	TCSA	Diff @30%
Asset	80,000	68,279	(11,721x 30%) = 3,516
DTL in head coy			3,516

After the third iteration the DTL is $3,516. This is different to the amount used in ACA step 2 for this iteration, although the difference is gradually reducing. The process is continued until the number does not change.

Table 12: Apply 705-70(1A) ($)

		4th calc	5th calc	6th calc (final)
ACA Step 1		200,000	200,000	200,000
Step 2	Provision for Tax	15,000	15,000	15,000
	DTL	**3,516**	**3,531**	**3,529**
Step 3		35,000	35,000	35,000
Total ACA		253,516	253,531	253,529
Apply to Cash		100,000	100,000	100,000
Available to reset cost base assets	Market value			
Property	100,000	85,287	85,295	85,294
Asset	80,000	68,229	68,236	68,235
Total	180,000	153,516	153,531	153,529
DTL in head entity				
Asset		3,531	3,529	3,529
Total DTL		3,531	3,529	3,529

To the nearest dollar the amount used for DTL at step 2 of the ACA calculation in the 6th iteration is the same as the DTL calculated for the group at the end of the 6th iteration. The correct amount of DTL to be counted at step 2 of the ACA under subsection 705-70(1A) is therefore $3,529. The step 2 amount will be $18,529 ($15 000 + 3,529) and not $24,000 (as in the first iteration).

Table 13: Final ACA calculation ($)

Step 1	Add cost of membership interests		200,000
Step 2	Add Liabilities		
	– Provision for Tax	15,000	
	– DTL to be carried by HCo	3,529	18,529
Step 3	Add undistributed taxed profits		35,000
Step 8	Total ACA		253,529

Table 14: Final TCSAs ($)

Step A	ACA	253,529
Step B	*Less* retained cost base assets	
	– Cash	(100,000)
Step C	Allocate balance of ACA to reset cost base assets	153,529
	Market value	**TCSA**
Property	100,000	85,294
Asset	80,000	68,235
	180,000	153,529

Applying the short cut methods to Example 1

Short cut method 1: shortening the process by informed judgement

Example 1 demonstrates that the result for the DTL at each iteration will lie between its original value in the joining entity and the first value calculated in the head company. The difference in value between iterations gradually declines until the DTL used in step 2 is the same as the DTL determined for the group. The use of an informed judgement after, say, two or three iterations may reduce the number of iterations required to reach the final result.

In Example 1, after the third iteration you could make the judgement that in the next iteration you will insert a value for the DTL of, say, $3,520. After two more iterations you may want to make another informed judgement of the DTL value to be inserted in the next iteration.

Short cut method 2: applying the materiality factor

The number of iterations can be reduced by applying a materiality factor to the percentage change in DTL between iterations – i.e., you do not need to do another iteration provided the change in value of the DTL between iterations is 2% or less and less than $1 million dollars.

This short cut method is demonstrated using Example 1 in table 15. By iteration 4, the change in the DTL value (i.e., $3,531-$3516 = $15 or 0.43%) is 2% or less and less than $1 million. Therefore, using this short cut, the number of iterations required in this example is limited to four.

Table 15: Applying the materiality factor short cut

Iteration	DTL used in step 2 ($)	DTL in head entity after calculation ($)	Difference ($)	Calculation	Percentage change (%)
1	9000	2,800	6,200	6,200/9,000 x 100/1	68.89
2	2,800	3,627	827	827/2,800 x 100/1	29.54
3	3,627	3,516	111	111/3,627 x 100/1	3.06
4	3,516	3,531	15	15/3,516 x 100/1	0.43
5	3,531	3,529	2	2/3,531 x 100/1	0.06
6	3,529	3,529	0		n/a

Short cut method 3: stopping the process when the DTL is less than the previous iteration

Example 1 demonstrates how the DTL value ‘zig zags’ between the original value in the joined entity and the first value calculated in the head entity. The change in the value of the DTL becomes smaller with each iteration.

The ATO will accept a value determined by you where you choose to stop at any point in the iterative process, provided the value of the DTL at that point is less than the DTL used in the previous iteration.

For instance, in Example 1, you may choose to halt the process after iterations 1 or 3. If you choose to stop at these iterations the DTL value that you would use at step 2 of the final ACA calculation would be $2,800 or $3,516 respectively.

Example 2

Facts

Head company HCo is the head company of an existing consolidated group. It acquires 100% of the membership interests in Sub Co for $245,500 on 1 July 2003. As a result Sub Co joins the consolidated group. Sub Co's balance sheet is shown in table 16.

Before the joining time, Sub Co paid an unfranked dividend of $15,000 to its holding company. The holding company was entitled to an inter-corporate dividend rebate in respect of the dividend.

Table 16: Sub Co – financial position at joining time ($)

Cash	85,000	Capital	200,000
Depreciating Asset	80,000	Retained earnings	41,000
Non-depreciating Asset	100,000	Provision for Tax	15,000
		Deferred tax liability	9,000
	265,000		265,000

Sub Co's book value for the Depreciating Asset is $80,000 and adjustable value is $50,000. In this case the market value of the Depreciating Asset is equal to its book value at the joining time.

Calculation

The following example shows how to work out the value of the DTL to be used at step 2 of the ACA calculation, starting, for convenience, with the joining entity's DTL amount.

Table 17: ACA calculation – 1st iteration ($)

Step 1	Add cost of membership interests		245,500
Step 2	Add Liabilities		
	– Provision for Tax	15,000	
	– DTL to be carried by HCo	9,000	24,000
Step 8	ACA		269,500

Table 18: TCSAs after 1st iteration ($)

Step A	ACA	$269,500
Step B	*Less* retained cost base assets	
	– Cash	($85,000)
Step C	Allocate balance of ACA to reset cost base assets and adjust for revenue like assets	$184, 500
	Market value	**TCSA**
Depreciating Asset	$80, 000	$80,000*
Non-depreciating Asset	$100,000	$104,500*
	$180,000	$184, 500
Step D	Adjust TCSA of over-depreciated asset	
Depreciating Asset		$65,000**
Non-depreciating Asset		$104,500

* Tax cost setting amount for reset cost base assets held on revenue account adjustment (section 705-40). The TCSA amount for a depreciating asset must not exceed the greater of the asset's market value and the joining entity's terminating value. In the above case the TCSA of the Depreciating Asset was $82,000, i.e. $2,000 greater than its market value. This excess is allocated to other reset cost base asset (i.e. Non-depreciating Asset increased from $102,500 to $104,500).

** The Depreciating Asset is over-depreciated by $30,000. The tax deferral amount for the Depreciating Asset is $15,000. The lesser of these two amounts (i.e., $15,000) is the over-depreciation reduction amount under former section 705-50. Therefore the TCSA for the Depreciating Asset is further reduced from $80,000 to $65,000. The excess of this amount is not reallocated to other reset cost base assets.

Table 19: Value of DTL to head company after 1st ACA iteration ($)

	Book value	TCSA	Diff @30%
Depreciating Asset	80,000	65,000	($15,000 x 30%) = 4,500
DTL in head coy			4,500

This does not match the DTL used in ACA step 2. This amount is used in the next iteration.

Table 20: ACA calculation – 2nd iteration ($)

Step 1	Add cost of membership interests		245,500
Step 2	Add Liabilities		
	– Provision for Tax	15,000	
	– DTL to be carried by HCo	4,500	19,500
Step 8	ACA		265,000

Table 21: TCSAs after 2nd iteration ($)

Step A	ACA	$265,000
Step B	*Less* retained cost base assets	
	– Cash	($85,000)
Step C	Allocate balance of ACA to reset cost base assets and adjust for revenue like assets	$180,000
	Market value	**TCSA**
Depreciating Asset	$80,000	$80,000*
Non-depreciating Asset	$100,000	$100,000
	$180,000	$180,000
Step D	Adjust TCSA of over-depreciated assets	
Depreciating Asset		$65,000**
Non-depreciating Asset		$100,000

* No revenue-like asset adjustment required. The TCSA amount for the depreciating asset does not exceed the greater of the asset's market value and the joining entity's terminating value (section 705-40).

** As previously determined, the over-depreciation reduction amount under former section 705-50 is $15,000. Therefore the TCSA for the Depreciating Asset is further reduced from $80,000 to $65,000. The excess of this amount is not reallocated to other reset cost base assets.

Table 22: Value of DTL to head company after 2nd ACA iteration ($)

	Book value	TCSA	Diff @30%
Depreciating Asset	80,000	65,000	($15,000 x 30%) = 4,500
DTL in head coy			4,500

This matches the DTL used in ACA step 2. Therefore, in this example, further iterations are not required and the short cuts do not need to be considered.

The final tax cost setting amounts for the reset cost base assets are the amounts as in table 21 – the amounts at the second iteration.

References

Income Tax Assessment Act 1997, subsections 705-70(1) and 705-70(1A); as amended by:

- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002)
- *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 8

Income Tax Assessment Act 1997, subsections 705-70(3) and 995-1(1) as inserted by *Tax Laws Amendment (2010 Measures No. 1) Act 2010 (No. 56 of 2010),* Schedule 5, Part 8

Income Tax (Transitional Provisions) Act 1997, sections 701-32 and 701-34; as inserted by *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1, Part 9

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004, paragraphs 1.156 – 1.162

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5

Revision history

Section C2-4-242 first published 3 December 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on proposed changes to consolidation rules.	Proposed legislative amendments.
26.10.05	Removal of note on proposed change to rules, p. 1, and insertion of reference to new concession for transitional entities, p. 2.	Legislative amendments.
26.6.07	Note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used, and to the cost setting rules to phase out over-depreciation deductions, p. 12.	Reflect announcement on 8 May 2007 by Assistant Treasurer in media release no. 50.
6.5.11	Modified reference to CGT event L7; and notes on proposed changes removed. Removal of note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used, and to the cost setting rules to phase out over-depreciation deductions.	Legislative amendments.

Worked example

Adjustment at ACA step 2 to allow for timing differences between accounting and tax recognition of liabilities

Description

The ACA step 2 amount for an accounting liability is reduced or adjusted in some circumstances → sections 705-70, 705-75, 705-80 and 705-85, *Income Tax Assessment Act 1997* (ITAA 1997). This example shows how:

- section 705-80 works in conjunction with sections 705-70 and 705-75, using liabilities raised by accrued employee leave entitlements to demonstrate the principle
- an administrative shortcut can be used to determine the amount and timing of notional deductions in situations where insufficient information is available for an accurate reconstruction, and
- administrative guidelines can be used in reconstructing the accounts as required by section 705-80.

Commentary

The second step in determining a joining entity's ACA involves adding all of its accounting liabilities, in accordance with its accounting principles for tax cost setting. The joining entity's accounting principles for tax cost setting are the accounting standards or authoritative pronouncements of the Australian Accounting Standards Board that the entity would use if it were to prepare its financial statements just before the joining time. → subsection 705-70(1), subsection 705-70(3), section 995-1, ITAA 1997

If any parts of an accounting liability will give rise to a deduction to the head company when discharged, the liability amount is reduced by the deduction amount multiplied by the general company tax rate (except to the extent that the liability amount has already been reduced because of the future tax benefit). → subsection 705-75(1)

Where there is a timing difference between income tax provisions and accounting standards in recognising a liability, a notional ACA calculation is required → section 705-80. The notional ACA is calculated by assuming the liability had been discharged for income tax purposes at the same time as it is taken into account for accounting purposes. This may in turn require a notional reconstruction of the joining entity's accounting and tax positions for the years in which the liability arose in order to align them. Under the reconstruction there may be adjustments to the amounts at step 3 (undistributed profits), step 5 (unused losses that have accrued to the group) and step 6 (unused losses that have not accrued to the group). Note that these adjustments are only relevant for the purposes of this calculation.

The notional ACA is then compared with the first ACA which is calculated without applying section 705-80. If:

notional ACA < first ACA:	reduce the step 2 amount by the difference
notional ACA > first ACA:	increase the step 2 amount by the difference
notional ACA = first ACA:	no adjustment to step 2 amount is required

→ section 705-80

The amounts calculated at each step of the first ACA calculation, other than the step 2 amount, will remain as the relevant amounts for the final ACA calculation. → Taxation Determination TD 2004/70; Taxation Determination TD 2004/71

Accrued employee leave entitlements

An accrued employee entitlement such as long service leave is a liability of the joining entity according to the accounting standards. For tax purposes, an accrued employee leave entitlement is not deductible in the year it accrues. It will be deductible by the head company when the liability is discharged. Consequently, an adjustment under section 705-80 may be required where the liabilities of a joining entity include such a provision.

Disaggregation of liabilities

The accounting liabilities to which section 705-80 applies need to be disaggregated into each liability type. For example, where the joining entity's provision for employee benefits is an aggregate of long service leave and annual leave entitlements, the provisions for long service leave and annual leave must be disaggregated and recognised.

Is a notional reconstruction required?

A notional reconstruction is required of the joining entity's accounting and tax positions for the years in which the liability arose in order to align them → section 705-80. Note that there are circumstances where the notional reconstruction will not change the position and therefore effectively does not have to be undertaken.

Short cut method for recognising amount and timing of notional deduction

In many cases taxpayers may not have sufficient information available to accurately reconstruct the tax position as required by section 705-80. Where the historical information needed to establish the amount and timing of any notional deduction is not available, the most reliable basis of estimation may be used. → section 705-80

To assist taxpayers to determine the amount of a notional deduction, and the time or period to which it relates, the short cut method illustrated in the decision flow chart in figure 1 provides a reasonable approximation of the deduction allocation required by section 705-80.

However, you can only use the shortcut method in situations where you do not have sufficient information on which to base a reliable estimate. If the short cut method is not suitable for your circumstances and you would like to use another approach you should contact the ATO for guidance.

The administrative short cut method is based on a concept of materiality under which an immaterial amount is deemed to relate to the immediate prior year.

Materiality thresholds

An amount for the total of the section 705-80 affected liabilities is material if it exceeds the greater of $5 million or 5% of the ACA as initially calculated. An amount for an individual liability is material if it exceeds the greater of $1 million or 1% of the initial ACA.

Guidelines for notional reconstruction to align accounting and tax positions

The notional reconstruction that may be required to align the tax and accounting positions should be undertaken in line with the following guidelines. (Note that the notional reconstruction is limited to the 'tax accounts' – deferred tax assets, deferred tax liabilities and the provision for taxation. The other accounts remain unchanged.)

- There must be consistency in the treatment of the financial accounts and the notionally reconstructed accounts.
  - For example, if a deferred tax asset reflecting the future benefit arising from an unused tax loss is not normally recorded in the financial accounts it should not be recorded in the notionally reconstructed accounts.
- If a notional reconstruction is required it must be undertaken for each year to which the liability relates.
- The notional reconstruction should be confined to the income tax accounts – i.e. the deferred tax assets, deferred tax liabilities and provision for income tax.
- Deferred tax assets and deferred tax liabilities in respect of liabilities to which section 705-80 applies will cease to exist for the purposes of the notional reconstruction.
- Deferred tax assets may need to be created for unused notional tax losses, but only if the deferred tax asset was previously recorded in the financial accounts or where the taxpayer applies the accounting standards in such a way that it would have been recorded had it existed.
- The notional reconstruction of the provision for tax must take into account 'real world' payments and refunds.
- The tax provision must always be treated as a liability regardless of the balance in the hypothetical account.
  - There will be instances where the notional reconstruction results in the entity moving from a real world taxable income to a notional tax loss, resulting in the provision for tax moving into a debit balance. In these circumstances the provision for tax will reduce the amount available to be included at step 2 of the notional ACA calculation.
- Notional journal entries reflecting the aligned taxation and accounting position should be completed where appropriate.
- A notional franking account must be prepared and it must take into account real world dividend payments.
- If there is any difference between the notional ACA and the first ACA the difference is set off against the total of the first ACA step 2 amount.

Examples

Examples 1 to 3 demonstrate how section 705-80 applies to the ACA calculation, examples 4 and 5 demonstrate use of the short cut method for the notional deduction, and example 6 demonstrates the notional reconstruction.

Example 1 shows how section 705-80 applies to the ACA calculation for a joining entity that has a tax loss. A notional reconstruction for the year immediately before consolidation is required because the joining entity has unutilised tax losses at the joining time.

Example 2 shows how section 705-80 applies to the ACA calculation for a joining entity that has accounting profits. A reconstruction is not necessary because the joining entity is in an accounting and tax profit situation at the joining time and on the application of section 705-80 the notional tax deductions for the provisions would not give rise to a notional tax loss.

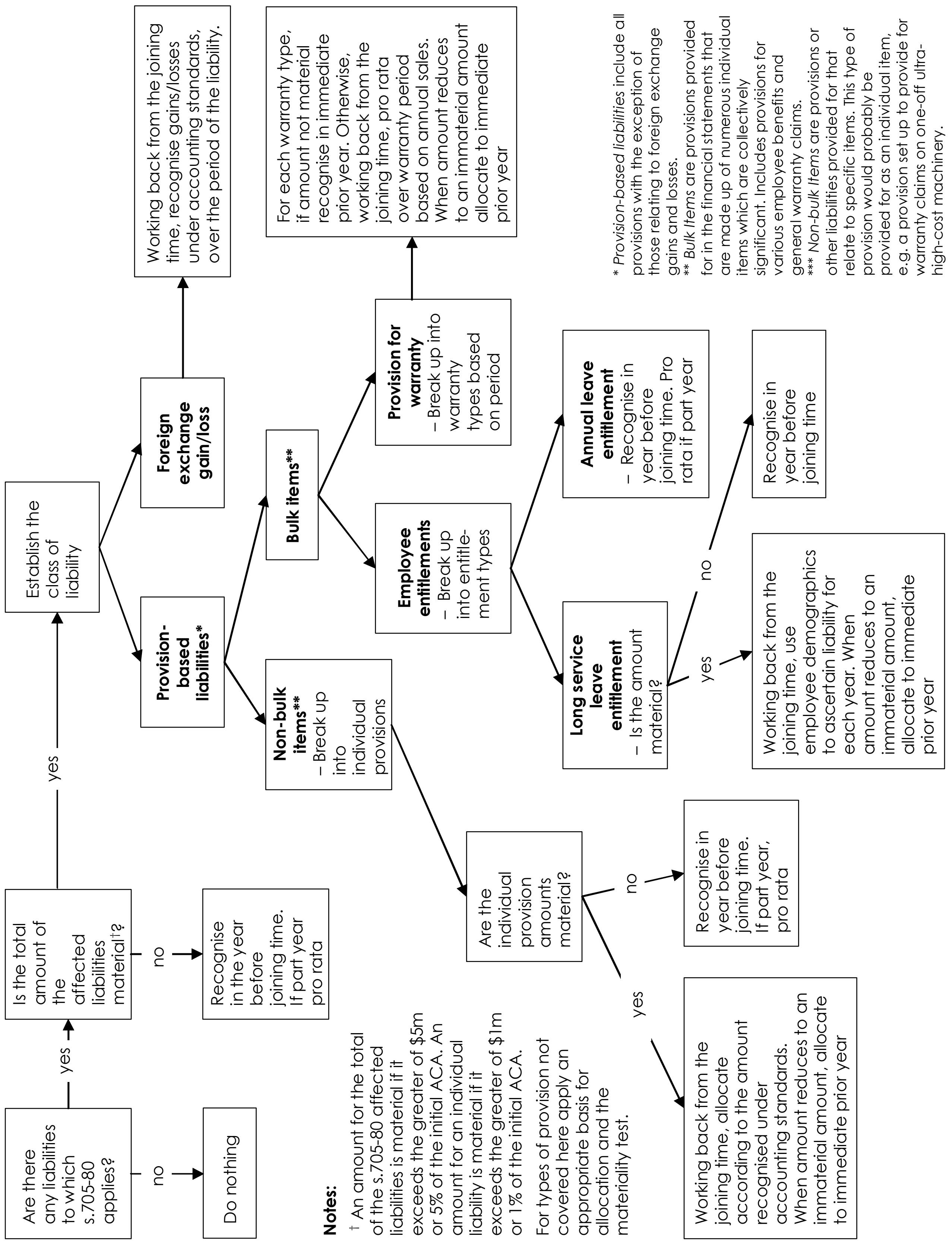
Example 3 shows how section 705-80 applies to the ACA calculation for a joining entity that has been incrementally acquired and has tax losses. In this example, a notional reconstruction is required for more than one year before consolidation occurs, as the joining entity has unutilised tax losses at the joining time.

Example 4 demonstrates the notional reconstruction process where reasonably accurate information is available.

Example 5 demonstrates how the amount and timing of a notional deduction is determined where only limited information is available, using the administrative shortcut method described in figure 1.

Example 6 demonstrates the notional reconstruction necessary to align the accounting and tax positions using the guidelines set out earlier in this section.

Figure 1: Decision flow chart for section 705-80 deduction allocation short cut



* *Provision-based liabilities* include all provisions with the exception of those relating to foreign exchange gains and losses.
** *Bulk Items* are provisions provided for in the financial statements that are made up of numerous individual items which are collectively significant. Includes provisions for various employee benefits and general warranty claims.
*** *Non-bulk Items* are provisions or other liabilities provided for that relate to specific items. This type of provision would probably be provided for as an individual item, e.g. a provision set up to provide for warranty claims on one-off ultra-high-cost machinery.

Notes:

† An amount for the total of the s.705-80 affected liabilities is material if it exceeds the greater of $5m or 5% of the initial ACA. An amount for an individual liability is material if it exceeds the greater of $1m or 1% of the initial ACA.

For types of provision not covered here apply an appropriate basis for allocation and the materiality test.

Example 1

Facts

ACo is incorporated on 1 July 2004 with $200 cash by HCo.

Table 1: Financial position at 1 July 2004 ($)

Cash	200	Capital	200
	200		200

During the financial year ending 30 June 2005, ACo makes a tax loss of $100 and a provision for annual leave of $100. The deferred tax asset includes $30 from the tax loss as well as $30 from the provision for annual leave. The provision for annual leave is a liability of ACo in accordance with its accounting principles for tax cost setting.

Table 2: Financial position at 30 June 2005 ($)

Cash	100	Capital	200
DTA	60	Retained earnings	(140)
		Provision for annual leave	100
	160		160

DTA: deferred tax asset

On 1 July 2005, HCo forms a consolidated group with ACo as a subsidiary member.

Calculation

First ACA calculation

The provision for annual leave is an accounting liability, and is not deductible for income tax purposes in the year it accrues. Therefore, as a subsection 705-70(1) liability, only its net cost to the group is recognised at step 2 of the ACA calculation → subsection 705-75(1):

Step 1	Add amount paid by HCo to incorporate ACo	$200
Step 2	Add amount accrued for annual leave ($100) – subsection 705-70(1), *less* $30, the future tax deductible amount – subsection 705-75(1)	$70
Steps 3 & 4		Nil
Step 5	Subtract unused tax losses	($100)
Steps 6 & 7		Nil
First ACA		$170

Notional ACA calculation (section 705-80)

Section 705-80 requires a notional ACA calculation based on the assumption that the employment leave entitlement is tax deductible in the same financial year as it is accrued. Accordingly, ACo is taken to have made a tax loss of $200 and the notional ACA calculation is as follows:

Step 1	Add amount paid by HCo to incorporate ACo	$200
Step 2	Add amount accrued for annual leave – subsection 705-70(1)	$100
Steps 3 & 4		Nil
Step 5	Subtract unused tax losses *plus* $100 for the accrued employee leave entitlement (as if it were deductible for income tax purposes)	($200)
Steps 6 & 7		Nil
Notional ACA		$100

Final ACA calculation

As the notional ACA is less than the first ACA, the difference of $70 is subtracted from the step 2 amount of the first ACA calculation ($70) → section 705-80. The step 2 amount after this adjustment is therefore nil, with the final ACA calculated as follows:

Step 1	Add amount paid by HCo to incorporate ACo	$200
Step 2	Add amount accrued for annual leave ($100) – subsection 705-70(1), *less* $30 for future tax deductible amount – subsection 705-75(1). Then subtract $70 (section 705-80 adjustment)	Nil
Steps 3 & 4		Nil
Step 5	Subtract unused tax losses	($100)
Steps 6 & 7		Nil
Final ACA		$100

Allocation of the final ACA

The final ACA is allocated to the retained cost base assets (cash of $100). The deferred tax asset for the provision for annual leave ($30) is an excluded asset under subsection 705-35(2). There is no excess or shortfall in the ACA.

Example 2

Facts

BCo is incorporated by HCo on 1 July 2004 with $200 cash.

Table 3: Financial position at 1 July 2004 ($)

Cash	200	Capital	200
	200		200

During the financial year ending 30 June 2005, BCo's taxable income is $200 and it makes a provision for annual leave of $100.

Table 4: Financial position at 30 June 2005 ($)

Cash	400	Capital	200
DTA	30	Retained earnings	70
		Provision for income tax	60
		Provision for annual leave	100
	430		430

On 1 July 2005, HCo forms a consolidated group with BCo as a subsidiary member.

The provision for annual leave is a liability of BCo in accordance with its accounting principles for tax cost setting.

Calculation

First ACA calculation

The provision for annual leave is an accounting liability, and is not deductible for income tax purposes in the year it accrues. Therefore, as a subsection 705-70(1) liability, only its net cost to the group is recognised at step 2 of the ACA calculation → section 705-75(1):

Step 1	Add amount paid by HCo to incorporate BCo	$200
Step 2	Add amount accrued for annual leave ($100) – subsection 705-70(1), *less* $30 for future tax deductible amount – subsection 705-75(1). Then add amount for provision for income tax ($60) – subsection 705-70(1)	$130
Step 3	Add amount of undistributed frankable profits	$70
Steps 3A to 7		Nil
First ACA		$400

Notional ACA calculation

Section 705-80 requires a notional ACA calculation based on the assumption that the accrued employment leave entitlements are tax deductible in the same financial year as they are accrued. Accordingly, BCo's taxable income would be $100 and therefore the provision for income tax would be $30. The amounts for the other liability (provision for annual leave) and profit would remain unchanged. The notional ACA calculation is as follows:

Step 1	Add amount paid by HCo to incorporate BCo	$200
Step 2	Add amount accrued for annual leave ($100) and the provision for income tax ($30) – subsection 705-70(1)	$130
Step 3	Add amount of undistributed frankable profits	$70
Steps 3A to 7		Nil
Notional ACA		$400

Final ACA and its allocation

The first ACA and the notional ACA are both $400. In this situation, no adjustment to the step 2 amount is required under section 705-80, and therefore the final ACA amount is also $400.

The final ACA is allocated to the retained cost base asset (cash of $400). The deferred tax asset is an excluded asset under subsection 705-35(2). There is no excess or shortfall in the ACA.

Example 3

Facts

On 1 July 2004, CCo is incorporated with $300 cash. On the same day, HCo purchases 60% of CCo for $180.

Table 5: Financial position at 1 July 2004 ($)

Cash	300	Capital	300
	300		300

During the financial year ending 30 June 2005, CCo incurs a tax loss of $100 and makes a provision of $100 for annual leave. The deferred tax asset includes $30 from the tax loss and $30 from the provision for annual leave.

Table 6: Financial position at 30 June 2005 ($)

Cash	200	Capital	300
DTA	60	Retained earnings	(140)
		Provision for annual leave	100
	260		260

On 1 July 2005, HCo purchases the remaining 40% of CCo for $64.

During the financial year ending 30 June 2006, CCo again incurs a tax loss of $100 and makes a provision for long service leave of $100. The deferred tax asset again includes $30 from the tax loss and $30 from the provision for long service leave.

Table 7: Financial position at 30 June 2006 ($)

Cash	100	Capital	300
DTA	120	Retained earnings	(280)
		Provision for annual leave	100
		Provision for long service leave	100
	220		220

On 1 July 2006, HCo forms a consolidated group with CCo as a subsidiary member.

The provisions for annual leave and long service leave are liabilities of CCo in accordance with its accounting principles for tax cost setting.

Calculation

First ACA calculation

The provisions for annual leave and long service leave are accounting liabilities, and they are not deductible for income tax purposes in the year they accrue. Therefore, as subsection 705-70(1) liabilities, only their net cost to the group is recognised at step 2 of the ACA calculation → subsection 705-75(1):

Step 1	Add amount paid by HCo for membership interests in CCo ($180 for 60% and $64 for 40%)	$244
Step 2	Add the provision for annual leave ($100) and long service leave ($100), *less* the future tax deductible amount of $60	$140
Steps 3 & 4		Nil
Step 5	Subtract unused owned tax losses: i.e., 60% of the $100 tax loss in the first year *plus* 100% of the $100 tax loss in the second year	($160)
Step 6	Subtract acquired tax losses multiplied by the company tax rate: i.e., 40% of the $100 tax loss from the first year *multiplied* by 30%	($12)
Step 7		Nil
First ACA		$212

Notional ACA calculation

Section 705-80 requires a notional ACA calculation based on the assumption that the accrued employment leave entitlements are tax deductible in the same financial year as they accrue. In HCo's situation, its financial position for both years requires a notional reconstruction so that a notional ACA can be calculated. Accordingly, the $100 annual leave accrued in the first year would be taken to be tax deductible in that year. This is added to the actual tax loss of $100 to give a notional tax loss for the first year of $200. Similarly, the $100 long service leave that accrued in the second year would be taken to be tax deductible in the second year resulting in a notional tax loss for the second year of $200.

The notional ACA calculation is as follows:

Step 1	Add amount paid by HCo for membership interests in CCo ($180 for 60% and $64 for 40%)	$244
Step 2	Add amount accrued for annual leave ($100) and long service leave ($100) – subsection 705-70(1)	$200
Steps 3 & 4		Nil
Step 5	Subtract the notional unused owned tax losses: i.e., 60% of the $200 tax loss in the first year *plus* 100% of the $200 tax loss in the second year	$320
Step 6	Subtract notional acquired tax losses multiplied by the company tax rate: i.e., 40% of the $200 tax losses from the first year *multiplied* by 30%	$24
Step 7		Nil
Notional ACA		$100

Final ACA calculation

As the notional ACA is less than the first ACA, the difference of $112 is subtracted from the step 2 amount of the first ACA calculation ($140) → section 705-80. The step 2 amount after this adjustment is therefore $28, and the final ACA calculation is as follows:

Step 1	Add amount paid by HCo to incorporate CCo	$244
Step 2	Add amount accrued for annual leave ($100) and long service leave ($100) – subsection 705-70(1), *less* $60, the future tax deductible amount – subsection 705-75(1), and $112, the section 705-80 reduction	$28
Steps 3 to 4		Nil
Step 5	Subtract unused owned tax losses: i.e., 60% of the $100 tax loss in the first year *plus* 100% of the $100 tax loss in the second year	($160)
Step 6	Subtract acquired tax losses multiplied by the company tax rate: i.e., 40% of the $100 tax loss from the first year *multiplied* by 30%	$12
Step 7		Nil
Final ACA		$100

Allocation of the final ACA

The final ACA is allocated to the retained cost base asset (cash of $100). The deferred tax assets for the annual leave ($30), the long service leave ($30) and for the unused tax losses ($60) are excluded assets under subsection 705-35(2). There is no excess or shortfall in the ACA.

Example 4

Company A is incorporated on 1 July 2000 with capital of $100 million. During the year it acquires land for $100 million, receives income of $100 million (taxable income $100 million) and makes provision for long service leave of $50 million and tax of $30 million.

Table 8: Financial position at 30 June 2001 ($m)

Cash	100	Capital	100
Land	100	Retained earnings	35
DTA	15	Provision for long service leave	50
		Provision for income tax	30
	215		215

During the year ending 30 June 2002, company A pays the 2001 income year tax of $30 million, receives income of $100 million, incurs costs of $30 million for long service leave (taxable income $70 million) and makes provision for long service leave of $50 million and tax of $21 million.

Table 9: Financial position at 30 June 2002 ($m)

Cash	140	Capital	100
Land	100	Retained earnings	70
DTA	21	Provision for long service leave	70
		Provision for tax	21
	261		261

During the year ending 30 June 2003, company A pays the 2002 income year tax of $21 million, receives income of $100 million (taxable income $100 million) and makes provision for long service leave of $50 million and tax of $30 million.

Table 10: Financial position at 30 June 2003 ($m)

Cash	219	Capital	100
Land	100	Retained earnings	105
DTA	36	Provision for long service leave	120
		Provision for tax	30
	355		355

During the year ending 30 June 2004, company A pays the 2003 income year tax of $30 million, receives income of $100 million (taxable income $100 million) and makes provision for long service leave of $50 million, tax of $30 million and annual leave of $50 million.

Table 11: Financial position at 30 June 2004 ($m)

Cash	289	Capital	100
Land	100	Retained earnings	105
DTA	66	Provision for long service leave	170
		Provision for tax	30
		Provision for annual leave	50
	455		455

Company A joins a consolidated group on 1 July 2004. Its section 705-80 affected liabilities can be allocated as follows:

Provision for annual leave

The liability arising from the provision for annual leave relates to the year ending 30 June 2004. While this is clearly the case in this example, it may also be reasonable to assume that the vast majority of employees would take their annual leave on an annual basis. Therefore, such an allocation provides a reasonable approximation of the deduction allocation. However, if information is available that can provide a more reliable basis of allocation that basis must be used.

Provision for long service leave

Company A has in its accounts made provision for an amount of $50 million per year for long service leave. In this instance, a first in, first out approach would be an appropriate basis of allocation as it would result in a reasonable approximation of the deduction allocation. The provision balance of $170 million for long service leave at 30 June 2004 would therefore be allocated as follows:

Year ending 30 June 2004	$50m
Year ending 30 June 2003	$50m
Year ending 30 June 2002	$50m
Year ending 30 June 2001	$20m

Again, if information is available that can provide a more reliable basis of allocation, that basis must be used.

Example 5

Using the same financial data as in example 4, assume that the only records that company A had, or could obtain, are its statement of financial position for the year ending 30 June 2004 and income tax data obtained from the ATO. This example shows how in these circumstances company A might reconstruct its tax position for the purposes of section 705-80 using the administrative shortcut.

The initial ACA is calculated as follows:

Step 1	$100m
Step 2	$184m
Step 3	$105m
ACA	$389m

For the purposes of the administrative shortcut, an amount for the total of the section 705-80 liabilities is material if it exceeds the greater of $5 million or 5% of the ACA as initially calculated.

As the total of company A’s section 705-80 affected liabilities ($220 million) exceeds $19.45 million (5% of the ACA), it is a material amount and it is necessary to establish the class of the liability.

The liabilities in this instance fall into the bulk items category and need to be broken up into the entitlement types, i.e. annual leave entitlements of $50 million and long service leave entitlements of $170 million.

The annual leave entitlements can be reasonably allocated to the year ending 2004.

As the total of the individual liability for long service leave ($170 million) is a material amount (it exceeds the greater of $1 million or 1% of the initial ACA), it is necessary to allocate the amount on an annual basis. The long service leave can be allocated on the basis of employee demographics at each year end, unless a more reliable basis is available, and the alignment of the accounting and taxation positions required by section 705-80 should proceed on that basis.

Example 6

Note that this example presumes a constant rate of tax in each of the four years but the guidelines are equally applicable where there have been changes in the tax rates.

Year 1

ACo, a wholly owned subsidiary of HC, was incorporated at the start of the Y1 financial year with contributed capital of $100. During the Y1 financial year it acquired land for $100, borrowed the equivalent of A$2000 in US$, purchased shares in BCo for $2000, received income of $100 and made provision for long service leave of $50 and tax of $30. At the end of Y1 the A$ value of the US$ debt was $1950.

Table 12

Item description	Tax outcome ($)	Accounting outcome ($)
Income	100	100
Forex gain		50
Gross income/loss	100	150
Expenses – long service leave		50
Income/loss	**100**	**100**

Table 13: Financial position at end of Y1 ($)

Cash	100	Capital	100
Land	100	Retained earnings	70
DTA	15	Provision for long service leave	50
Shares in BCo	2000	Provision for tax	30
		US$ debt	1950
		DTL	15
	2215		2215

DTL: deferred tax liability

Table 14: Journal entries for Y1 ($)

Dr Tax expense	30		
Dr DTA – long service leave	15		
		Cr Provision for tax	30
		Cr DTL – forex	15

Table 15: Financial position reflecting the alignment of tax and accounting positions at end Y1 for section 705-80 purposes ($)

Cash	100	Capital	100
Land	100	Retained earnings	70
Shares in BCo	2000	Provision for long service leave	50
		Provision for tax	30
		US$ debt	1950
	2200		2200

Note: The alignment of the Y1 accounting and tax positions has not resulted in a change in the amount of taxable income (though the component parts are different). The notional journal entries to reflect the alignment are:

Dr Tax expense	$30		
		Cr Provision for tax	$30

Year 2

During the Y2 financial year, ACo paid the Y1 tax of $30, received income of $100, paid expenses of $60 and made provision for long service leave of $50 and tax of $12. At end of Y2 the A$ value of the US$ debt is $2050.

Table 16

Item description		Tax outcome ($)		Accounting outcome ($)
Income		100		100
Gross income		100		100
Expenses	60		60	
Long service leave			50	
Forex loss			100	
Total deductions/expenses		60		210
Income/loss		**40**		**(110)**

Table 17: Financial position at end Y2 ($)

Cash	110	Capital	100
Land	100	Retained earnings	(7)
Shares in BCo	2000	Provision for long service leave	100
DTA – long service leave	30	Provision for tax	12
DTA – forex	15	US$ debt	2050
	2255		2255

Table 18: Journal entries for Y2 ($)

Dr DTA – long service leave	15		
Dr DTA – forex	15		
Dr DTL – forex	15		
		Cr Tax expense	33
		Cr Provision for tax	12

Table 19: Financial position reflecting the alignment of tax and accounting positions at end Y2 for section 705-80 purposes ($)

Cash	110	Capital	100
Land	100	Retained earnings	(7)
Shares in BCo	2000	Provision for long service leave	100
DTA – loss	33	US$ debt	2050
	2243		2243

Note: As a consequence of the alignment of the Y2 accounting and tax positions, a notional loss of $110 is available to be offset against the Y3 profits. The notional journal entries reflecting the carry forward tax loss of $110 are:

Dr Deferred tax asset – Tax loss	$33		
		Cr Tax expense	$33

Year 3

During the Y3 financial year, ACo paid the Y2 tax of $12, received income of $100, paid a $70 fully franked dividend ($100 – $30 franking credits) and made provision for long service leave of $50 and tax of $30. At end Y3 the A$ value of the US$ debt is $1300.

Table 20

Item description	Tax outcome ($)	Accounting outcome ($)
Income	100	100
Forex gain		750
Gross income	100	850
Expenses – long service leave		50
Income/loss	**100**	**800**

Table 21: Financial position at end Y3 ($)

Cash	128	Capital	100
Land	100	Retained earnings	483
DTA – long service leave	45	Provision for long service leave	150
Shares in BCo	2000	Provision for tax	30
		US$ debt	1300
		DTL	210
	2273		2273

Table 22: Journal entries for Y3 ($)

Dr DTA – long service leave	15		
Dr Tax expense	240		
		Cr Provision for tax	30
		Cr DTL – forex	210
		Cr DTA – forex	15

Table 23: Financial position reflecting the alignment of tax and accounting positions at end Y3 for section 705-80 purposes ($)

Cash	128	Capital	100
Land	100	Retained earnings	483
DTA – long service leave	NIL	Provision for long service leave	150
Shares in BCo	2000	Provision for tax	195
		US$ debt	1300
	2228		2228

Note: As a consequence of the alignment of the Y3 accounting and tax positions, the Y3 notional taxable income is $690 (accounting profit of $800 less the notional carry forward loss from Y2 of $110). The notional journal entries reflecting the alignment are:

Dr Tax expense	$240		
		Cr Provision for tax	$207
		Cr Deferred tax asset – Tax loss	$33

The balance in the tax provision of $195 reflects the journal entry credit of $207 less the real world payment of $12 – there was no notional tax provision in the Y2 alignment accounts.

Year 4

During theY4 financial year, A Co paid the Y3 tax of $30, received income of $100, paid expenses of $150, made provision for long service leave of $50 and annual leave of $50. At the end of Y4 the A$ value of the US$ debt is $1600.

HC forms a consolidated group at the commencement of the Y5 financial year.

Table 24

Item description		**Tax outcome ($)**		**Accounting outcome ($)**
Income		100		100
Gross income		100		100
Expenses	150		150	
Long service leave			50	
Annual leave			50	
Forex loss			300	
Total deductions/expenses		150		550
Income/loss		**(50)**		**(450)**

Table 25: Financial position at end Y4 ($)

Cash	48	Capital	100
Land	100	Retained earnings	168
Shares in BCo	2000	Provision for long service leave	200
		Provision for annual leave	50
DTA – long service leave	60	US$ debt	1600
DTA – annual leave	15	DTL	120
DTA – tax loss	15		
	2238		2238

Table 26: Journal entries for Y4 ($)

Dr DTA – long service leave	15		
Dr DTA – annual leave	15		
Dr DTA – tax loss	15		
Dr DTL	90		
		Cr Tax expense	$135

Table 27: Financial position reflecting the alignment of tax and accounting positions at end Y4 for section 705-80 purposes ($)

Cash	48	Capital	100
Land	100	Retained earnings	168
Shares in BCo	2000	Provision for long service leave	200
DTA – long service leave	NIL	Provision for annual leave	50
DTA – annual leave	NIL	Tax	165
DTA – tax loss	135	US$ debt	1600
	2283		2283

Note: The Y4 alignment of accounting and taxation positions has resulted in a notional tax loss of $450. The notional journal entries reflecting the alignment outcome are:

Dr Deferred tax asset – tax loss $135

Cr Tax expense $135

Franking accounts for multi year example

Table 28: Franking account

Financial year	Description	Dr ($)	Cr ($)	Balance ($)
Y2	Paid Y1 tax		30	30
Y3	Paid Y2 tax		12	42
	Franked div.	30		12
Y4	Paid Y3 tax		30	42

Note: ACo's franking account balance at the joining time is $42. Because Y4 results in a tax loss, the assumptions in subsection 705-90(4) have no application.

The amount of undistributed profits for section 705-90 purposes (ACA step 3) is $98 ($42 x 70/30).

Table 29: Hypothetical franking account (reflecting the alignment of the taxation and accounting positions for section 705-80 purposes)

Financial year	Description	Dr ($)	Cr ($)	Balance ($)
Y2	Hypothetical payment of Y1 tax		30	30
Y3	Franked div.	30		NIL
Y4	Hypothetical payment of Y3 tax		207	207

Note: The amount of undistributed profits for hypothetical section 705-90 purposes (ACA step 3) is $483 ($207 x 70/30).

Table 30: ACA calculation ($)

ACA step	Initial ACA	Hypothetical ACA	Final ACA
Step 1	$100	$100	$100
Step 2 (Less 705-70 adjustment – Initial $75)	$1895	$2015	$2000
Step 3	$98	$168	$98
	$2093	$2283	$2198
Step 5 (Less 705-100(2) adjustment – Initial nil, Hypothetical $450 – $315)	$50	$135	$50
ACA	**$2043**	**$2148**	**$2148**

ACA is allocated to Cash $48, Land $100 and Shares $2000.

Accounts for multi-year example

Table 31: Capital ($)

Balance cfwd	100	Y1 Cash	100
	100		100
		Balance bfwd	**100**

Table 32: Cash ($)

Y1 Capital	100	Y1 Land	100
Y1 Loan	2000	Y1 Shares	2000
Y1 Income	100	Balance cfwd	100
	2200		2200
Balance bfwd	100	Y2 Tax	30
Y2 Income	100	Y2 Expenses	60
		Balance cfwd	110
	200		200
Balance bfwd	110	Y3 Tax	12
Y3 Income	100	Y3 Dividend	70
		Balance cfwd	128
	210		210
Balance bfwd	128	Y4 Tax	30
Y4 Income	100	Y4 Expenses	150
		Balance cfwd	48
	237		237
Balance cfwd	**48**		

Table 33: Land ($)

Y1 Cash	100	Balance cfwd	100
	100		100
Balance cfwd	**100**		

Table 34: Shares ($)

Y1 Cash	2000	Balance cfwd	2000
	2000		2000
Balance cfwd	**2000**		

Table 35: US$ debt ($)

Y1 Profit & loss	50	Y1 Cash	2000
Balance cfwd	1950		
	2000		2000
		Balance bfwd	1950
Balance cfwd	2050	Y2 Profit & loss	100
	2050		2050
Y3 Profit & loss	750	Balance bfwd	2050
Balance cfwd	1300		
	2050		2050
		Balance bfwd	1300
Balance cfwd	1600	Y4 Profit & loss	300
	1600		1600
		Balance bfwd	**1600**

Table 36: Income ($)

Y1 Profit & loss	100	Y1 Cash	100
	100		100
Y2 Profit & loss	100	Y2 Cash	100
	100		100
Y3 Profit & loss	100	Y3 Cash	100
	100		100
Y4 Profit & loss	100	Y4 Cash	100
	100		100

Table 37: Provision for long service leave ($)

Balance cfwd	50	Y1 Profit & loss	50
	50		50
		Balance bfwd	50
Balance cfwd	100	Y2 Profit & loss	50
	100		100
		Balance bfwd	100
Balance cfwd	150	Y3 Profit & loss	50
	120		150
		Balance bfwd	150
Balance cfwd	200	Y4 Profit & loss	50
	200		200
		Balance bfwd	**200**

Table 38: Provision for annual leave ($)

Balance cfwd	50	Y4 Profit & loss	50
	50		50
		Balance bfwd	**50**

Table 39: Provision for tax ($)

Balance cfwd	30	Y1 Journal	30
	30		30
Y2 Cash	30	Balance bfwd	30
Balance cfwd	12	Y2 Journal	12
	42		42
Y3 Cash	12	Balance bfwd	12
Balance cfwd	30	Y3 Journal	30
	42		42
Y4 Cash	30	Balance bfwd	30
	30		30

Table 40: Tax expense ($)

Y1 Journal	30	Y1 Profit & loss	30
	30		30
Y2 Profit & loss	33	Y2 Journal	33
	33		33
Y3 Journal	240	Y3 Profit & loss	240
	240		240
Y4 Profit & loss	135	Y4 Journal	135
	135		135

Table 41: DTA – Long service leave ($)

Y1 Journal	15	Balance cfwd	15
	15		15
Balance bfwd	15		
Y2 Journal	15	Balance cfwd	30
	30		30
Balance bfwd	30		
Y3 Journal	15	Balance cfwd	45
	45		45
Balance bfwd	45		
Y4 Journal	15	Balance cfwd	60
	60		60
Balance bfwd	**60**		

Table 42: DTA – Annual leave ($)

Y4 Journal	15	Balance cfwd	15
	15		15
Balance bfwd	**15**		

Table 43: **DTA – tax loss ($)**

Y4 Journal	15	Balance cfwd	15
	15		15
Balance bfwd	**15**		

Table 44: **DTA – forex ($)**

Y2 Journal	15	Balance cfwd	15
	15		15
Balance bfwd	15	Y3 Journal	15
	15		15

Table 45: **DTL – forex ($)**

Balance cfwd	15	Y1 Journal	15
	15		15
Y2 Journal	15	Balance bfwd	15
	15		15
Balance cfwd	210	Y3 Journal	210
	210		210
Y4 Journal	90	Balance bfwd	210
Balance cfwd	120		
	210		210
		Balance bfwd	**120**

Table 46: **Expenses ($)**

Y2 Cash	60	Y2 Profit & loss	60
	60		60
Y4 Cash	150	Y4 Profit & loss	150
	150		150

Table 47: Profit & loss ($)

Y1 Long service leave	50	Y1 Income	100
Y1 Tax expense	30	Y1 Forex gain	50
Y1 Retained earnings	70		
	150		150
Y2 Long service leave	50	Y2 Income	100
Y2 Expense	60	Y2 Tax expense	33
Y2 Forex loss	100	Y2 Retained earnings	77
	210		210
Y3 Long service leave	50	Y3 Income	100
Y3 Tax expense	240	Y3 Forex gain	750
Y3 Retained earnings	560		
	850		850
Y4 Long service leave	50	Y4 Income	100
Y4 Annual leave	50	Y4 Tax expense	135
Y4 Expense	150	Y4 Retained earnings	315
Y4 Forex loss	300		
	550		550

Table 48: Retained earnings ($)

Balance cfwd	70	Y1 Profit & loss	70
	70		70
Y2 Profit & loss	77	Balance bfwd	70
		Balance cfwd	7
	77		77
Balance bfwd	7		
Y3 Dividend	70		
Balance cfwd	483	Y3 Profit & loss	560
	560		560
Y4 Profit & loss	315	Balance bfwd	483
Balance cfwd	168		
	483		483
		Balance bfwd	**168**

Table 49: Trial balance

Account	Dr ($)	Cr ($)
Capital		100
Cash	48	
Land	100	
Shares	2000	
US$ debt		1600
Provision – Long service leave		200
Provision – Annual leave		50
DTA – Long service leave	60	
DTA – Annual leave	15	
DTA – Tax loss	15	
DTL – Forex		120
Retained earnings		168
Total	**2238**	**2238**

Hypothetical accounts for multi-year example

(Reflecting the alignment of the taxation and accounting positions for s705-80 purposes)

Table 50: Hypothetical provision – tax ($)

Balance cfwd	30	Y1 Journal	30
	30		30
Y2 Cash	30	Balance bfwd	30
	30		30
Y3 Cash	12	Y3 Journal	207
Balance cfwd	195		
	207		207
Y4 Cash	30	Balance bfwd	195
Balance cfwd	165		
	195		195
		Balance bfwd	**165**

Table 51: Hypothetical DTA – tax loss ($)

Y2 Journal	33	Balance cfwd	33
	33		33
Balance bfwd	33	Y3 Journal	33
	33		33
Y4 Journal	135	Balance cfwd	135
	135		135
Balance bfwd	**135**		

Table 52: Hypothetical trial balance

Account	Dr ($)	Cr ($)
Capital		100
Cash	48	
Land	100	
Shares	2000	
US$ debt		1600
Provision – Long service leave		200
Provision – Annual leave		50
Provision – Tax		165*
DTA – Long service leave	NIL*	
DTA – Annual leave	NIL*	
DTA – Tax loss	135*	
DTL – Forex		NIL*
Retained earnings		168
Total	**2283**	**2283**

* These entries differ from those in the actual trial balance (table 49).

References

Income Tax Assessment Act 1997, sections 705-35, 705-70, 705-75, 705-80 and 995-1; as amended and inserted by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax system (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2
- *Tax Laws Amendment (2010 Measures No.1) Act 2010* (No.56 of 2010), Schedule 5, Part 8

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 5.65 to 5.74.

Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5

Taxation Determination TD 2004/70 – Income tax: consolidation: does the phrase 'is taken into account at a later time' in paragraph 705-80(1)(a) of the *Income Tax Assessment Act 1997* require that an accounting liability, or a change in the amount of an accounting liability, of a joining entity that is first recognised after the joining time be examined when determining whether or not section 705-80 of that Act applies?

Taxation Determination TD 2004/71 – Income tax: consolidation: can section 705-80 of the *Income Tax Assessment Act 1997* apply to a liability (or a change in a liability) that is recognised for accounting purposes because of an event that occurred after the joining time that provides new evidence of conditions that existed at the joining time?

Revision history

Section C2-4-245 first published 28 May 2003.

Revisions are described below.

Date	Amendment	Reason
3.12.03	Extra examples included to clarify the operation of section 705-80 using liabilities raised by accrued employee leave entitlements to demonstrate the principle.	Clarification.
	Administrative short cut provided for notional reconstruction where limited information is available.	Provided under Commissioner's administrative powers.
27.1.05	Guidelines provided for notional reconstruction to align accounting and tax positions, illustrated with an example.	Provided under Commissioner's administrative powers.
26.10.05	References to two new tax determinations.	
	Deletion of table on notional reconstruction, p. 2.	To correct misleading information.
26.6.07	Changes to tables 26 and 30.	To correct errors.
	Note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used.	Reflect announcement on 8 May 2007 by Assistant Treasurer in media release no. 50.
6.5.11	Reference to 'accounting standards for tax cost setting' and definition of that term included on p. 1, consequential minor changes to examples 1, 2 and 3.	Legislative amendments.
	Removal of note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used.	

Worked example

Estimating undistributed, frankable profits accruing to group before joining time (ACA step 3)

Description

This example shows acceptable methods for estimating, for the purpose of working out the ACA step 3 amount, profits accruing for all or part of a financial period to a consolidated group's membership interests in an entity before it joins the group. These methods can also be used to estimate accrued losses.

Commentary

At step 3 of the ACA calculation an amount is added for the undistributed, frankable profits of a joining entity that have accrued to membership interests held continuously by the joined group until the joining time. → section 705-90

The purpose of this step is to prevent double taxation by allowing the group a cost for retained taxed or frankable profits that accrued to membership interests when they were continuously held (as can occur where there is an incremental acquisition of an entity).

The amount to be added at step 3 is determined as follows:

Firstly, work out the undistributed profits of the joining entity that are retained profits under the joining entity's accounting principles for tax cost setting. The joining entities accounting principles for tax cost setting are the accounting standards or authoritative pronouncements of the Australian Accounting Standards Board that the entity would use if it were to prepare its financial statements just before the joining time.
→ subsection 705-90(2), subsection 705-70(3), section 995-1, *Income Tax Assessment Act 1997* (ITAA 1997); Taxation Determination TD 2004/55

Secondly, work out the extent to which the undistributed profits are fully frankable. This is done by assuming all income tax liabilities or refunds of income tax have been taken into account for the purposes of determining the joining entity's franking account surplus just before the joining time (but not any period while it was a member of another consolidated group).
→ subsections 705-90 (3) to (5)

A profit is held to have accrued to the joined group before the joining time if, on the assumption that it was distributed by the joining entity (and any entity interposed between the joining entity and the head company successively distributed the profit immediately after receiving it), it would have been received by the head company as it accrued. That is, the amount of undistributed frankable profit included at step 3 is determined by reference to the amount of undistributed profit accruing over a period in which membership interests are continuously held, not just when the profit is realised. → subsections 705-90(6) to (8)

Methods of estimating accrued profits (or losses)

To help reduce the costs of compliance, subsection 705-90(9) allows the amount of profit (or loss) that accrued to the joined group in a particular period to be worked out using the most reliable basis for estimation available. This recognises that detailed records may not always be available to permit a precise calculation of the profits (or losses) that accrued to the group.

Where there is insufficient information to enable a precise calculation, the ATO will accept the methods outlined below as providing a reliable estimate of the accrued profits for the purposes of step 3. These methods can also be used to estimate losses that have accrued to the joined group. Note that:

- The accounting profit for a particular accounting period is used as the starting point for working out profit or loss accruing in that period.
- Where the profit or loss accruing to the group during part of an accounting period must be estimated (e.g. where membership interests were acquired during the period and accounts were not taken at that time), the profit or loss accruing during the part-period may be estimated by apportioning the profit between the part periods on a daily basis (see Method 1 and Example 1 below).
- Profit or loss on disposal of an asset may be accepted as having accrued in the financial period the profit or loss has been recognised for accounting purposes, unless the asset has been held by the joining entity over two or more accounting periods and the realised gain or loss is over $1 million, in which case the gain or loss must be spread over the period in which the asset was held (see Method 2 and Example 2 below).

Method 1 – Estimating profits accruing during part of an accounting period

For example, where membership interests were acquired part way through an accounting period, a reliable estimate of the profits that accrued during each part period can be obtained by apportioning the annual profits of the joining entity on a daily basis. Where accounts are taken on a more frequent basis (e.g. every six months) the profits made in the shorter period could be apportioned on a daily basis.

This method, as it applies to the disposal of an asset, is illustrated in Example 1 below.

Method 2 – Estimating accrued profits where gain/loss on disposal of asset > $1m

Under this method, the profits accruing to the joined group can be estimated on the basis of relevant information such as the asset's market value at the time that the membership interests in the joining entity were acquired by the joined group. If a market value or other more reliable information is not available, an estimate based on an average figure over the period that a membership interest was continuously held may be acceptable. For example, where market values are used for this purpose, it may be assumed that the value of an asset increases or decreases on a straight-line basis between any two reference points where a market valuation is available. Such points of reference might be the time of purchase (using the purchase price), the time of sale (using the sale price), or an appropriate estimate of value at the end of a financial period (e.g. where assets have been revalued for the accounts).

This method is illustrated in Example 2.

Distribution of profits – in order from the most recent income year to the earliest

Changes to the consolidation rules permit profits to be allocated between income years using a last-in-first-out (LIFO) approach. Under this method the amount of profit that accrued to the joined group during a particular period is worked out by assuming that profits were distributed in order from the most recent income year to the earliest.

Once profits are allocated between years for which distributions were made, it is further assumed that unfranked distributions were paid out of profits of the relevant year that were not subject to income tax before they were paid out of profits that were subject to income tax.

Where it is necessary to identify the source of profits within a year, a proportional approach may be applied.

Note that although use of this method is specifically provided for in the legislation, it does not limit the use of other means of arriving at a reliable estimate for the amount of profit that accrued to the group during a particular period. → subsection 705-90(10), ITAA 1997; paragraphs 1.135 – 1.143 of the Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004

Example 1 – gain or loss from disposal of asset ≤ $1m

Facts

This example demonstrates how to use a daily apportionment of annual profits to determine the profit accruing to a joined group from the disposal of an asset (where gain or loss ≤ $1m), for the purposes of step 3.

HCo is the head company of a consolidated group. On 1 November 2004, HCo acquires 20% of ACo for $70,000. ACo prepares its accounts at the end of each financial year. ACo's financial position at 30 June 2004 is shown in table 1.

Table 1: ACo – financial position at 30 June 2004 ($'000s)

Cash	200	Equity (10,000 ordinary shares)	350
Investments 1 (MV 100)	100		
Land 1 (MV 50)	50		
	350		350

MV: market value

ACo disposes of Investment 1 on 30 April 2005 for $107,143, realising an after tax profit of $5,000. It then acquires another asset, Land 2, on 1 May 2005 for $105,000. ACo's financial position at 30 June 2005 is shown in table 2.

Table 2: ACo – financial position at 30 June 2005 ($'000s)

Cash	200	Equity	350
Land 1 (MV 60)	50	Profit (after tax)	5
Land 2 (MV 125)	105		
	355		355

HCo acquires a further 40% of membership interests in ACo on 1 September 2005 for $154,000. ACo disposes of Land 1 on 31 March 2006 for $64,286, realising an after tax profit of $10,000. It acquires Investment 2 on the same day for $60,000. ACo's financial position at 30 June 2006 is shown in table 3.

Table 3: ACo – balance sheet at 30 June 2006 ($'000s)

Cash	200	Equity	350
Land 2 (MV 120)	105	Profit (after tax)	15
Investment 2 (MV 60)	60		
	365		365

On 1 July 2006, HCo acquires the remaining 40% of membership interests in ACo for $152,000 and ACo joins the group.

Calculation

A: Calculate the ACA

The ACA is calculated as follows:

Step 1

Membership interest

Purchased 1/11/2004 (20%)	$70,000
Purchased 1/9/2005 (40%)	$154,000
Purchased 1/7/2006 (40%)	$152,000
TOTAL	**$376,000**

Note: As the market value of each share exceeded or equalled its cost base the cost base is used → section 705-65.

Step 2

There are no liabilities. The result after step 2 is $376,000.

Step 3: Add undistributed frankable profits accrued to the joined group

As the gains from the disposal of Investment 1 and Land 1 were each less than $1 million, method 1 can be used to estimate the profit that accrued to HCo from the disposal of these assets.

Accounting year ending	Annual profit	Percentage MI* held	Period MI held in year	No. days MI held	Accrued profit
30/6/2005	$5,000	20%	1/11/04 to 30/6/05	242	$663 i.e. 20% x $5,000 x 242/365
Subtotal					$663
30/6/2006	$10,000	20%	1/7/05 to 31/8/05	62	$340 i.e. 20% x $10,000 x 62/365
		60%	1/9/05 to 30/6/06	303	$4,981 i.e. 60% x $10,000 x 303/365
Subtotal					$5,321
Total accrued profits to be added at step 3					**$5,984**

* MI: membership interests

The result after step 3 is $381,984.

Steps 4 to 7

These steps are not applicable as there are no distributions, no losses, and no inherited deductions. Therefore, the result after step 7 is $381,984.

Step 8

The final ACA amount is $381,984.

B: Allocate ACA to retained cost base assets

Cash $200,000

Remaining ACA $181,984

C: Apportion remaining ACA over reset cost base assets

The tax cost setting amounts for the reset cost base assets are:

Asset	Market value	Apportionment	Tax cost setting amount
Land 2	$120,000	$181,984 x 120/180	$121,323
Investments 2	$60,000	$181,984 x 60/180	$60,661
Totals	$180,000		$181,984

Example 2 – gain or loss > $1m

Facts

This example demonstrates how to use available information to determine a profit accruing to a joined group from the disposal of an asset (where gain or loss > $1m) for the purposes of step 3.

HCo acquires 10% of the membership interests in ACo for $20 million on 1 July 1999. On the same day ACo purchases Asset 1.

ACo's financial position at 1 July 1999 is shown in table 4.

Table 4: ACo – financial position at 1 July 1999 ($m)

Cash	100	Capital	200
Asset 1	100		
	200		200

On 1 July 2000, HCo acquires a further 15% of ACo for $38 million. No market value of the asset is obtained.

On 31 December 2001, HCo acquires a further 75% of ACo for $262 million. The market value of the asset is $250 million.

On 1 June 2002, Asset 1 is disposed for $300 million.

On 1 July 2002, HCo forms a consolidated group with ACo. Its financial position at 1 July 2002 is shown in table 5.

Table 5: ACo – financial position at 1 July 2002 ($m)

Cash	400	Capital	200
		Retained earnings	140
		Provision for tax	60
	400		400

Calculation

The sale of Asset 1 has realised an after tax profit $140 million which is recorded as retained earnings. When the $60 million provision for tax is paid, the undistributed profits of $140 million will be fully frankable. The profit has accrued over a period in which HCo has incrementally acquired membership interests in ACo. The gain from the sale of the asset exceeds $1 million. Therefore, for the purpose of step 3, the profit that accrued to the membership interests in ACo is determined using available information on the market values of the asset (method 2).

Figure 1 shows how the profit is estimated as having accrued to the group over the period in which HCo has incrementally acquired membership interests in ACo and up to the formation of the consolidated group.

1 July 1999 to 31 December 2001

HCo acquires 10% of the membership interests in ACo on 1 July 1999, when the market value of Asset 1 is $100 million. An additional 15% is acquired on 1 July 2000, when no market value or other reliable information on the asset is available. As the market values of the asset at 1 July 1999 and 31 December 2001 are available, an estimate based on average market values over this period is acceptable. If more reliable information existed as at 1 July 2000, a separate calculation of the profit that accrued to HCo would be required.

Based on the change in market values of the asset, a $150 million pre-tax profit has accrued between 1 July 1999 and 31 December 2001. The after tax profit on the asset that has accrued to HCo's membership interest in ACo is $105 million. HCo held 10% of the membership interests in ACo for 366 days (from 1 July 1999 to 30 June 2000) and 25% for 548 days (from 1 July 2000 to 30 December 2001).

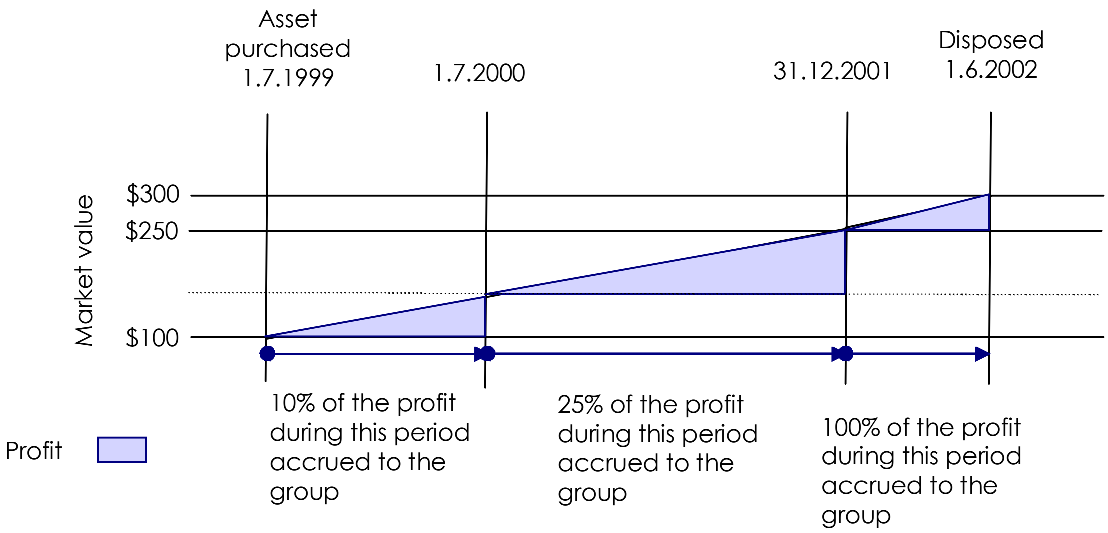
The after tax profit that has accrued to HCo during the period 1 July 1999 to 30 June 2000 is therefore $4.205 million – i.e. $105m x 366/(366 + 548) x 10%.

The after tax profit that has accrued to HCo during the period 1 July 2000 to 30 December 2001 is therefore $15.739 million – i.e. $105m x 548/(366 + 548) x 25%.

31 December 2001 to 30 June 2002

During the period in which HCo holds 100% of the membership interests in ACo, $50 million of pre-tax profit accrued to the asset. The after-tax profit on the asset that has accrued to HCo's membership interests in ACo is therefore $35 million.

Figure 1: How the profit from the disposal of Asset 1 is estimated as having accrued to the group



ACA calculation ($m):

Step 1	10% membership interest acquired – 1/7/1999	20	
	15% membership interest acquired – 1/7/2000	38	
	75% membership interest acquired – 31/12/2002	262	
			320
Step 2	Add liability: provision for tax		60
Step 3	Add accrued profits:		
	1/7/1999 to 30/6/2000	4	
	1/7/2000 to 30/12/2001	16	
	31/12/2001 to 1/6/2002	35	
			55
Steps 3A to 7			Nil
ACA			**435**

Allocating the ACA

The ACA is $435 million. The tax cost setting amount for the retained cost base asset of Cash is $400 million. There are no reset cost base assets to which the excess ACA can be allocated. Therefore HCo incurs a capital loss of $35 million by virtue of CGT event L4.

References

Income Tax Assessment Act 1997, section 705-90; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002)
- *New Business Tax system (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2

Income Tax Assessment Act 1997, subsections 705-90(2); as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 8

Income Tax Assessment Act 1997, subsections 705-70(3) and 995-1(1); as inserted by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 8

Explanatory Memorandum to the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, paragraph 1.43 to 1.46

Income Tax Assessment Act 1997, subsection 705-90(10); as inserted by *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1, Part 7

Income Tax Assessment Act 1997, subsection 705-90(2A); as inserted by *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1, Part 8

Income Tax Assessment Act 1997, subsection 705-90(6); as substituted by *Tax Laws Amendment (2004 Measures No. 7) Act 2005* (No. 41 of 2005), Schedule 6, Part 3

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004, paragraphs 1.135 –1.155

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 7) Bill 2004, paragraphs 6.24 – 6.29

Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5 [amending subsection 705-90(2)]

Taxation Determination TD 2004/53 – Income tax: consolidation tax cost setting rules: are distributions paid up a chain of entities sourced from profits in a lower-tier entity that did not accrue to the joined group added at step 3 of the entry allocable cost amount of the higher-tier entity?

Taxation Determination TD 2004/55 – Income tax: consolidation tax cost setting rules: step 3 of the allocable cost amount: is the 'retained profits' amount referred to in subsection 705-90(2) of the *Income Tax Assessment Act 1997* a cumulative retained profits balance?

Revision history

Section C2-4-260 first published 23 December 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on proposed changes to consolidation rules.	Proposed legislative amendments.
26.10.05	Changes to Commentary.	Legislative amendments.
26.6.07	Note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used.	Reflect announcement on 8 May 2007 by Assistant Treasurer in media release no. 50.
6.5.11	Reference to 'accounting standards for tax cost setting' and definition of that term included on p. 1. Removal of note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used.	Legislative amendments.

Worked example

Determining undistributed, taxed (frankable) profits accrued to group before joining time (ACA step 3)

Description

The entry ACA step 3 adds the amount of undistributed, taxed (frankable) profits that accrued to the joined group before the joining time. This example shows how to determine the amount of profits that are accrued to the joined group at step 3 of the ACA calculation in accordance with section 705-90 of the *Income Tax Assessment Act 1997* (ITAA 1997).

Commentary

Where a joining entity is a corporate tax entity, step 3 of the ACA calculation starts with working out the undistributed profits of the joining entity at the joining time. These are the amounts that, in accordance with the joining entity's accounting principles for tax cost setting, are retained profits of the joining entity**.** The joining entity's accounting principles for tax cost setting are the accounting standards or authoritative pronouncements of the Australian Accounting Standards Board that the entity would use if it were to prepare its financial statements just before the joining time.→ subsections 705-90(1) and (2), subsection 705-70(3), section 995-1, ITAA 1997

The exception to subsection 705-90(2) is provided by subsection 705-90(2A). If a loss that did not accrue to the joined group before the joining time would be taken into account in working out the undistributed profits, the loss is not so taken into account in working out the subsection 705-90(2) amount.
→ subsection 705-90(2A)

Once the undistributed profits of the joining entity are ascertained, the extent to which the undistributed profits would be fully frankable is calculated. In calculating the amount the joining entity would be able to frank, it is assumed that the joining entity's income tax liabilities or refunds of income tax as at the joining time (but not any period before leaving another consolidated group) have been taken into account for the purpose of determining the franking account balance. → subsections 705-90(3) to (5)

Next, the extent to which the undistributed frankable profits accrued to the joined group before the joining time is calculated → subsection 705-90(6). A profit accrued to the joined group before the joining time if, on the assumptions that:

- it was distributed to holders of membership interests as it accrued, and
- entities interposed between the head company and the joining entity successively distributed it immediately after receiving it,

it would have been received by the head company in respect of membership interests that it held continuously until that time either directly or indirectly through interposed entities. → subsection 705-90(7)

Where membership interests in the joining entity have been progressively acquired and continuously held until the joining time, each period in which the membership interests have been acquired is required to be tested against subsection 705-90(7). When testing for a particular period, the starting point is the profits derived in that particular period to the extent the amount satisfied subsection 705-90(3). Any profits derived other than during the testing period are excluded from the test of that period.

The examples

Example 1 and 2 demonstrate how to ascertain the step 3 amount of the entry ACA calculation where:

- the joining entity had undistributed profits before the head company acquired some or all of the membership interests
- the entity then incurred losses, and
- the entity followed this by deriving profits again,

during different financial years before the head company acquires the remaining membership interests (if any) and forms a consolidated group.

In example 1, the head company acquires all the membership interests in a company and forms a consolidated group two years later with the subsidiary company.

Example 2 shows how to determine the step 3 amount where there have been progressive acquisitions of membership interests in the joining entity.

Example 3 demonstrates how to ascertain the amount of profits accrued to the joined group before the joining time where there are different classes of shares with different entitlements to profits in the joining entity.

Although examples 2 and 3 illustrate the step 3 amount calculation for an entity that is joining on a group's formation, the methodology in determining the amount of profits accrued to the joined group before the joining time also applies to a joining entity that joins a consolidated group where the membership interests of that joining entity were acquired progressively before the joining time.

Example 1

On 1 July 2001, X Co is incorporated with $1,000 contributed capital in cash by Mr F. During the first year of trading, X Co purchases a non-depreciating asset for $1,000 and derives a taxed profit of $350 after providing for income tax of $150. The financial position at 1 July 2002 is shown in table 1:

Table 1: X Co – financial position at 1 July 2002 ($)

Cash	500	Equity	1,000
Non-depreciating asset	1,000	Retained profits	350
		Provision for tax	150
	1,500		1,500

On 1 July 2002, M Co acquires all the membership interests of X Co for $1,350 from Mr F. During the financial year ending 30 June 2003, X Co incurs a tax loss of $300. The financial position at 1 July 2003 is shown in table 2:

Table 2: X Co – financial position at 1 July 2003 ($)

Cash	50	Equity	1,000
Deferred tax asset (DTA)	90	Retained profits	140
Non-depreciating asset	1,000		
	1,140		1,140

X Co derives a profit before tax of $500 during the financial year ending 30 June 2004. After deducting the previous year's tax loss of $300, X Co has a taxable income of $200 and makes a provision for tax of $60. The financial position at 1 July 2004 is shown in table 3:

Table 3: X Co – financial position at 1 July 2004 ($)

Cash	550	Equity	1,000
Non-depreciating asset	1,000	Retained profits	490
		Provision for tax	60
	1,550		1,550

On 1 July 2004, M Co forms a consolidated group with X Co as its subsidiary member.

The step 3 calculation

The tax position and retained profit account balance at the end of each income year is summarised in table 4:

Table 4: Summary of X Co's tax position and retained profit balance

Year	Tax position	Retained profit balance
2001-02	Taxed profit $350	$350
2002-03	Tax loss $300	$140
2003-04	Taxed profit $140 (after utilising $300 previous year loss)	$490

At the joining time, as X Co is a corporate tax entity, the ACA step 3 amount is calculated according to section 705-90, which determines how much of X Co's undistributed, taxed profits that accrued to the joined group are added at step 3 of the ACA calculation.

Applying section 705-90

At the joining time, X Co has retained profits of $490. That amount satisfies subsection 705-90(3) because X Co's franking account balance would be $210. Of this, $150 is the franking account balance from tax paid. This amount is increased by the provision for tax of $60, a result of the modification in subsection 705-90(4). The exclusion under subsection 705-90(5) does not apply as X Co has not been a member of another consolidated group before joining the M Co group. Therefore, undistributed profits of $490 worked out under subsection 705-90(2) would be fully frankable.

Subsection 705-90(6) allows only the amount of undistributed, fully frankable profits that accrued to the joined group to be added. To work out whether any of the $490 accrued to the joined group before the joining time, subsection 705-90(7) needs to be considered.

In this example, the profits of $490 were derived during the financial years ending 30 June 2002, 2003 and 2004. Because there has been a change in the holder of the membership interests in X Co, the test under subsection 705-90(7) is required for each period (1 July 2001 to 30 June 2002 and 1 July 2002 to 30 June 2004) to ascertain whether any profits accrued to the M Co group.

For the financial year ending 30 June 2002, X Co derived a retained profit of $350. Had it been distributed on 30 June 2002 to the holder of membership interests, it would have been distributed to Mr F, with M Co not receiving any of the distribution. Therefore, none of the $350 accrued to the joined group.

During the financial years ending 30 June 2003 and 2004, while M Co holds 100% of the membership interests in X Co, X Co derives retained profits totalling $140. Had this been distributed on 30 June 2004 to the holder of membership interests, M Co would have received $140. This means $140 accrued to the joined group.

Therefore, the amount to be added at step 3 under section 705-90 is $140.

ACA calculation ($):

Step 1	100% membership interest acquired – 1/7/2003	1,350	1,350
Step 2	Add liability: provision for tax	60	1,410
Step 3	Add accrued profits:		
	1/7/2001 to 30/6/2002	nil	
	1/7/2002 to 30/6/2004	140	
		140	1,550
Steps 3A to 7		Nil	1,550
ACA			**1,550**

Allocating the ACA

$550 of the ACA is allocated to cash. This leaves $1,000 to be allocated to the non-depreciating asset. There is no shortfall or surplus in the ACA.

Example 2

On 1 July 2004, B Co is incorporated with $1,000 contributed capital in cash by C Co. During the first year of trading, B Co purchases a non-depreciating asset for $1,000 and derives a taxed profit of $280 after providing for income tax of $120. The financial position at 1 July 2005 is shown in table 5:

Table 5: B Co – financial position at 1 July 2005 ($)

Cash	400	Equity	1,000
Non-depreciating asset	1,000	Retained profits	280
		Provision for tax	120
	1,400		1,400

On 1 July 2005, A Co acquires 50% of B Co for $640 from C Co. During the financial year ending 30 June 2006, B Co incurs a tax loss of $200. The financial position at 1 July 2006 is shown in table 6:

Table 6: B Co – financial position at 1 July 2006 ($)

Cash	80	Equity	1,000
DTA	60	Retained profits	140
Non-depreciating asset	1,000		
	1,140		1,140

B Co derives a profit before tax of $300 from trading during the financial year ending 30 June 2007. After deducting the previous year's tax loss of $200, B Co has a taxable income of $100 and makes a provision for tax of $30. The financial position at 1 July 2007 is shown in table 7:

Table 7: B Co – financial position at 1 July 2007 ($)

Cash	380	Equity	1,000
Non-depreciating asset	1,000	Retained profits	350
		Provision for tax	30
	1,380		1,380

On 1 July 2007, A Co acquires the remaining 50% of the membership interests in B Co for $675 and forms a consolidated group with B Co as its subsidiary member.

The step 3 calculation

The tax position and retained profit account balance as at the end of each income year is summarised in table 8:

Table 8: Summary of B Co's tax position and retained profit balance

Year	Tax position	Retained profit balance
2004-05	Taxed profit $280	$280
2005-06	Tax loss $200	$140
2006-07	Taxed profit $70 (after utilising $200 previous year loss)	$350

At the joining time, as B Co is a corporate tax entity, the ACA step 3 amount is calculated according to section 705-90, which determines how much of B Co's undistributed, taxed profits that accrued to the joined group are added at step 3 of the ACA calculation.

Applying section 705-90

At the joining time, B Co has retained profits of $350. That amount satisfies subsection 705-90(3) because B Co's franking account balance would be $150. Of this, $120 is the franking account balance from tax paid. This amount is increased by the provision for tax of $30, a result of the modification in subsection 705-90(4). The exclusion under subsection 705-90(5) does not apply as B Co has not been a member of another consolidated group before joining the A Co group. Therefore, undistributed profits of $350 worked out under subsection 705-90(2) would be fully frankable.

Subsection 705-90(6) allows only the amount of undistributed, fully frankable profits that accrued to the joined group to be added. To work out whether any of the $350 accrued to the joined group before the joining time, subsection 705-90(7) needs to be considered.

In this example, the profits of $350 were derived during the financial years ending 30 June 2005, 2006 and 2007. Because there have been changes in the holders of the membership interests in B Co, the test under subsection 705-90(7) is required for each period (1 July 2004 to 30 June 2005 and 1 July 2005 to 30 June 2007) to ascertain whether any profits accrued to the A Co group.

For the financial year ending 30 June 2005, B Co derived a retained profit of $280. Had it been distributed on 30 June 2005 to the holder of membership interests, it would have been distributed to C Co, with A Co not receiving any of the distribution. Therefore, none of the $280 accrued to the joined group.

Note

Had A Co's acquisition of the first 50% (on 1 July 2005) been on 1 June 2005, there would be two testing periods for the financial year ending 30 June 2005 – 1 July 2004 to 31 May 2005 and 1 to 30 June 2005. In that case, the estimating methods set out in section C2-4-260 of this manual could be used to estimate the amount of profits accrued to the joined group.

During the financial years ending 30 June 2006 and 2007, while A Co holds 50% of the membership interests in B Co, B Co derives retained profits totalling $70. Had this profit been distributed on 30 June 2007 to the holders of membership interests, A Co would have only received $35. This means $35 accrued to the joined group.

Therefore, the amount to be added at step 3 under section 705-90 is $35.

Note

Had A Co acquired the second 50% of membership interests on 1 July 2006 (instead of 1 July 2007) while still forming the group on 1 July 2007, a test to ascertain how much of the loss did not accrue to the joined group would be required. The test is provided by subsection 705-90(8) in conjunction with subsection 705-90(7) to test whether any amount of loss would not be accrued to the group. If any loss that did not accrue to the joined group reduces the amount of retained profits, subsection 705-90(2A) permits the non-accrued loss not to be taken into account from the retained profits.

ACA calculation ($):

Step 1	50% membership interest acquired – 1/7/2005	640	
	50% membership interest acquired – 1/7/2007	675	
		1,315	1,315
Step 2	Add liability: provision for tax	30	1,345
Step 3	Add accrued profits:		
	1/7/2005 to 30/6/2006	nil	
	1/7/2005 to 30/6/2007	35	
		35	1,380
Steps 3A to 7		Nil	1,380
ACA			**1,380**

Allocating the ACA

$380 of the ACA is allocated to cash. This leaves $1,000 to be allocated to the non-depreciating asset. There is no shortfall or surplus in the ACA.

Example 3

D Co is incorporated on 1 July 2005 with 1,000 Class A ordinary shares at $8 each and 1,000 Class B ordinary shares at $2 each, raising capital of $10,000 in cash. Pursuant to D Co's constitution and the terms of issue, the Class A ordinary shareholders are entitled to 80% of D Co's profits and the Class B ordinary shareholders are entitled to the remaining 20% of D Co's profits. The Class A and Class B ordinary shares represent all the membership interests in D Co.

E Co acquires 900 (90% of) Class A ordinary shares for $7,200 on 1 July 2005.

During the year ending 30 June 2006, D Co purchases a non-depreciating asset for $10,000 and derives an after tax profit of $2,100. D Co's financial position is shown in table 9.

Table 9: D Co – financial position at 1 July 2006 ($)

Cash	3,000	Equity	10,000
Non-depreciating asset	10,000	Retained profits	2,100
		Provision for tax	900
	13,000		13,000

On 1 July 2006, E Co acquires the remaining 100 Class A ordinary shares at $9.68 each and all the 1,000 Class B ordinary shares at $2.42 each, for a total of $3,388. E Co forms a consolidated group with D Co on 1 July 2006.

The step 3 calculation

At joining time, as D Co is a corporate tax entity, the ACA step 3 amount is determined according to section 705-90.

At the joining time, D Co has undistributed profits of $2,100. That amount satisfies subsection 705-90(3) because D Co's franking account balance would be $900. D Co's franking account balance is nil, but it is increased by the provision for tax of $900, a result of the modification in subsection 705-90(4). The exclusion under subsection 705-90(5) does not apply as D Co has not been a member of another consolidated group before joining the E Co group. Therefore, undistributed profits of $2,100 worked out under subsection 705-90(2) would be fully frankable.

Subsection 705-90(6) allows only the amount of undistributed, fully frankable profits that accrued to the joined group to be added. To work out whether any of the $2,100 accrued to the joined group before the joining time, subsection 705-90(7) needs to be considered.

In this example, the profits of $2,100 were derived during the financial year ending 30 June 2006. During that period, E Co holds 90% of the Class A shares and none of the Class B shares. Had the profits been distributed on 30 June 2006 to the holders of the membership interests, E Co would have received $1,512 (i.e. $2,100 x 80% x 900/1,000). Therefore, only $1,512 of the retained and fully frankable profits accrued to the E Co group and is added at step 3 of the ACA calculation.

ACA calculation ($):

Step 1	90% A class membership interest acquired – 1/7/2005	7,200	
	10% A class membership interest acquired – 1/7/2006, and 100% B class membership interest acquired – 1/7/2006	3,388	
		10,588	10,588
Step 2	Add liability: provision for tax	900	11,488
Step 3	Add accrued profits:		
	1/7/2005 to 30/6/2006	1,512	13,000
Steps 3A to 7		Nil	13,000
ACA			**13,000**

Allocating the ACA

$3,000 of the ACA is allocated to cash. This leaves $10,000 to be allocated to the non-depreciating asset. There is no shortfall or surplus in the ACA.

References

Income Tax Assessment Act 1997, section 705-90

Income Tax Assessment Act 1997, subsection 705-90(2); as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 8

Income Tax Assessment Act 1997, subsections 705-70(3) and 995-1(1); as inserted by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 8

Income Tax Assessment Act 1997, subsections 705-90(1) to 705-90(8)

Explanatory Memorandum to New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, paragraph 1.43 to 1.46

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004, paragraphs 1.135 – 1.148 [inserting (2A)]

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 7) Bill 2004, paragraphs 6.24 – 6.29 [amending (6)(b)]

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5 [amending subsection 705-90(2)]

Taxation Determination TD 2004/53 – Income tax: consolidation tax cost setting rules: are distributions paid up a chain of entities sourced from profits in a lower-tier entity that did not accrue to the joined group added at step 3 of the entry allocable cost amount of the higher-tier entity?

Taxation Determination TD 2004/55 – Income tax: consolidation tax cost setting rules: step 3 of the allocable cost amount: is the 'retained profits' amount referred to in subsection 705-90(2) of the *Income Tax Assessment Act 1997* a cumulative retained profits balance?

Revision history

Section C2-4-261 first published 15 November 2006.

Further revisions are described below.

Date	Amendment	Reason
26.6.07	Note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used, p. 9.	Reflect announcement on 8 May 2007 by Assistant Treasurer in media release no. 50.
6.5.11	Removal of note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used. Reference to 'accounting standards for tax cost setting' and definition of that term included on p. 1.	Legislative amendments.

Worked example

Pre-joining time rollover from foreign-resident company or a company that becomes the head company (ACA step 3A)

Description

This example explains the adjustment made to the allocable cost amount (ACA) when there is a pre-joining time rollover of a capital loss or gain from a foreign-resident company or from a company that becomes the head company of the consolidated group. This step 3A adjustment is necessary to ensure the rolled over cost base – under Subdivision 126-B of the *Income Tax Assessment Act 1997* (ITAA 1997) or former section 160ZZO of the *Income Tax Assessment Act 1936* (ITAA 1936) – of the joining entity's assets is reflected in the tax cost setting amounts.

Under Subdivision 126-B or former section 160ZZO, the originating company's cost base for the rolled over asset becomes the recipient's cost base. Without adjustment, the tax cost setting process would allocate an amount to the joining entity's assets based on the consideration paid for membership interests in the joining entity, since this reflects the market value of the joining entity's underlying assets. The step 3A adjustment increases or reduces the ACA depending on whether a capital loss or a capital gain has been rolled over.

Note that, after 30 June 2003, a rollover under Subdivision 126-B is only available when:

- an asset is transferred between foreign-resident companies or between a foreign-resident company and an Australian-resident company, and
- the asset has the necessary connection with Australia under section 136-25 of the ITAA 1997 or, if the rollover happens on or after 12 December 2006, the asset must be taxable Australian property as defined in section 855-15 of the ITAA 1997.

Commentary

Section 705-93 of the ITAA 1997

When an asset that is not a membership interest is rolled over within a wholly-owned group, any gain or loss is deferred. The gain is not taxed until there is a CGT event (without further rollover) and the asset leaves the group – whether because it is disposed of directly or with a leaving entity.

As part of this deferral of tax, the recipient company retains the originating company's cost base for the asset. When the originating company is a foreign resident or the company that becomes the head company, this can mean that the group's aggregate cost for its assets is not the same as it would have been if the rollover had not occurred. The purpose of this provision is to offset any such alteration in a group's aggregate cost for its assets.

Step 3A of the ACA applies when:

- a CGT asset is rolled over before the joining time under Subdivision 126-B or former section 160ZZO and at the joining time, as a result of the rollover, the rollover asset has a deferred rollover gain or a deferred rollover loss as defined in subsection 995-1(1) of the ITAA 1997
- the originating company is a foreign resident or a company that becomes the head company and the recipient company is an Australian resident that does not become the head company of the group
- if the recipient company was a subsidiary member of another consolidated group, the conditions in section 104-182 of the ITAA 1997 were not satisfied at any time in relation to the other group between the rollover time and the joining time
- the CGT asset is not a pre-CGT asset at the joining time, and
- the entity that was the recipient of the asset, or received the asset as a result of a further rollover, was an Australian resident that subsequently became a subsidiary member of the group and was a spread entity as defined in subsection 995-1(1).

When step 3A applies, the ACA for the joining entity is:

- increased by the amount of the deferred rollover loss that was disregarded as a result of the rollover, or
- reduced by the amount of the deferred rollover gain that was disregarded as a result of the rollover.

When section 705-93 applies to one or more rollover assets, the ACA is increased or reduced by the net of all deferred rollover gains and deferred rollover losses. If the ACA – after application of step 3A – is negative, the head company makes a capital gain under CGT event L2 equal to the negative amount, and the ACA for the entity is nil.

Sections that modify section 705-93

Sections 705-147 and 705-227 of the ITAA 1997 ensure that section 705-93 applies correctly when a consolidated group is formed and when linked entities join a consolidated group. These sections modify the operation of section 705-93 to ensure that it applies to the rollover of a membership interest held by a subsidiary entity in another entity that becomes a subsidiary member of the consolidated group at the same time. A membership interest that is a pre-CGT asset is not excluded from the operation of these sections. Depending on when an entity joins a consolidated group, the pre-CGT status of the membership interest is preserved by either working out a pre-CGT proportion (measured by market value) or attaching a pre-CGT factor to each of the underlying assets (other than current assets) of the joining entity. → 'Pre-CGT status of membership interests in a joining entity – pre-CGT proportion rules', C2-4-813; 'Pre-CGT factor for assets of a joining entity', C2-4-810

Sections 705-147 and 705-227 also require that the step 3A adjustment be made to the ACA for the entity that the head company holds direct membership interests in (the first level entity) when that entity holds direct or indirect membership interests in the entity with the rollover asset (the subject entity). For example, when a number of first level entities hold direct or indirect membership interests in the subject entity, the step 3A adjustment is apportioned between the first level entities on the basis of the respective market values of those membership interests. Any remaining amount is allocated to the ACA of the entity holding the rolled over asset.

Note

When a non-membership interest asset is rolled over after 16 May 2002, but before a transitional group comes into existence, sections 701-35 and 719-163 of the *Income Tax (Transitional Provisions) Act 1997* may apply.

Example 1

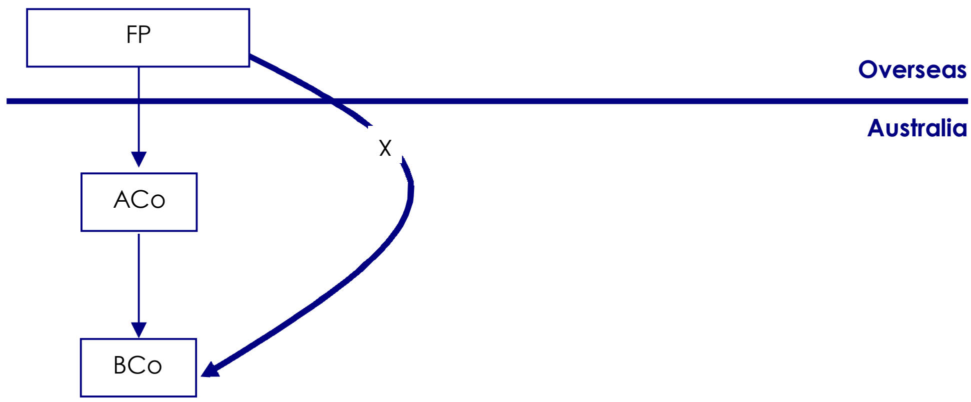
Formation case

In figure 1, the foreign parent (FP) sells a non-membership asset X to BCo and both companies opt for Subdivision 126-B rollover relief on the capital gain. X is not a pre-CGT asset.

When ACo and BCo later consolidate, the calculation of BCo's ACA will require a step 3A adjustment so that the tax deferral amount is appropriately maintained.

Because the asset does not include any membership interests, section 705-93 applies on its own.

Figure 1: Non-membership interest asset rollover to a company that does not become the head company (section 705-93)



In this example, the sequence of events is:

- FP capitalises ACo with $200, and ACo uses $100 to capitalise BCo as its wholly-owned subsidiary.
- FP transfers asset X to BCo. The cost base of X is $30, and the market value is $100. FP and BCo elect rollover relief under Subdivision 126-B.
- ACo and BCo form a consolidated group with ACo as head company.

The ACA for BCo is calculated as follows:

Step 1: cost base of membership interests in BCo	$100
Step 3A: reduction amount	($70)
ACA	**$30**

The step 3A amount is the amount of the deferred rollover gain in relation to asset X (i.e. $100 market value less $30 cost base).

The ACA is then allocated to BCo's assets as follows:

Tax cost setting amount for asset X	$30

Whether asset X is sold by itself or as an asset of a leaving entity, the correct capital gain will now occur.

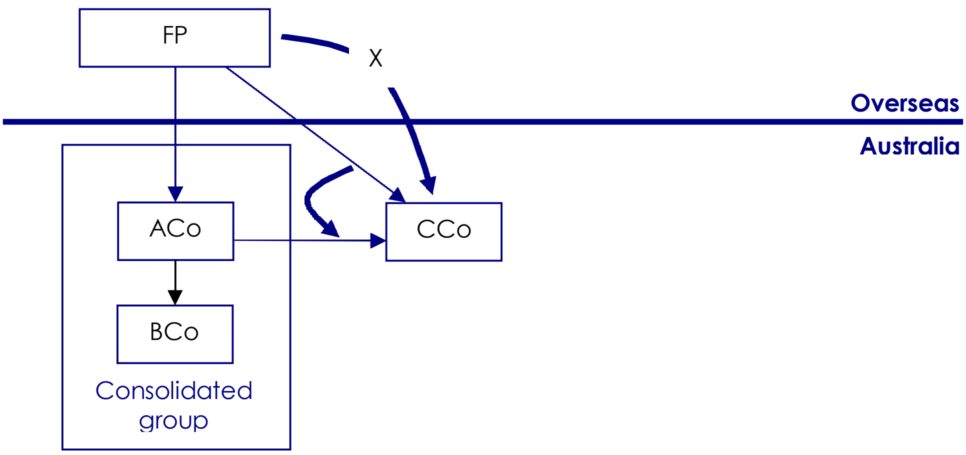
The step 3A amount is applied at the first level entity in which the head company holds membership interests – an entity that is interposed between the head company and the entity that holds the rollover asset. In this example, there is no interposed entity between the head company and BCo, which holds the rollover asset.

Example 2

Joining case

In figure 2, a non-membership interest asset (X) is sold by FP to CCo and both companies opt for Subdivision 126-B rollover relief on the capital gain. X is not a pre-CGT asset.

Figure 2: Non-membership interest asset rollover before joining time (section 705-93)



FP later sells its interests in CCo to ACo, the head company of the consolidated group.

When calculating CCo's ACA, step 3A applies to ensure that the tax deferral associated with asset X is appropriately maintained. Because the asset does not include any membership interests, section 705-93 applies on its own.

Note that there is not another step 3A adjustment if Subdivision 126-B rollover is elected for the second transfer, as that rollover is to a head company.

In this example, the sequence of events is:

- FP capitalises two Australian-resident companies – ACo with $200, and CCo with $100.
- ACo in turn capitalises a wholly-owned subsidiary, BCo, with $100 and they form a consolidated group.
- CCo purchases asset X from FP for the asset's market value of $100. FP's cost base for asset X is $30, and FP and CCo both opt for Subdivision 126-B rollover relief.
- FP sells all its membership interests in CCo to ACo for $100. CCo becomes a member of the consolidated group and asset X becomes an asset of ACo under the single entity rule in subsection 701-1(1) of the ITAA 1997.

The ACA for CCo is calculated as follows:

Step 1: cost base of membership interests in CCo	$100
Step 3A: reduction amount	($70)
ACA	**$30**

The step 3A amount is the amount of the deferred rollover gain in relation to asset X (i.e. $100 market value less $30 cost base).

The ACA is then allocated to CCo's assets as follows:

Tax cost setting amount for asset X	$30

Whether asset X is sold by itself, or as an asset of a leaving entity, the correct capital gain will now occur.

The step 3A amount is applied at the first level entity in which the head company holds membership interests – an entity that is interposed between the head company and the entity that holds the rollover asset. In this example, there is no interposed entity between the head company and CCo, which holds the rollover asset.

Example 3 Allocation of step 3A amount after rollover of asset X

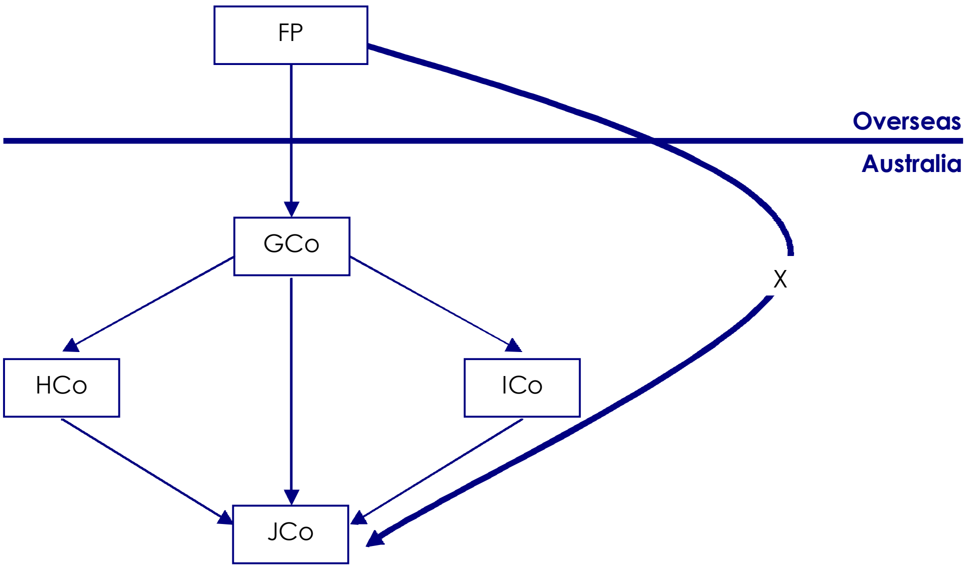
In figure 3, FP sells its non-membership asset (X) to JCo and both companies opt for Subdivision 126-B rollover relief. X is not a pre-CGT asset.

When GCo, HCo, ICo and JCo consolidate, the ACA calculation requires a step 3A adjustment so that the tax deferral amount is appropriately maintained.

Although the head company, GCo, has a direct interest in JCo (the company owning the rollover asset), there are also companies interposed between them. This means section 705-147 applies to modify section 705-93 and apportion the step 3A amount.

The apportionment between the first level entities (HCo and ICo) is made using the market value of their respective direct and indirect membership interests in JCo as a proportion of the total value of all the membership interests in JCo. The balance of the step 3A amount is allocated to JCo's ACA.

Figure 3: Non-membership interest asset with multiple interposed companies (section 705-147)



In this example, the sequence of events is:

- FP capitalises GCo with \$200, and GCo capitalises two wholly-owned subsidiaries, HCo and ICo, with \$40 each.
- GCo (\$20), HCo (\$40) and ICo (\$40) capitalise JCo with \$100.
- JCo purchases asset X from FP for its market value of \$100. FP's cost base for asset X is \$30. FP and JCo opt for Subdivision 126-B rollover relief.
- GCo, HCo, ICo and JCo form a consolidated group with GCo as the head company.

The ACA for membership interests in JCo is calculated as follows:

HCo's membership interests in JCo

Step 1: cost base of membership interests	$40
Step 3A: reduction amount	
$70 step 3A amount* x $\frac{\text{market value of HCo's membership interests in JCo}}{\text{market value of all membership interests in JCo}} = \frac{70 \times 40}{100} =$	($28)
ACA	**$12**

* The step 3A amount is the amount of the deferred rollover gain in relation to asset X (i.e. $100 market value less $30 cost base).

The ACA is allocated as follows:

Tax cost setting amount for HCo's membership interests in JCo	$12

ICo's membership interests in JCo

Step 1: cost base of membership interests	$40
Step 3A: reduction amount	
$70 step 3A amount* x $\frac{\text{market value of ICo's membership interests in JCo}}{\text{market value of all membership interests in JCo}} = \frac{70 \times 40}{100} =$	($28)
ACA	**$12**

* The step 3A amount is the amount of the deferred rollover gain in relation to asset X (i.e. $100 market value less $30 cost base).

The ACA is allocated as follows:

Tax cost setting amount for ICo's membership interests in JCo	$12

JCo's ACA

Step 1: cost base of all membership interests in JCo (held by GCo, HCo and ICo = 20 + 12 + 12)	$44
Step 3A: reduction amount (the balance)	($14)
ACA	**$30**

The ACA is allocated as follows:

Tax cost setting amount for asset X	$30

The step 3A adjustment is made in working out the ACA for HCo and ICo – the first level entities below the head company. Any balance is allocated to JCo's ACA (i.e. $70 less $28 less $28).

Section 705-140 of the ITAA 1997, contained in Subdivision 705-B, provides that Subdivision 705-A (which contains section 705-93) applies to each entity becoming a member of a consolidated group in the same way as Subdivision 705-A applies to an entity becoming a subsidiary member of a consolidated group in circumstances covered by Subdivision 705-A. Section 705-147 modifies the application of section 705-93 to ensure that it applies when the rolled over asset is a membership interest in an entity that becomes a subsidiary member of the group at formation time.

Example 4

Allocation of step 3A amount after rollover of membership interests in CCo

This example differs from example 3 in that the rollover assets are 100% of the membership interests in a group company.

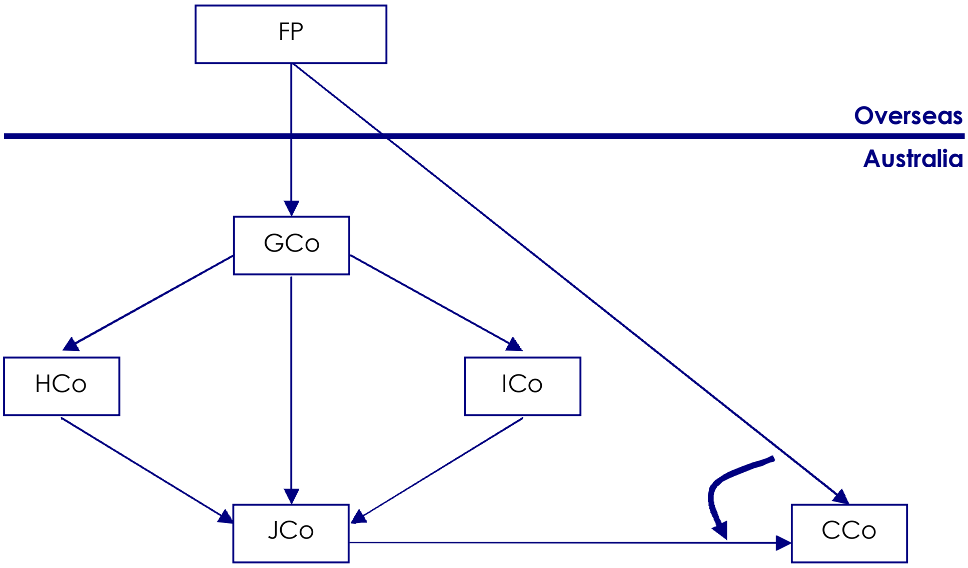
In figure 4, FP sells all its membership interests in CCo to JCo and both companies opt for Subdivision 126-B rollover relief.

When GCo, HCo, ICo, JCo and CCo consolidate, the ACA calculation requires a step 3A adjustment to ensure that that the tax deferral amount is appropriately maintained.

The rollover assets are membership interests. The head company, GCo has a direct interest in JCo (which owns the rollover asset), but there are also companies interposed between the two companies. Section 705-147 applies to modify section 705-93 and apportion the step 3A amount.

The apportionment between the first level entities (HCo and ICo) is made using the market value of their respective direct and indirect membership interests in JCo as a proportion of the total value of all the membership interests in JCo. Any balance of the step 3A amount is allocated to JCo's ACA.

Figure 4: Membership interest asset when there are multiple interposed companies (section 705-147)



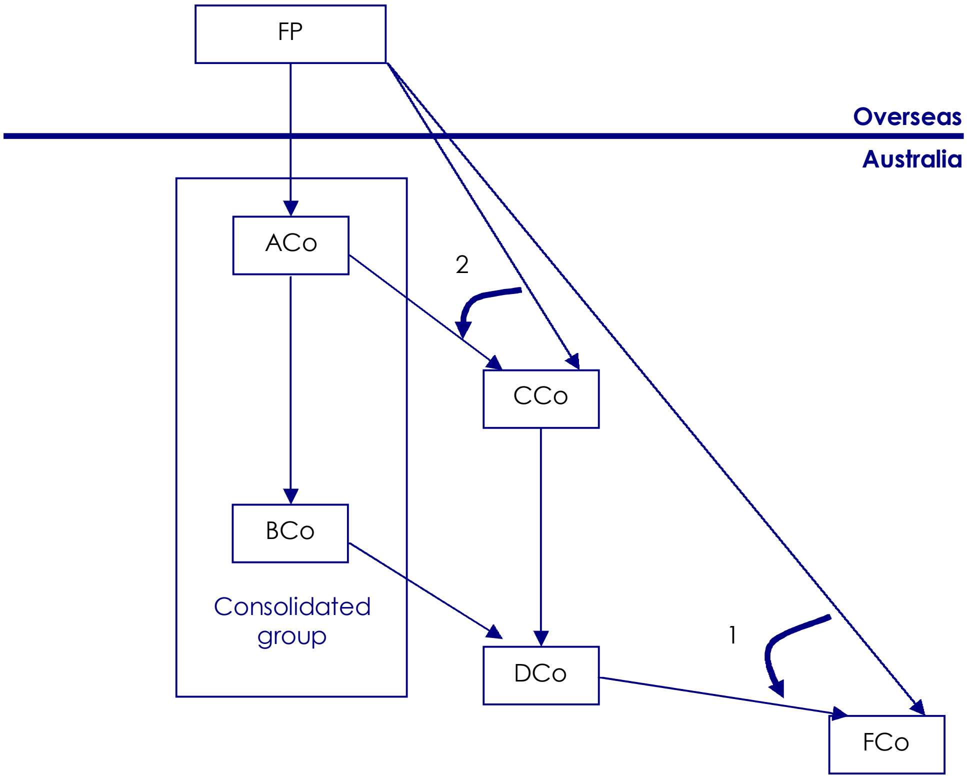
The outcome is similar to the previous example except that the ACA is apportioned by the market value over all assets in JCo – including the membership interests in CCo (whereas in example 3, the only asset of JCo was asset X.).

Example 5 Allocation of step 3A amount and linked entities

In figure 5, FP sells all its membership interests in FCo to DCo and both elect Subdivision 126-B rollover relief.

FP later sells all its membership interests in CCo to ACo, which means the linked entities – CCo, DCo and FCo – all join the consolidated group headed by ACo. The rollover of the membership interests in FCo requires a step 3A adjustment in the ACA calculation.

Figure 5: Membership interest asset and linked entities (section 705-227)



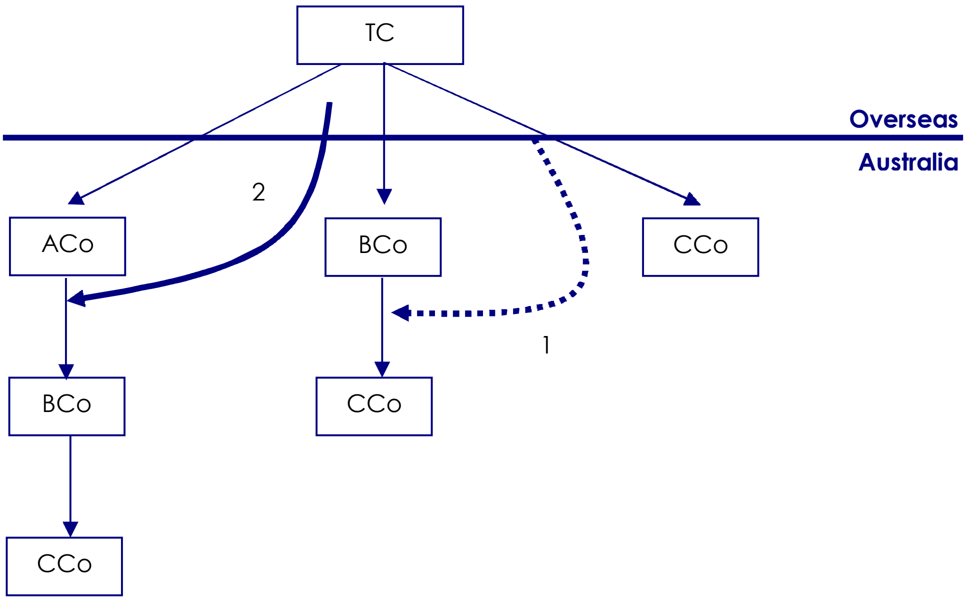
Section 705-227 modifies section 705-93 to take account of the membership interests that one linked entity holds in another. In this example, the rollover assets (all the membership interests in FCo) are held by DCo. DCo, FCo, and CCo are linked entities that join the consolidated group as a result of the second transaction.

The step 3A amount is apportioned between any first level entities (in this case, CCo) based on the market value of its direct and indirect membership interests in DCo as a proportion of the total value of all the membership interests in DCo.

Any balance of the step 3A amount is allocated to DCo's ACA.

Example 6 In figure 6, foreign parent TC first sells its interests in CCo to BCo, then sells its interests in BCo to ACo – on both occasions, the parties to the transaction opt for Subdivision 126-B rollover relief.

Figure 6: Eligible tier-1 companies of a MEC group are rolled under to form a consolidatable group (section 705-147)



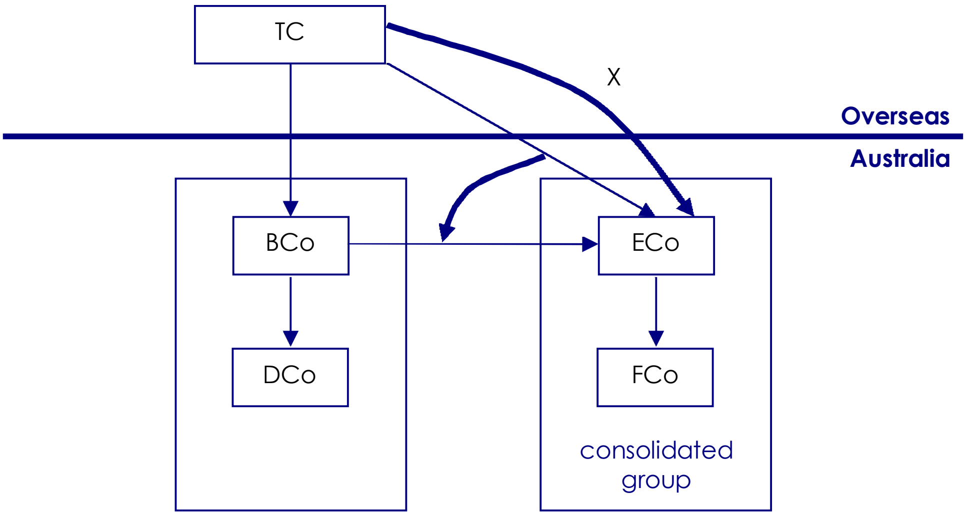
When ACo, BCo and CCo consolidate (with ACo as the head company), section 705-147 applies – a step 3A amount with respect to the first rollover is applicable in calculating BCo's ACA.

Step 3A is not applicable to the second rollover because the recipient ACo becomes the head company of the consolidated group.

Example 7

Figure 7 shows one consolidated group taking over another consolidated group. Step 3A applies if there is a Subdivision 126-B rollover from foreign parent TC to the consolidated group of ECo and FCo.

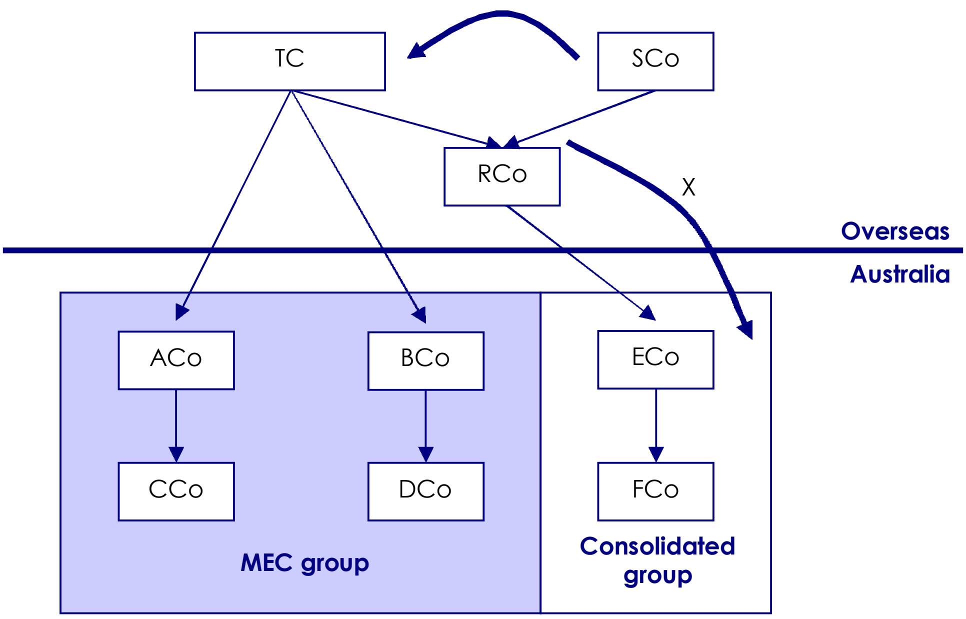
Figure 7: Membership interests and consolidated group (section 705-93)



Example 8

In figure 8, ECo and FCo are members of a consolidated group with ECo as the head company. Assume, before formation, that RCo transferred asset X to either ECo or FCo. At the formation time, step 3A would have applied depending on who the recipient was. Subsequently, when foreign parent TC acquires SCo's interests in RCo, the MEC group can choose to include ECo and FCo, but step 3A does not apply.

Figure 8: No step 3A – if TC acquires the remaining interests in RCo



References

Income Tax Assessment Act 1936, former section 160ZZO

Income Tax Assessment Act 1997, Subdivision 126-B and section 136-25

Income Tax Assessment Act 1997, subsection 701-1(1), Subdivision 705-A and Subdivision 705-B; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 1

Income Tax Assessment Act 1997, section 855-15; as inserted by *Tax Laws Amendment (2006 Measures No. 4) Act 2006* (No. 168 of 2006)*,* Schedule 4

Income Tax Assessment Act 1997, sections 705-60, 705-93, 705-147, 705-227 and subsection 995-1(1); as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010)*,* Schedule 5, Part 5

Income Tax Assessment Act 1997, section 705-125; as inserted by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1, and amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 3

Income Tax (Transitional Provisions) Act 1997, section 701-35; as amended by *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002*, Schedule 7

Income Tax (Transitional Provisions) Act 1997, sections 701-35 and 719-163; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 17

Explanatory Memorandum to New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, paragraphs 1.104 to 1.107

Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, paragraphs 5.75 to 5.88 and 5.45 to 5.52

Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006 (No. 101 of 2006); which repealed section 160ZZO of the *Income Tax Assessment Act 1936*

Explanatory Memorandum to Tax Laws Amendment (2006 Measures No. 4) Bill 2006 paragraphs 4.22 to 4.27

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010 paragraphs 5.158 – 5.179

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010 paragraphs 5.111 to 5.142

Revision history

Section C2-4-270 first published 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
15.11.06	Updated references to inoperative provisions.	Legislative amendment.
6.5.11	Significant revisions to reflect changes to step 3A of the ACA made by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 5.	Legislative amendment.

Worked example

Adjustment at formation for distributions of profits to head company (ACA step 4)

Description

This example shows how the adjustment for distributions by the joining entity at step 4 of the allocable cost amount (ACA) calculation is modified on formation where there has been an effective return of profits to the head company. → 'Treatment of assets', C2-1

Commentary

At step 4 of the ACA calculation, certain pre-joining time distributions by a subsidiary entity are subtracted, in order to reduce the cost of membership interests where some or all of that amount has been returned as a distribution.

This reduction is not made unless the distribution is in respect of the direct membership interests held by the head company, because it is only the cost of these direct interests that is pushed down to the assets of the subsidiary members.

On formation, a reduction is made only in relation to:

- distributions to the head company, or
- effective distributions to the head company, such as where the membership interest in the entity making the distribution (the subject entity) was acquired by the head company from an entity or entities for which rollover relief was obtained, and which had received a distribution from the subject entity.

→ section 705-155, *Income Tax Assessment Act 1997* (ITAA 1997)

Example

Facts

ACo pays $100 to purchase all membership interests in BCo. Then BCo makes a trading profit of $30. Then, on 1 July 2004, HCo pays $130 to purchase all membership interests in ACo.

Table 1: ACo – financial position at 1 July 2004

Shares in B (MV $130)	$100	Equity	$100
	$100		$100

Table 2: BCo – financial position at 1 July 2004

Asset 1 (MV $50)	$50	Equity	$100
Cash	$80	Profits	$30
	$130		$130

Note: MV = market value

On 2 July 2004, BCo pays a $30 dividend to ACo. On 3 July 2004, ACo successively distributes the $30 to HCo. On 4 July 2004, HCo forms a consolidated group with ACo and BCo.

Calculation

Calculation of new tax values of assets in the consolidated group

The step 1 amount of $130 is reduced by $30 at step 4 because there has been a direct pre-formation distribution to the head company. Therefore, $100 is the tax cost setting amount for ACo's sole asset, Shares in B.

This amount is used as the step 1 amount in the ACA calculation for BCo. There will be no adjustment at step 4 of the ACA calculation, giving BCo a total ACA of $100. .

BCo's cash asset retains its $50 value (after the $30 distribution to ACo, BCo has $50 cash left). The remainder of the ACA ($50) is the tax cost setting amount for Asset 1.

References

Income Tax Assessment Act 1997, section 705-155; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 1

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, paragraphs 5.53-60

Revision history

Section C2-4-280 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on proposed changes to consolidation rules.	Proposed legislative amendments.
26.10.05	Removal of note on proposed changes to consolidation rules, p. 1.	Legislative amendments.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Adjustments for losses (ACA steps 5 and 6)

Description

This example shows the calculations at steps 5 and 6 of the allocable cost amount (ACA) calculation:

- Step 5 deducts amounts for 'owned' losses – that is, losses incurred by the joining entity that accrued to a head company during the period before the joining time in which it continuously held membership interests in the joining entity.
- Step 6 reduces the entry ACA to the extent of the future tax benefit embedded in an unused loss of any sort[9] that did not accrue to the joined group and was transferred to it by the joining entity.

Commentary

The purpose of step 5 is to prevent a double benefit being obtained from these losses by the group and to ensure that losses that cannot be transferred, or whose transfer has been cancelled by the head company, are not reinstated.
→ section 705-100, *Income Tax Assessment Act 1997* (ITAA 1997)

The adjustment at step 6 is to stop the group getting a double benefit through both higher acquisition payments for the joining entity's assets and losses transferred to the head company. → section 705-110, ITAA 1997

Step 5 subtracts an amount for the joining entity's unused losses of any sort whether or not those losses are transferred or transferable to the head company. A loss is included at step 5 if it accrued to membership interests in the joining entity that were directly or indirectly owned by the head company and were continuously held by it until the joining time.

The amount of the loss that accrued to a membership interest is the amount that would be distributed (before the joining time) to that membership interest, as the loss accrued, if it were a profit instead of a loss.

However, an accrued loss is *not* included at step 5 to the extent to which it is used to reduce undistributed profits added to the ACA at step 3.
→ Taxation Determination TD 2004/59

A transferred loss is included for the purposes of **step 6** if it *did not* accrue to membership interests in the joining entity that were directly or indirectly owned by the head company and were continuously held by it until the joining time – that is, it includes losses that are effectively acquired. Step 6 does not include unused losses that have not been transferred to the group or for which the transfer has been cancelled by the head company.

[9] A sort of loss is defined as a tax loss, a film loss and a net capital loss (see A2 'Glossary of terms').

The step 6 amount is calculated as follows:

Carry-forward transferred losses that did not accrue to the group joined	X	General company tax rate

Example 1: step 5

Facts

In 1998, HCo subscribes $60 for 60% of the membership interests in a new company, BCo. The other 40% is subscribed for $40 by CCo. BCo acquires two assets for $40 and $60 respectively.

Table 1: BCo – financial position at 1 July 1998

Asset 1	$40	Equity	$100
Asset 2	$60		
	$100		$100

In 1999, BCo disposes of asset 2 for its market value of $20, realising a net capital loss of $40.

On 1 July 2003, HCo acquires the remaining 40% of BCo's membership interests for $24 and consolidates BCo into its group.

Table 2: BCo – financial position at 1 July 2002

Asset 1 (MV $40)	$40	Equity	$100
Cash	$20	Loss	($40)
	$60		$60

Note: MV = market value

Calculation

All of the loss in value of Asset 2 on which the net capital loss is realised occurs while HCo holds 60% of the membership interests in BCo. Therefore $24 of BCo's loss (60% x $40) accrues in relation to the membership interests held by HCo. The amount to be deducted at step 5 is therefore $24.

The remaining $16 (40% x $40) of the loss is considered at step 6.

Example 2: step 6

Facts

In 2001, ACo subscribes $100 for all the membership interests in BCo, a new company. BCo acquires two assets for $40 and $60 respectively.

Table 3: BCo – financial position at 1 July 2000

Asset 1 (MV $40)	$40	Equity	$100
Asset 2 (MV $60)	$60		
	$100		$100

In 2002, BCo disposes of Asset 2 for its market value of $20, realising a net capital loss of $40.

BCo's financial position at 30 June 2002 is shown in Table 4.

Table 4: BCo – financial position at 30 June 2002

Asset 1 (MV $40)	$40	Equity	$100
Cash	$20	Loss	($40)
	$60		$60

On 1 July 2003, HCo acquires 100% of BCo's membership interests for $72, ($60 for the assets and $12 for the losses).[10] It consolidates BCo into its group. The same business test (SBT) is passed in relation to BCo so the $40 is transferred to HCo as head company. None of the loss is cancelled by the head company.

Calculation

There is no incremental acquisition of the membership interests in BCo by HCo, so none of the transferred losses accrue while HCo holds interests in BCo. The amount by which the entry ACA is reduced at step 6 is therefore $12, i.e. acquired losses transferred from BCo ($40) x 30%.

[10] It is not necessary for an amount to have been included in the purchase price of an entity for its losses for those losses to be held as 'acquired' for the purposes of step 6. It is only necessary that the losses did not accrue to the joined group during the period in which the head company continuously held interests in the relevant joining entity.

Example 3: steps 5 and 6

Facts

On 1 July 2000, ACo is incorporated. Its financial position is shown in Table 5.

Table 5: ACo – financial position at 1 July 2000

Asset 1 (MV $300)	$300	Equity	$1,000
Asset 2 (MV $400)	$400		
Asset 3 (MV $300)	$300		
	$1,000		$1,000

On 1 July 2001, ACo disposes of Asset 3 for its market value at that time of $200, realising a $100 loss.

On 1 July 2002, HCo, the head company of a consolidated group, acquires 60% of ACo for $780 (net value of $1,300 x 60%). ACo's financial position at that date is shown in Table 6.

Table 6: ACo – financial position at 1 July 2002

Asset 1 (MV $700)	$300	Equity	$1,000
Asset 2 (MV $400)	$400	Loss (asset 3)	($100)
Cash	$200		
	$900		$900

On 1 July 2003, ACo disposes of Asset 2 for its market value at that time of $200, realising a loss of $200.

On 1 July 2004, HCo acquires the remaining 40% in ACo for $440 (net value of $1,100 x 40%) and consolidates ACo into its group. ACo's financial position is as shown in Table 7.

Table 7: ACo – financial position at 1 July 2002

Asset 1 (MV $700)	$300	Equity	$1,000
Cash	$400	Loss (asset 3)	($100)
		Loss (asset 2)	($200)
	$700		$700

The SBT is passed with respect to the loss on Asset 3 and the continuity of ownership test is passed with respect to the loss on Asset 2. All losses are therefore transferred to HCo as head company of the consolidated group. None of the losses are recouped by undistributed profits, nor are any of the transfers of losses cancelled by the head company.

Calculation of ACA

Step 1

The total amount paid by HCo for all the membership interests in ACo (the ACA step 1 amount) is $1,220 ($780 + $440).

Steps 2 to 4

There are no liabilities, no distributed or distributable profits, and no rollovers, so no adjustments need to be made for ACA steps 2 to 4.

Step 5

The loss from the disposal of Asset 3 was realised and therefore accrued before HCo held any interests in ACo. Therefore, this loss cannot be included at step 5 of the ACA calculation. However, this 'acquired' loss is transferred to HCo on consolidation, so it must be considered for the purposes of step 6 of the ACA.

All of the loss from Asset 2 has accrued while HCo continuously holds 60% of the membership interest in ACo. Therefore, the amount that accrues in relation to HCo's membership interest in ACo, to be subtracted at step 5, is $120 ($200 x 60%). The remaining $80 of the loss is transferred to HCo on consolidation, so it must be considered for the purposes of step 6 of the ACA.

The ACA after step 5 is therefore $1,100 ($1,220 – $120).

Step 6

The amount to be deducted at step 6 is the amount of carry-forward transferred losses that do not accrue to the joined group while it continuously holds interests in ACo multiplied by the general company tax rate.

The step 6 amount is therefore $54, i.e. ($100 + $80) x 30%.

The result after step 6 is therefore $1,046 ($1,100 – $54).

Step 7

HCo does not become entitled to any deductions on ACo joining the group, so no adjustment is required at this step.

The ACA available to be allocated to ACo's assets will therefore be:

Step 1 amount	$1,220
Less step 5 amount	$120
Less step 6 amount	$54
Final entry ACA	**$1,046**

References

Income Tax Assessment Act 1997, sections 705-90, 705-100, 705-105 and 705-110; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2

Explanatory Memorandum accompanying the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 5.88–95

Income Tax Assessment Act 1997, subsection 713-225(6A) as inserted by *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (No. 83 of 2004), Schedule 2, Part 5

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 2) Bill 2004, paragraphs 2.61 – 2.62

Taxation Determination TD 2004/59 – Income tax: consolidation tax cost setting rules: how do you work out the amount subtracted at step 5 of the allocable cost amount where the loss taken into account under subsection 705-100(1) of the *Income Tax Assessment Act 1997* has also reduced the step 3 amount?

Revision history

Section C2-4-300 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on recent and proposed changes to consolidation rules.	Recent and proposed legislative amendments.
26.10.05	Reference to new taxation determination and update of note in 'Commentary' on recent and proposed changes to consolidation rules.	Legislative amendments.
30.6.09	Minor changes including removal of note in Commentary to reflect new rules for treatment of foreign losses.	Legislative amendment.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Adjustment for certain inherited deductions (ACA step 7)

Description

This example shows how, at step 7 of the allocable cost amount (ACA) calculation, an amount is subtracted for certain unclaimed deductions of the joining entity that become available to the head company because of the inherited history rule.

Commentary

The inherited history rule provides that for most purposes a consolidated group inherits the tax history of its joining subsidiaries. This means that the head company may be entitled to certain unclaimed deductions of the joining entity.

At step 7, adjustments are made to preclude the joined group from getting benefits from both higher tax cost setting amounts for the joining entity's assets *and* the deductions inherited by the head company.

This adjustment involves subtracting the full amount of any relevant 'owned' deductions and an amount equal to the future tax benefit embedded in any relevant 'acquired' deductions.

The deductions covered in this step of working out the entry ACA are any deductions (both owned and acquired) to which the head company becomes entitled under section 701-5 of the *Income Tax Assessment Act 1997* (ITAA 1997) as a result of the joining entity becoming a subsidiary member of the group, other than a deduction for expenditure:

- that is, forms part of or reduces, the cost of an asset that becomes an asset of the head company because subsection 701-1(1) of the ITAA 1997 (the single entity rule) applies, or
- to which section 110-40 of the ITAA 1997 (expenditure on assets acquired before 7.30 pm on 13 May 1997) applies, or
- to the extent that the expenditure reduced the undistributed profits comprising the step 3 amount of the ACA, or
- under section 43-15 (which relates to undeducted construction expenditure), if the joining entity acquired the asset to which the deduction relates at or before 7.30pm on 13 May 1997.

→ subsection 705-115(2) and (3), ITAA 1997

'Owned deductions' are the sum of all deductions mentioned above that accrued to the joined group. → subsection 705-115(1)

'Acquired deductions' are deductions mentioned above for expenditure that are not owned deductions.

An unclaimed deduction for expenditure that would be included in the cost of an asset of the joining entity, or would reduce it, is not included at step 7.

Unclaimed Division 43 deductions

Unclaimed deductions for allowable capital expenditure on assessable income-producing buildings and other capital works under Division 43 of the ITAA 1997 that were previously available to a joining entity become available to the head company when the entity joins a consolidated group. These unclaimed Division 43 deductions do not reduce the entry ACA at step 7 when an entity joins a consolidated group, and unclaimed Division 43 deductions do not increase the exit ACA at step 2 when the entity leaves the group.

See also → 'Adjustment for certain inherited deductions (exit ACA step 2)', C2-5-240

Example 1

Facts

On 1 July 2000, HCo subscribes $60,000 for 60% of the membership interests in a new company, ACo, with the other 40% being subscribed for $40,000 by BCo.

Table 1: ACo – financial position at 1 July 2000 ($'000)

Cash	100	Equity	100
	100		100

ACo then borrows $400,000 for which it incurs $50,000 of borrowing costs. ACo's financial position immediately before consolidation is as shown in table 2. The borrowing costs are expensed in the accounts.

Table 2: ACo – financial position at 30 June 2002 ($'000)

Asset (MV $400)	400	Equity	100
Cash	50	Liability	400
Deferred tax assets	15	Loss	(35)
	465		465

MV: market value

The expenditure incurred is allowable as an income tax deduction apportioned over five years, that is, $10,000 per year. As ACo derives no assessable income in the income tax years ending 30 June 2001 and 2002, it incurs a tax loss of $10,000 in each of those years.

On 1 July 2002, HCo acquires the remaining 40% of ACo's membership interests for $26,000, i.e. ($465k – $400k) x 40%, and forms a consolidated group with ACo.

By virtue of the inherited history rule, the remaining $30,000 of borrowing expenses as yet unclaimed by ACo becomes available to HCo on consolidation (as head company), to be claimed as a tax deduction over the remaining three income years.

The $20,000 of carry-forward tax losses of ACo is transferred to the head company on consolidation. None of the losses are recouped by undistributed profits nor does the head company cancel the transfer of any of the losses.

Calculation of the step 7 amount

HCo becomes entitled to deductions totalling $30,000 for the borrowing expenses as yet unclaimed by ACo. Of the deductions, $18,000 (60%) is owned deductions, being expenditure incurred by ACo that, at the time it was incurred, was in respect of membership interests continuously held by HCo until the joining time. The remaining $12,000 is acquired deductions. So the amount that must be subtracted at step 7 is $21,600, i.e. $18,000 + ($12,000 x 30%).

Calculation of the ACA

Step 1

Add the total amount paid by HCo for all the membership interests in ACo, i.e. $86,000 ($60,000 + $26,000).

Steps 2

Add ACo's liabilities taken on by HCo ($400,000), giving a result after step 2 of $486,000.

Steps 3, 3A and 4

There are no distributed or distributable profits, or rollovers, so no adjustments need to be made for ACA steps 3, 3A and 4.

Step 5

An adjustment must be made for the $20,000 loss that accrued while HCo continuously held 60% of the membership interest in ACo. An amount of $12,000 ($20,000 x 60%) for owned losses is subtracted, giving a result after step 5 of $474,000 ($486,000 – $12,000).

Step 6

The remaining $8,000 of the $20,000 carry-forward loss transferred did not accrue to membership interests continuously held by HCo in ACo until the joining time. Therefore $2,400 ($8,000 x 30%) must be subtracted, giving a result after step 6 of $471,600 ($474,000 – $2,400).

Step 7

Subtract $21,600, giving a result after step 7 of $450,000 ($471,600 – $21,600).

Step 8

The entry ACA is therefore $450,000.

Example 2

On 1 July 2006, HCo, the head company of a consolidated group, acquires all of the membership interests in ACo for $600,000. ACo's only asset is an income producing property acquired on 1 July 1996. On 1 July 1994, the owner of the property at that time incurred capital expenditure of $100,000 on it, giving rise to Division 43 deductions of $4,000 each year (4% per annum) for 25 years.

When ACo joins the consolidated group on 1 July 2006, HCo becomes entitled to Division 43 deductions of $52,000 (13 years @ $4,000 per year).

Table 3: ACo – financial position at 30 June 2006 ($'000)

Income producing property	600	Equity	600
Total	600	Total	600

Calculation of the ACA

Step 1

Start with the amount paid by HCo for membership interests in ACo, i.e. $600,000.

Steps 2 to 7

No amounts are added or deducted at these steps. The unclaimed Division 43 deductions do not reduce the ACA at step 7.

Step 8

The entry ACA is therefore $600,000.

References

Income Tax Assessment Act 1997, sections 701-1 and 701-5; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Income Tax Assessment Act 1997, sections 705-90, 705-100, 705-105, 705-110 and 705-115; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2
- *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 9

Income Tax Assessment Act 1997, sections 705-60, 705-65

Income Tax Assessment Act 1997, section 110-40

Explanatory Memorandum to New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 5.88–105

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5

Revision history

Section C2-4-340 first published 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
2.10.03	Substantial revisions to Commentary definitions and example calculation figures.	To take deferred tax assets into account.
15.11.06	New paragraphs on Division 43 unclaimed deductions in Commentary.	For clarification.
	Additional example, showing treatment of unclaimed Division 43 deductions.	For clarification.
26.6.07	Note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used, and proposed changes to the treatment of certain inherited deductions.	Reflect announcement on 8 May 2007 by Assistant Treasurer in media release no. 50.
6.5.11	Changes to Commentary to reflect changes to the treatment of certain inherited deductions and removal of note on proposed change to consolidation rules.	Legislative amendment.

Worked example

Tax cost setting amount for retained cost base assets – entitlement to pre-paid services

Description

This example shows the calculation of a head company's cost setting amount for an asset created by a prepayment for services, based on the undeducted portion of the prepayment.

Commentary

If a retained cost base asset is an entitlement to a pre-paid service or other entitlement arising from a pre-paid amount, a head company's tax cost for the asset is equal to its entitlement to deductions in relation to the pre-paid amount arising out of the head company's inheritance of the joining entity's entitlements.

Example

Facts

ACo is wholly acquired by HeadCo (the head company of a consolidated group) on 1 July 2002 for $420,000. The financial position of ACo on joining the group is shown in table 1.

Table 1: ACo – financial position at 1 July 2002

Land & Buildings (MV $120,000)	$100,000	Capital	$400,000
Pre-paid services	$300,000	Mortgage on Land & Buildings	$20,000
Cash at bank	$20,000		
	$420,000		$420,000

Note: MV = market value

On 1 July 2000, ACo pre-pays $500,000 for financial services, based on a five-year service agreement. The allowable deduction is spread over the eligible service period – that is, $100,000 per year. (At the date of consolidation $300,000 of the prepayment has not been claimed and allowed as a deduction.)

Calculation

The tax cost setting amount for the retained cost base assets will be Cash $20,000 and Pre-paid Services $300,000, totalling $320,000.

The remainder of ACo's allocable cost amount (ACA), after deducting the sum of the tax cost setting amounts for retained cost base assets, will be $120,000. This will be allocated to the only reset cost base asset, Land & Buildings – i.e. ACA step 1 ($420,000) + ACA step 2 ($20,000) less retained cost base assets ($320,000) = $120,000.[11]

[11] The $300,000 of the prepayment that has been inherited by the head company at the time ACo joined the group is not an 'acquired deduction' for the purposes of step 7 of the ACA calculation. This is because the expenditure forms the cost base of the asset, being the entitlement to pre-paid services, and is excluded by subsection 705-115(2).

References

Income Tax Assessment Act 1997, subsection 705-25(4); as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Explanatory Memorandum to New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraph 5.26

Revision history

Section C2-4-410 first published (excluding drafts) 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
26.6.07	Note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used.	Reflect announcement on 8 May 2007 by Assistant Treasurer in media release no. 50.
6.5.11	Removal of note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used.	Legislative amendment.

Worked example

Tax cost setting amount for goodwill

Description

This example shows the calculation of the tax cost setting amount for goodwill when an entity joins a consolidated group. The goodwill of a joining entity, as well as the synergistic goodwill that arises out of the entity joining the group, is treated as a reset cost base asset of the joining entity. Some of the entry allocable cost amount (ACA) will be allocated to each part of the goodwill.

Commentary

When a subsidiary joins a consolidated group, the head company becomes the holder for income tax purposes of the assets brought into the group by the subsidiary. Each asset's tax cost setting amount is worked out by allocating the entry ACA among the assets. After allocation to retained cost base assets, the remainder of the entry ACA is apportioned to the reset cost base assets in proportion to their market values. For this purpose, the goodwill of the subsidiary is a reset cost base asset. It does not matter whether or not this goodwill is recognised in the subsidiary's accounts.

Goodwill includes synergistic goodwill, which is goodwill created as a result of businesses combining, and is part of the goodwill treated as a reset cost base asset of the joining entity.

→ Taxation Ruling TR 2005/17; Taxation Determination TD 2007/1; 'Market valuing goodwill' in 'Market valuation guidelines', C4-1

Example

Facts

HeadCo (the head company of a consolidated group) acquires all of the shares in SubCo on 1 July 2003 for $320,000. The financial position of SubCo on joining the group is shown in Table 1.

Table 1: SubCo – financial position at 1 July 2003

Asset 1 (MV $150,000)	$100,000	Capital	$200,000
Asset 2 (MV $100,000)	$80,000		
Cash at bank	$20,000		
	$200,000		$200,000

Note: MV = market value

As at the joining time, SubCo has built up business goodwill of $30,000 not reflected in its accounts. As a consequence of the group's ownership and control of SubCo, some of the synergistic goodwill accrues to the business of another group operating subsidiary. This component of synergistic goodwill has a market value of $20,000. For the purpose of allocating the ACA, this goodwill is also treated as an asset of SubCo at the joining time.

The goodwill of the group before SubCo joined had a cost base of $50,000.

Calculation

Assume the entry ACA is $320,000. The tax cost setting amount for the retained cost base assets will be $20,000 for Cash. The remainder of the ACA is $300,000. This will be allocated to the reset cost base assets in proportion to their market values.

Table 2: SubCo's tax setting amounts

Asset	Market value	Apportionment of remainder of entry ACA	Cost setting amount
Asset 1	$150,000	150,000/300,000x300,000	$150,000
Asset 2	$100,000	100,000/300,000x300,000	$100,000
Goodwill (business)	$30,000	30,000/300,000x300,000	$30,000
Goodwill (synergies)	$20,000	20,000/300,000x300,000	$20,000
Total	**$300,000**		

Record keeping tip: It is necessary to record amounts of goodwill used in setting the tax costs of a joining entity's assets, as well as details of how goodwill has been calculated for this purpose. It is also useful to keep track of the cost setting amounts calculated on entry for subsequent income tax assessments. For example, a head company will need to know the cost base of any goodwill disposed of or lost because an entity leaves a consolidated group.

References

Income Tax Assessment Act 1997, section 705-35; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Explanatory Memorandum accompanying the New Business Tax System (Consolidation) Bill (No 1) 2002, paragraph 5.34

Taxation Ruling TR 2005/17 – Income tax: goodwill: identification and tax cost setting for the purposes of Part 3-90 of the *Income Tax Assessment Act 1997*

Taxation Determination TD 2007/1 – Income tax: consolidation: in working out the market value of the goodwill of each business of an entity that becomes a subsidiary member of a consolidated group, should the value of related party transactions of each business of the entity be recognised on an arm's length basis?

Revision history

Section C2-4-520 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
26.10.05	Reference to new tax ruling.	
26.6.07	Reference to new tax determination.	

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Reduction for revenue-like assets (step C)

Description

This example shows how the tax cost setting amount for revenue-like assets may be reduced (at step C of the cost setting process).

Note

Trading stock, depreciating assets and revenue assets are referred to in the consolidation legislation as 'assets held on revenue account' and 'revenue etc. assets'. In the reference manual, they are generally referred to as 'revenue-like' assets.

A partly constructed asset that has a limited effective life is a depreciating asset for the purposes of Division 40 of the ITAA 1997.

Commentary

At step C of the cost setting process the remaining ACA of the joining entity is allocated among its reset cost base assets in proportion to their market values.

Where the amount allocated to a revenue-like asset (i.e. a revenue asset, item of trading stock or depreciating asset) exceeds the greater of its terminating value or market value, the allocated amount is reduced by the amount of the excess.

- The terminating value of a revenue asset is its cost base just before the entity becomes a member of a consolidated group.
- The terminating value of an item of trading stock is its value at the beginning of the joining entity's non-membership period that precedes the joining time, or its purchase price if acquired during that period. (A non-membership period is a period during an income year in which the entity is not a member of a consolidated group. Note that an entity will have more than one non-membership period in an income year if it leaves and then rejoins the same consolidated group or joins another consolidated group during that year.)
- The terminating value of a depreciating asset is its adjustable value at the joining time. For a partly constructed asset the adjustable value is the cost of the asset to the point of construction at the joining time.

The excess is then reallocated to the other reset cost base assets in accordance with their market values, but not so as to exceed the limit for any revenue-like assets.

The reduction at this step applies to revenue assets, trading stock and depreciating assets. A CGT asset is a revenue asset if the profit or loss on disposal would be taken into account in calculating taxable income (or losses) other than under the CGT provisions, and the asset is neither trading stock nor a depreciating asset.

The reduction addresses the potential for unrealised capital losses to be converted to revenue losses when an entity joins a consolidated group. This relates to situations where assets still held by a joining entity have declined in value after the group it is joining purchased membership interests in it.

Example

Facts

Assume the ACA for a joining entity, ACo, is $9,400. The retained cost base assets consist of Cash of $650. After this amount is subtracted, the remainder of the ACA ($8,750) is first apportioned to the reset cost base assets according to their market values (Table 1).

Table 1: Allocation to reset cost base assets

	Cost ($)	Terminating value ($)	Market value ($)	Apportionment	Tax cost setting amount before reduction ($)	section 705-40 max. amount ($)	Excess for revenue -like assets ($)	Tax cost setting amount after reduction ($)
Land 1	1,000	1,000	1,200	8750x1200/7400	1,419			1,419
Land 2	2,000	2,000	2,500	8750x2500/7400	2,956			2,956
Plant 1	500	200	220	8750x220/7400	260	220	40	220
Plant 2	300	160	130	8750x130/7400	154	160	0	154
Partly built Plant 3	1,000	1,000	1,500	8750x1500/7400	1,774	1,500	274	1,500
Partly built Plant 4	800	800	650	8750x650/7400	769	800	0	769
Trading stock 1	800	800	1,000	8750x1000/7400	1,182	1,000	182	1,000
Trading stock 2	200	200	200	8750x200/7400	236	200	36	200
Totals			**7,400**		**8,750**		**532**	

Note: The trading stocks 1 & 2 in this example are reset cost base assets. In certain circumstances, trading stocks may be treated as retained cost base assets. → 'Treatment of assets', C2-1; and section 701A-5 of the *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A 1997)

The excess of $532 must be reallocated against all reset cost base assets that have not had their tax cost setting amounts reduced → section 705-35, *Income Tax Assessment Act 1997* (ITAA 1997). For revenue-like assets the reallocation must not result in the tax cost setting amount exceeding the limit set in section 705-40 of the ITAA 1997. The first stage of this reallocation is shown in Table 2.

Table 2: First reallocation

	Market value ($)	Apportionment	Share of excess ($)	Share of 1st cut ($)	Tax cost setting amount with 1st excess ($)	section 705-40 max. amount ($)	Excess for revenue -like assets ($)	Tax cost setting amount after reduction ($)
Land 1	1,200	532x1200/4480	143	1,419	1,562			1,562
Land 2	2,500	532x2500/4480	297	2,956	3,253			3,253
Plant 2	130	532x130/4480	15	154	169	160	9	160
Partly built Plant 4	650	532x650/4480	77	769	846	800	46	800
Totals	**4,480**		**532**				**55**	

The tax cost setting amounts for plant 2 and partly built plant 4 have exceeded the maximum allowable by a combined total of $55. This amount must be reallocated against the reset cost base assets whose tax cost setting amounts have not exceeded their limits. This second stage of the reallocation is shown in table 3.

Table 3: Second reallocation

	Market value ($)	Apportionment	Share of excess ($)	Share after 2nd cut ($)	Tax cost setting amount with 2nd excess ($)
Land 1	1,200	55x1200/3700	18	1,562	1,580
Land 2	2,500	55x2500/3700	37	3,253	3,290
Totals	**3,700**		**55**		

The final results of step C of the cost setting process for each of ACo's reset cost base assets are shown in table 4. Note that a further reduction may be required for over-depreciated assets (step D) → Worked example: 'Reduction for over-depreciated assets (step D)', C2-4-610. A further reduction for certain revenue-like assets may also be required (step E) → 'Treatment of assets', C2-1; Worked example: 'Limiting the tax cost setting amounts of revenue-like assets (step E)', C2-4-710; and section 705-57, ITAA 1997.

Table 4: Final ACA allocation

	Allocation ($)	1st reallocation ($)	2nd reallocation ($)	Tax cost setting amount ($)
Land 1	1,419	143	18	1,580
Land 2	2,956	297	37	3,290
Plant 1	220			220
Plant 2	154	6		160
Partly built Plant 3	1,500			1,500
Partly built Plant 4	769	31		800
Trading stock 1	1,000			1,000
Trading stock 2	200			200
Totals	**8,218**	**477**	**55**	**8,750**

References

Income Tax Assessment Act 1997, sections 705-35 and 705-40; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 4

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 5.37-5.41

Income Tax Assessment Act 1997, section 977-50; as amended by *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002 (No. 90 of 2002)*, Schedule 15

Explanatory Memorandum to the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, paragraphs 1.28-1.30

Income Tax Assessment Act 1997, section 705-57; as amended by: *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 3

Income Tax (Transitional Provisions) Act 1997, section 701A-5; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 9

H. Coonan (Minister for Revenue and Assistant Treasurer*, Government delivers on business tax reform*, media release C72/02, 27 June 2002

Revision history

Section C2-4-530 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
3.12.03	Changes to Commentary and Example to illustrate treatment of partly constructed assets that have a limited effective life as revenue-like assets.	To further expand interpretative information on treatment of revenue-like assets.
14.7.04	Note in Commentary on recent changes to consolidation rules.	Legislative amendments.
26.10.05	Deletion of note in Commentary on recent changes to consolidation rules.	Legislative amendments.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Adjustment for ACA allocation at formation to membership interests in subsidiaries with owned profits (step C)

Description

This example shows how the allocable cost amount (ACA) allocated to a subsidiary's reset cost base assets on formation (step C in the cost setting process) is adjusted where such assets include membership interests in another subsidiary entity that has profits added at step 3 of its ACA calculation.

Commentary

In step C of the cost setting process the remainder of the ACA is allocated over the subsidiary's reset cost base assets in proportion to their market values to set new tax costs for these assets. → 'Treatment of assets', C2-1

Where on formation these assets (of the first subsidiary) include a membership interest in another subsidiary (second subsidiary) that has profits added at step 3 in calculating the second subsidiary's ACA, the value to be used as the market value of the asset for the purpose of step C is its market value less the profit amount added at step 3.

The membership interest's share of the profits is calculated as follows (where the profit adjustment amount is the amount added at step 3 of the second subsidiary's ACA calculation):

$$\frac{\text{market value of first subsidiary's membership interest in second subsidiary}}{\text{market value of all membership interests in second subsidiary}} \times \text{profit adjustment amount} = \text{membership interest's share of profits}$$

The result is subtracted from the market value of the first subsidiary's membership interest in the second subsidiary, in order to obtain an adjusted market value, which is used in turn to calculate the tax cost setting amount for the membership interest as an asset of the first subsidiary.

The purpose of the adjustment is to prevent a distortion in the allocation of the ACA. Without this adjustment, the profits of the second subsidiary would increase both:

- the second subsidiary's ACA (this is an intended effect of step 3 of the ACA calculation), and
- the amount of the first subsidiary's ACA that is allocated to membership interests (this is not intended).

However, this adjustment is not made under certain circumstances. → Taxation Determination TD 2005/24; Taxation Determination TD 2005/25

Example

Facts

Head company HCo pays $200 to buy all the shares in company ACo.

ACo pays $100 to buy all shares in BCo.

BCo makes taxed profits of $50.

On 1 July 2004, HCo, ACo and BCo form a consolidated group.

Table 1: ACo – financial position at 1 July 2004

Land (MV $100)	$100	Equity	$200
Shares in B (MV $150)	$100		
	$200		$200

Note: MV = market value

Table 2: BCo – financial position at 1 July 2004

Asset 1 (MV $100)	$100	Equity	$100
Cash	$50	Profits	$50
	$150		$150

Calculation

Calculation of new tax values of assets in the consolidated group

ACo's ACA is $200 (only step 1 amount of $200 is applicable).

Table 3: Calculating ACo's new tax costs

Reset cost base assets	Modified market value	Apportionment of ACA	Tax cost setting amount
Land	$100	$200 x ($100 / $200)	$100
Shares in B	$100*	$200 x (100 / $200)	$100
Total	$200		$200

* BCo has accrued profits of $50 that will be added at step 3 of its ACA calculation. This amount is deducted from the $50 market value of the asset for the purpose of apportioning ACo's ACA.

BCo's ACA step 1 amount is set by the cost allocated to ACo's membership interest in BCo – i.e. $100 (in accordance with the rules for the order of cost setting application → 'Treatment of assets', C2-1). This amount is then increased by the ACA step 3 amount of $50. To determine the tax cost setting amount of BCo's assets, first reduce the ACA by the value of the retained cost base asset of Cash ($50). As BCo has only one reset cost base asset, the tax cost setting amount is $100.

References

Income Tax Assessment Act 1997, section 705-160; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 1

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, paragraphs 5.61 to 5.71

Taxation Determination TD 2005/24 – Income tax: consolidation: is an adjustment under section 705-160 of the *Income Tax Assessment Act 1997* required where the relevant membership interests are in a chosen transitional entity with losses?

Taxation Determination TD 2005/25 – Income tax: consolidation: if a transitional group has a non-chosen subsidiary in which all membership interests of the head company are held indirectly through a chosen transitional entity, and the non-chosen subsidiary has accrued profits, can an adjustment arise under section 705-160 of the *Income Tax Assessment Act 1997* when working out the head company adjusted allocable amount under section 701-20 of the *Income Tax (Transitional Provisions) Act 1997* for another non-chosen subsidiary?

Revision history

Section C2-4-540 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
26.10.05	Reference to new taxation determinations.	

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Reduction for privatised depreciating assets (at step D)

Description

This example shows how the tax cost setting amount (TCSA) for a privatised depreciating asset may be reduced (at step D of the tax cost setting process).

Commentary

After the joining entity's ACA is allocated among its reset cost base assets in proportion to their market values, and any necessary reductions are made for revenue-like assets (step C of the cost setting process), a further reduction may be required for each privatised depreciating asset (step D).

A privatised depreciating asset is a depreciating asset in respect of which, as a result of a past or simultaneously occurring privatisation, a relevant privatised asset provision directly or indirectly affects the amount the joining entity could deduct for decline in value of the previously exempt asset.

The relevant privatised asset provisions are:

- section 61A of the ITAA 1936 – which applied to tax exempt entities that became taxable between 1 July 1988 and 2 July 1995
- Subdivisions 57-I and 57-J in Schedule 2D of the ITAA 1936 – which applied to tax exempt entities that became taxable between 3 July 1995 and 3 August 1997
- former Division 58 of the ITAA 1997 – which applied to tax exempt entities that became taxable and to asset sales in connection with a business from a tax exempt entity between 4 August 1997 and 30 June 2001, and
- current Division 58 of the ITAA 1997 – which applies to tax exempt entities that became taxable and to asset sales in connection with a business from a tax exempt entity from 1 July 2001.

Where the TCSA for a privatised depreciating asset (calculated so far) exceeds the terminating value of the asset, the TCSA is reduced to the terminating value.

The purpose of this reduction is to ensure that the limiting of decline in value deductions under the privatised assets provisions (such as Division 58 of the ITAA 1997) is not overridden by the consolidation tax cost setting process. Reducing the TCSA to the joining entity's terminating value for the asset ensures that decline in value deductions allowable to the head company for such privatised assets continue to be appropriately limited.

This reduction does not apply where the privatised asset has been held for at least 24 months by an earlier consolidated group that is not an associate of the joined group.

Example

Facts

ACo is a wholly-owned subsidiary of HCo.

On 2 July 2001, ACo acquires a privatised depreciating asset in connection with a business from a tax exempt entity for $96. The asset has an effective life of 10 years.

Under section 58-65 of the ITAA 1997, ACo chooses to work out the first element of the cost of the privatised asset using its notional written down value, which is calculated as $90.

ACo uses the prime cost method and for the 2001-02 income year deducts $9 for the decline in value (based on a cost of $90) under Division 40 of the ITAA 1997, leaving an adjustable value of $81 on 30 June 2002.

On 1 July 2002, HCo forms a consolidated group with ACo as a subsidiary member.

After ACo's ACA is calculated and allocated, the TCSA for the privatised asset is $86. No reduction at step C is necessary because the asset has a market value of $92.

However, at step D a reduction in the privatised depreciating asset's TCSA is required under section 705-47 of the ITAA 1997, because Division 58 of the ITAA 1997 has directly affected ACo's deductions (by reducing the asset's cost from $96 to $90) and the asset's TCSA calculated up to this point ($86) exceeds its terminating value ($81).

The TCSA for the privatised depreciating asset is reduced to its terminating value of $81, a reduction of $5 ($86 – $81).

References

Income Tax Assessment Act 1997, section 705-47; as inserted by *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (83 of 2004), Schedule 2

Explanatory Memorandum to the Tax Laws Amendment (2004 Measures No.2) Bill 2004, paragraphs 2.206 to 2.241

Revision history

Section C2-4-605 first published 11 March 2005.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Reduction for over-depreciated assets (step D)

Description

This example shows how the tax cost setting amount for over-depreciated assets may be reduced (step D of cost setting process).

Commentary

After the joining entity's ACA is allocated among its reset cost base assets in proportion to their market values, and any necessary reductions are made for revenue-like assets (step C of cost setting process), a further reduction may be required for each over-depreciated asset (step D).

This further reduction will be required where all of the following tests are satisfied for the particular asset:

- the asset is over-depreciated at the joining time
- the head company's tax cost setting amount (calculated so far) is more than the joining entity's terminating value for the asset (its tax written down value) at the joining time
- the joining entity paid an unfranked or partly franked dividend during the period from when it acquired the asset to the joining time
- an amount representing the unfranked or partly franked dividend had not been further distributed as a dividend before the joining time to a recipient that was not entitled to the intercorporate dividend rebate, and
- the dividends were paid out of profits that were sheltered from income tax, at least in part, by over-depreciation of the asset.

The amount of the reduction is the least of:

- the over-depreciation amount – this is the lesser of the excess of market value of an asset over its adjustable value just before the joining time (tax written down value at the joining time), and the excess of the asset's cost over its adjustable value at that time
- the amount of income that continues to be sheltered from tax, or
- the amount by which the tax cost setting amount would, apart from this provision, exceed the joining entity's terminating value of the asset.

This reduction prevents an increase in the adjustable value of a depreciating asset where there has been a tax deferral resulting from its over-depreciation. The potential for indefinite deferral arises where a company holds an over-depreciated asset at the joining time, and the income sheltered from tax by the over-depreciation was distributed as an unfranked dividend to a recipient who was entitled to the intercorporate dividend rebate (i.e. the tax deferral amount). The example below shows how to work out the reduction for each over-depreciated asset.

Note

Transitional rule on formation

The tax deferral amount is increased to include any unfrankable undistributed profits accrued to the head company and included in ACA step 3 (under transitional rules) to the extent that:

- those profits were not subject to tax because of deductions for depreciation representing over-depreciation, and
- the deductions did not form part of a loss that reduced the ACA under step 5.

→ former subsection701-30(3), *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A 1997)

In many cases taxpayers will not have sufficient information available to work out the reduction for over-depreciation on an asset-by-asset basis or in strict accordance with section 705-50. In other cases, taxpayers may be able to work out the amount of reduction accurately, but with significant costs of compliance. For these reasons, administrative short cut methods are available to work out the reduction amounts for over-depreciated assets. These short cut methods give a reasonable approximation of the reduction required by section 705-50 and will generally be accepted by the Tax Office, subject to certain constraints. → 'Reduction for over-depreciated assets (step D) – administrative short cuts', C2-4-640

Example

Facts

A joining entity, SubCo, has two depreciating assets, Plant 1 and Plant 2. Their details are shown in the table below. Profits of $20 were sheltered from income tax by the over-depreciation of Plant 1 and the whole amount was distributed unfranked to SubCo's parent company in a fully rebatable form.

Table 1: Depreciating assets

	Cost	Terminating value (TV)	Market value (MV)	Section 705-40 maximum amount	Tax cost setting amounts after reduction
Plant 1	$500	$200	$220	$220	$220
Plant 2	$300	$160	$130	$160	$160

The amounts allocated to Plant 1 and Plant 2 are $220 and $160 respectively (no reduction was required for revenue-like assets).

Calculation

Now consider whether a further reduction to each payment amount is required for over-depreciated assets.

First it is necessary to determine whether the assets are over-depreciated.

Worksheet 1: For Plant 1 – is an asset over-depreciated?

	Test for each depreciable asset At the joining time:	**Test satisfied? Yes/No**	**Excess amount ($)**
M	Does market value exceed adjustable value?	Yes	20
N	Does the cost exceed adjustable value?	Yes	300
	If the answer is YES to both questions, the asset is over-depreciated by the lesser of M and N.		20

The market value of $220 exceeds the adjustable value of $200 by $20. The cost of $500 exceeds the adjustable value of $200 by $300. Under both tests for over-depreciation, Plant 1 is over-depreciated.

The tax cost setting amount for an over-depreciated asset is reduced by the least of the over-depreciation amount (calculated above), the excess of the tax cost setting amount over its terminating value, and the tax deferral amount (worksheet 2).

Worksheet 2: For Plant 1 – over-depreciation reduction

	Test for each over-depreciated asset	**$**	**$ amount**
	Over-depreciation amount		
(a)	Over-depreciation amount from previous table		20
	Tax cost setting amount exceeds terminating value		
(b)	Excess of the tax cost setting amount over its value		20
	Tax deferral amount		
(c)	*Start with* the amount of unfranked dividends paid by the joining entity before the joining time that were subject to the former section 46 or former section 46A rebate	20	
(d)	The amount of the profits paid as dividends in (c) above (the *qualifying profits amount*) that were not subject to tax because of the over-depreciation of the asset, *but* count only to the extent they were not counted in ACA step 4 and to the extent the deductions for over-depreciation did not form part of a loss that reduced the ACA under step 5, were not counted in ACA step 4 (but the depreciation did not generate a tax loss to be subtracted from the entry ACA at step 5)	20	
(e)	The extent to which the dividend in (c) – adjusted to amount in (d) – was *not* further distributed (directly or indirectly) to a taxpayer who was *not* entitled to such a rebate. This is the *tax deferral amount*	20	
	Transitional rule on formation		
(f)	*Add* – The tax deferral amount is increased to include any unfrankable undistributed profits accrued to head company and included in ACA step 3 (under transitional rules) to the extent that those profits were not subject to tax because of deductions for depreciation representing over-depreciation, and the deductions did not form part of a loss that reduced the ACA under step 5 (former subsection 701-30(3), IT(TP)A 1997).	0	
(g)	**Is there a tax deferral amount?** How much?	Yes	20
	Reduction of tax cost setting amount is the lesser of (a), (b) and (g).		20

The tax cost setting amount for Plant 1 of $220 must be further reduced by $20 to $200. (However, the $20 reduction amount is not re-allocated among other assets.)

Worksheet 3: For Plant 2 – is an asset over-depreciated?

	Test for each depreciable asset At the joining time:	Test satisfied? Yes/No	Excess amount ($)
M	Does market value exceed adjustable value?	No	0
N	Does the cost exceed adjustable value?	Yes	140
	If the answer is YES to both questions, the asset is over-depreciated by the lesser of M and N.		0

The market value of $130 does not exceed the adjustable value of $160. The cost of $300 exceeds the adjustable value of $160 by $140. Plant 2 is not over-depreciated, so no further reduction in the payment amount of $160 is required.

Note

Changes to the over-depreciation provisions

The over-depreciation provisions in the tax cost setting rules have been modified for an entity that becomes a member of a consolidated group between 9 May 2007 and 30 June 2009. In this case a head company will only need to look at five years of dividend history immediately before the joining time to determine whether an over-depreciation adjustment is required in relation to the joining entity's asset. Effective from 1 July 2009, the over-depreciation adjustment in section 705-50 has been repealed, so it will no longer apply to over-depreciated assets of entities that become subsidiary members of a consolidated group on or after that date. → *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010)

References

Income Tax Assessment Act 1997, section 705-50; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2

Explanatory Memorandum to New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 5.44–52

Income Tax Transitional Provisions Act 1997, former subsection 701-30(3); as amended by *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 7

Income Tax (Transitional Provisions) Act 1997, Subdivision 705-E; as inserted by *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1, Part 4

Income Tax (Transitional Provisions) Act 1997, Subdivision 712-E; as inserted by *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1, Part 4

Income Tax Assessment Act 1997, Subdivision 716-G; as inserted by *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1, Part 5

Income Tax (Transitional Provisions) Act 1997, Subdivision 716-G; as inserted by *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1, Part 5

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004, paragraphs 1.49 – 1.92

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004, paragraphs 1.93 – 1.134

Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006 (No. 101 of 2006), which repealed:

- section 701-30 of the *Income Tax (Transitional Provisions) Act 1997*, and
- sections 46 and 46A of the *Income Tax Assessment Act 1936*

Income Tax Assessment Act 1997, section 705-50 and subsection 995-1(1) as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010 (No. 56 of 2010),* Schedule 5, Part 6

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5

Revision history

Section C2-4-610 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on proposed changes to consolidation rules.	Proposed legislative amendments.
27.1.05	Insertion of note on transitional rule on formation, p. 2.	For clarification.
26.10.05	Update of notes on proposed changes to consolidation rules.	Legislative amendments.
15.11.06	Updated references to inoperative provisions.	Legislative amendment.
26.6.07	Note on proposed changes to the cost setting rules to phase out over-depreciation deductions.	Reflect announcement on 8 May 2007 by Assistant Treasurer in media release no. 50.
6.5.11	Note on proposed changes replaced to reflect the changed wording in section 705-50.	Legislative amendment.

Worked example

Reduction for over-depreciated assets (step D) – administrative short cuts

Description

This example shows how the tax cost setting amount for over-depreciated assets may be calculated (step D of cost setting process) using either one of two administrative short cuts.

Commentary

After the joining entity's allocable cost amount (ACA) is allocated among its reset cost base assets in proportion to their market values, and any necessary reductions are made for revenue-like assets (step C of cost setting process), a further reduction may be required for each over-depreciated asset (step D).

This further reduction is required where all of the following tests are satisfied for the particular asset:

- the asset is over-depreciated at the joining time
- the head company's tax cost setting amount (as calculated so far) is more than the joining entity's terminating value for the asset (its tax written down value at the joining time)
- the joining entity paid an unfranked or partly franked dividend during the period from when it acquired the asset to the joining time
- an amount representing the unfranked or partly franked dividend had not been further distributed as a dividend before the joining time to a recipient that was not entitled to the inter-corporate dividend rebate, and
- the dividends were paid out of profits that were sheltered from income tax, at least in part, by over-depreciation of the asset.

The amount of the reduction is the least of:

- the over-depreciation amount – this is the lesser of the excess of market value of an asset over its adjustable value just before the joining time (tax written down value at the joining time), and the excess of the asset's cost over its adjustable value at that time
- the amount of income that continues to be sheltered from tax, or
- the amount by which the tax cost setting amount would, apart from this provision, exceed the joining entity's terminating value of the asset.

This reduction prevents an increase in the adjustable value of a depreciating asset where there has been a tax deferral resulting from its over-depreciation. The potential for indefinite deferral arises where a company holds an over-depreciated asset at the joining time, and the income sheltered from tax by the over-depreciation was distributed as an unfranked dividend to a recipient who was entitled to the inter-corporate dividend rebate.

Note

Determining the extent to which dividends have been paid out of profits sheltered from income tax

A last-in-first-out (LIFO) method can be used to determine the extent to which dividends were paid out of profits that were sheltered from income tax for the purpose of calculating any reduction to the tax cost setting amounts for over-depreciated assets.

Under the LIFO method, two assumptions are made. Firstly, it is assumed that dividends were paid out of profits of income years in order from the most recent to the earliest. Once the profits have been allocated between income years according to the first assumption, it is further assumed that unfranked distributions were paid out of profits of the relevant year that were not subject to income tax before they were paid out of profits that were subject to income tax. → former subsection 705-50(3A), ITAA 1997; paragraphs 1.135 – 1.140 and 1.147 – 1.148 of the Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004

Changes to the over-depreciation provisions

The over-depreciation provisions in the tax cost setting rules have been modified for an entity that becomes a member of a consolidated group between 9 May 2007 and 30 June 2009. In this case a head company will only need to look at five years of dividend history immediately before the joining time to determine whether an over-depreciation adjustment is required in relation to the joining entity's asset. Effective from 1 July 2009, the over-depreciation adjustment in section 705-50 has been repealed, so it will no longer apply to over-depreciated assets of entities that become subsidiary members of a consolidated group on or after that date. → *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010)

A worked example showing how to calculate the over-depreciation adjustment for each asset is provided separately. → 'Reduction for over-depreciated assets (step D)', C2-4-610

In many cases taxpayers will not have sufficient information available to work out the reduction for over-depreciation on an asset-by-asset basis or in strict accordance with former section 705-50. In other cases, taxpayers may be able to work out the amount of reduction accurately, but with significant costs of compliance. For these reasons, the administrative short cut methods outlined in figure 1 may be used to work out the reduction amounts for over-depreciated assets. These short cut methods give a reasonable approximation of the reduction required by former section 705-50 and will be accepted by the ATO.

These administrative short cut methods have been discussed in draft form with representatives of business and the accounting profession to ensure they achieve the legislation's policy objectives and also meet the needs of the user. If these short cut methods are not suitable for your circumstances and you would like to use another administrative approach, contact the ATO for guidance.

The administrative short cut methods are summarised in figure 1, which is followed by four examples that demonstrate how they work.

Examples

Example 1 demonstrates the Aggregate Method and Example 2 demonstrates the Annual Method. Both are based on the same facts where the joining entity has no profits at the joining time.

Example 3 demonstrates how to estimate the proportion of unfranked dividends paid by listed public companies that reach entities not entitled to the inter-corporate dividend rebate.

Example 4 demonstrates both the Aggregate Method and the Annual Method where a joining entity has retained profits that are not accrued to the joined group. This can occur where an entity joins an existing group as a result of a 100% acquisition by the group. In this case, there is no step 3 amount as there is no retained profit accrued to the group.

Note

Short cuts cannot be used for grapevines and horticultural plants

While former section 705-50 applies to all depreciating assets under the Uniform Capital Allowances regime in Division 40, these short cut methods are *not* available for grapevines and horticultural plants.

Figure 1: Summary of the over-depreciation short cut process

1	AGGREGATE METHOD	2	ANNUAL METHOD
1A	**Determine the potential over-depreciation:** For all depreciating assets on hand at the joining time, total the excess of the BWDV (book written down value) over the TWDV (tax written down value).	2A	**Determine the potential over-depreciation:** For all depreciating assets on hand at the joining time, total the excess of the BWDV over the TWDV for each year back to the dates of acquisition and work out the incremental increase of the excess each year.
1B	**Limit the amount of over-depreciation to the extent it could result in untaxed profits:** Multiply the result from 1A by 70%.	2B	**Limit the amount of over-depreciation to the extent it could result in untaxed profits:** Multiply the results from 2A for each year by 70%.
1C	**Reduce the potential over-depreciation adjustment for untaxed profits still in retained earnings at the joining time:** Reduce the result from 1B above by the amount of IB x [a/(a+b+c)] where: a = unfrankable retained earnings at the joining time (excluding any ACA transitional step 3 amount for the joining entity) b = unfranked amount of dividends paid by the joining entity since 1.7.1987, and c = the ACA transitional step 3 amount for the joining entity.	2C	**Reduce each year's potential over-depreciation adjustment for untaxed profits still in retained earnings at the joining time:** Reduce each year's result from 2B above by the amount of 2B x [d/(d+e+f)] where: d = untaxed profits of that year to the extent they are in unfrankable retained earnings at the joining time (excluding those profits that are in any ACA transitional step 3 amount for the joining entity) e = unfranked amount of dividends from untaxed profits of that year paid by the joining entity (or by a transferor under a Subdivision126-B rollover, to the extent they relate to over-depreciation of the rollover assets), and f = untaxed profits of that year that are in the ACA transitional step 3 amount for the joining entity.
1D	**Remove double counting of revenue tax losses:** Reduce the result from 1C above to the extent that the over-depreciation resulted in any revenue tax losses in the ACA step 5 adjustment for the joining entity.		**Other adjustments that may reduce the over-depreciation amount:**
		2D	Reduce each year's result from 2C above to the extent resulting unfranked dividends paid were pre-acquisition dividends in ACA step 4.
1E	**Limit adjustment to total unfranked dividends paid and transitional step 3 ACA amounts:** Reduce the result from 1D above to the extent that it exceeds the total of the following amounts: (a) unfranked dividends paid by joining entity since 1.7.1987, and (b) transitional step 3 unfranked profits.	2E	Reduce each year's result from 2D above to the extent that the over-depreciation resulted in any revenue tax losses in the ACA step 5 adjustment for the joining entity.
		2F	Reduce each year's result from 2E above to the extent that direct or indirect shareholders paid tax on the resulting unfranked dividends paid (excluding dividends that have resulted in a 2D reduction).
1F	**Estimate the over-depreciation reduction amount per asset:** Allocate the result from 1E above between each asset that has been prima facie stepped up proportionately based on the amount of each asset's prima facie cost base step up (prior to the application of the over-depreciation adjustment).	2G	Add each year's result from 2F above.
		2H	**Limit adjustment to total unfranked dividends paid and transitional step 3 ACA amounts:** Reduce the result from 2G above to the extent that it exceeds the total of the following amounts: (a) unfranked dividends paid by the joining entity (or by a transferor under a Subdivision 126-B rollover, to the extent they relate to over-depreciation of the rollover assets), and (b) transitional step 3 unfranked profits.
		2I	**Estimate the over-depreciation reduction amount per asset:** Allocate the result from 2H above to each asset proportionately based on each asset's excess of BWDV over TWDV.

Notes to figure 1, Aggregate Method

This is the simplest method for calculating the over-depreciation reduction and will minimise the cost of compliance. Broadly, this approach compares book and tax written down values at the joining time and draws some conclusions as to how the difference has given rise to prior unfranked dividends or untaxed profits that are attributable to over-depreciation.

While less precise than the Annual Method, the Aggregate Method is still considered to provide a reasonable estimate of the over-depreciation adjustment. Taxpayers should note that a different result will arise under the Annual Method. This could be higher or lower than the result under the Aggregate Method.

Step 1A: In some cases taxpayers may have assets with book written down values (BWDV) less than their tax adjustable values (TWDV); for example, where there have been write-downs of depreciating assets for accounting purposes. Where the difference is significant, inclusion of those assets in step 1A could materially impact on the result. If an asset's adjustable value (its tax written down value) is more than 1% of the joining entity's ACA and its TWDV is greater than its BWDV, that asset should be excluded from the calculation.

Step 1C variable b: Taxpayers should not include pre-1 July 1987 dividends in the variable 'b' amount. Ordinarily, those dividends pre-date the dividend imputation system, and taxpayers may be required to undertake a detailed analysis of those dividends to ascertain the extent to which they were paid out of untaxed profits. In the interests of minimising the costs of compliance, those dividends are not included in the Aggregate Method.

Step 1D: Where losses have been subtracted at step 5 in calculating the ACA they are not counted again in working out the reduction for over-depreciation. The relevant amount can be estimated by considering the ACA step 5 losses for each relevant year, and the difference between the total book and tax depreciation claim for that year. This information should be readily available in the joining entity's prior year income tax returns or working papers. Where only part of a loss for a year remains unused at the joining time, the component attributable to over-depreciation can be worked out by apportioning the remainder between over-depreciation and profits sheltered from tax for other reasons (e.g. R&D) on a pro-rata basis.

Step 1E amount (a): If ascertainable, exclude any such dividends paid before the acquisition date of depreciating assets held at the joining time. To maintain consistency with step 1C, only dividends paid from 1 July 1987 should be counted.

Step 1F: In order to keep compliance costs to a minimum, the Aggregate Method involves a proportional allocation of the overall over-depreciation adjustment amount based on the initial cost base step-up.

Note

Where *Law Administration Practice Statement PS LA 2004/12* is being applied in determining the tax cost setting amounts (TCSAs) for depreciating assets, this step should be applied subject to paragraph 44 of that practice statement. That is, first allocate the result from step 1E to significant individual assets and to categories of non-significant assets; then, within a category of non-significant assets, allocate the result across the individual assets within that category on the basis of their book written down values.

Notes to figure 1, Annual Method

This approach considers over-depreciation on a yearly basis, but again by reference only to assets on hand at the joining time. Over-depreciation may have been recovered for assets sold before the joining time. In effect, this method 'reconstructs' the historical differences between book and tax depreciation. It also considers unfranked dividends and untaxed profits on a year by year basis.

This method also differs from the Aggregate Method in that it takes account of dividends paid out of pre-acquisition profits (step 2D). It also has regard to whether direct or indirect shareholders paid tax on unfranked dividends relating to over-depreciation (step 2F).

These additional steps mean that this method may more closely approximate the adjustment required by former section 705-50.

Step 2A: In some cases taxpayers may have assets with book written down values (BWDV) less than their tax adjustable values (TWDV); for example, where there have been write-downs of depreciating assets for accounting purposes. Where the difference is significant, inclusion of those assets in step 2A could materially affect the result. If an asset's adjustable value (TWDV) is more than 1% of the joining entity's ACA and its TWDV is greater than its BWDV, that asset should be excluded from the calculation.

Tip: *The easiest way to work out the annual amounts may be to import details of all depreciating assets, along with the book and tax WDVs, depreciation rates and methods into a spreadsheet. Then reconstruct annual book and tax depreciation for each asset for each year.*

Note: Reconstruction of book and tax WDV for assets on hand at the joining time results in a reasonably accurate calculation of the total over-depreciation amount. However this requirement may give rise to a significant compliance burden. As an alternative, companies may base the step 2A amounts on the actual difference between book and tax WDV year by year. This alternative may have the effect of over-stating the over-depreciation for a year, because its use could involve counting the difference for assets held in that year but not held at the joining time. However, this would have a trade-off in reduced compliance costs.

Step 2B: The percentage of 70% used here reflects the current general company tax rate. Even though different tax rates may have applied in the years leading up to the joining time, restatement of future tax liabilities at the new rates will release (or draw) profits such that the amount available for distribution will be aligned with the tax rate at the joining time.

Taxpayers may use a percentage based on the tax rate applicable for a particular year in this step, instead of using 70%, provided adjustments are made to the potential over-depreciation figure to reflect the impact of changes in the tax rate on the deferred (or future) tax liability account and the consequential change to distributable profits in the year the tax rate changed.

Step 2C variable e: Variable 'e' in the formula could potentially include pre-1 July 1987 dividends, which pre-date the dividend imputation system. Taxation Determination TD 2004/4 confirms that dividends paid before 1 July 1987 are unfranked dividends for the purposes of former section 705-50 and therefore should be counted. Note, that this will not be the case where the entity has joined the group on or after 9 May 2007, as the head company will only need to look at five years of dividend history immediately before the joining time to determine whether an over-depreciation adjustment is required in relation to the joining entity's asset → *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010). Given the removal of the inter-corporate dividend rebate for non-group public company shareholders from 1 July 2000, dividends after 30 June 2000 should not be counted in variable 'e' where the public company examined is not a wholly-owned subsidiary of another resident public company.

Variable 'e' should also include unfranked dividends paid by a transferor of a depreciating asset under a Subdivision 126-B rollover, to the extent the dividend was paid out of profits of the transferor that were sheltered from tax by over-depreciation of the transferred asset. If the annual method is also used to work out the over-depreciation adjustment for depreciating assets still held by the transferor when it joins the consolidated group, dividends related to rollover assets counted at variable 'e' in step 2C in the transferee's calculation should not be counted in steps 2C and 2H of the transferor's calculation. This will prevent double counting of those dividends.

Step 2D: To the extent that dividends paid out of profits sheltered from income tax because of over-depreciation have been subtracted at step 4 in calculating the ACA, they are not counted again in working out the reduction for over-depreciation. This amount should be subtracted at step 2D of the short cut process.

Step 2E: This is the same process as in step 1D.

Step 2F: Where unfranked dividends from profits sheltered from tax by over-depreciation have been paid as (or used to pay) unfranked dividends by a public company, it may not be possible for the consolidated group to work out the extent to which those dividends have ultimately reached the hands of recipients not entitled to the inter-corporate dividend rebate. Such a tracing exercise would also involve significant costs.

In those cases, an analysis of the public company's share register should be undertaken to estimate the breakdown between those shares for which it is clear the shareholder would not be entitled to the inter-corporate dividend rebate (e.g. an individual or non-resident), and those for which it is unclear who may be the ultimate recipient (e.g. a nominee). A methodology for estimating the step 2F amount, without the need for tracing, is explained in example 3.

Where a taxpayer is able to demonstrate that a higher percentage of dividends ultimately reaches beneficial shareholders who are not entitled to the inter-corporate dividend rebate, that higher percentage may be used at step 2F.

Note:

Where a public company does not use either the Aggregate or Annual method but calculates the over-depreciation adjustment otherwise in accordance with the requirements of former section 705-50, the ATO will accept Step 2F being used to ascertain the extent to which the unfranked dividends reached the hands of direct or indirect shareholders who were not entitled to the inter-corporate dividend rebate.

Step 2F is not available to be used in conjunction with the Aggregate Method.

Step 2H amount (a): If ascertainable, excluding any such dividends paid before the acquisition date of depreciating assets held at the joining time. However, dividends paid by a transferor of an asset subject to a rollover under Subdivision 126-B that relate to over-depreciation of the asset in the hands of the transferor should be included.

If the annual method is also used to work out the over-depreciation adjustment for depreciating assets still held by the transferor when it joins the consolidated group, dividends related to rollover assets counted at variable 'e' in step 2C in the transferee's calculation should not be counted in steps 2C and 2H of the transferor's calculation. This will prevent double counting of those dividends.

Given the removal of the inter-corporate dividend rebate for non-group public company shareholders from 1 July 2000, dividends after 30 June 2000 should not be counted in amount 'a' where the public company examined is not a wholly-owned subsidiary of another resident public company.

Step 2I: The Annual Method uses a proportional allocation of the overall over-depreciation adjustment amount based on the difference between the book written down value (BWDV) and the tax adjustable value or written down value (TWDV). This is different to the allocation under the Aggregate Method, and more closely approximates the methodology required by former section 705-50.

Note

Where *Law Administration Practice Statement PS LA 2004/12* is being applied in determining the TCSAs for depreciating assets, this step should be applied subject to paragraph 44 of that practice statement. That is, first allocate the result from step 1E to significant individual assets and to categories of non-significant assets; then, within a category of non-significant assets, allocate the result across the individual assets within that category on the basis of their book written down values.

Example 1 – Aggregate Method

Facts

Sub Co was incorporated by Hold Co on 1 July 1995. Hold Co elects to form a consolidated group on 1 July 2002. Sub Co's financial position is as follows:

Table 1: Sub Co – financial position at 30 June 2002 ($)

Cash	13,144	Capital	50,487
Stock on hand	6,693	Retained earnings (loss)	(298)
Depreciating assets	9,520	Asset revaluation reserve	863
Other assets	23,850	Provision for long service	1,393
Future tax asset	418	Future tax liability	1,180
		Provision for income tax	0
	53,625		53,625

Sub Co's franking account has a credit balance on 20 June 2002 of $56. After adjusting for hypothetical payments etc. under subsection 705-90(4), the hypothetical balance is $56.

Sub Co's depreciation schedules for the year ending 30 June 2002 are shown in tables 2 and 3. In this case the market values (MV) of depreciating assets are equal to their book values at the joining time.

Sub Co incurs a tax loss of $640 in the year ending 30 June 2002. Tax deductions related to over-depreciation and R&D for that year are $378 and $26 respectively. As the total loss exceeds these tax deductions, $378 of the loss is treated as being attributable to deductions related to over-depreciation. But for the loss incurred in the year ending 30 June 2002, Sub Co would have had $99 in undistributed profits accrued to the head company able to be counted in ACA step 3.

Before the consolidated group was formed, Sub Co paid a total of $1,135 in unfranked dividends. These were partly attributable to profits sheltered from tax by over-depreciation and partly attributable to profits sheltered from tax by concessional deductions for research and development expenditure.

Table 2: Accounting depreciation schedule for year ending 30 June 2002

Asset	Cost ($)	Opening WDV ($)	Method	Life (years)	Rate %	Depreciation ($)	Closing WDV ($)
Asset 1	1,100	732	PC	15	6.7	74	658
Asset 2	1,200	480	PC	10	10	120	360
Asset 3	1,300	1,040	PC	20	5	65	975
Asset 4	1,400	980	PC	10	10	140	840
Asset 5	1,500	1,283	DV	20	7.5	96	1,187
Asset 6	1,600	1,493	PC	15	6.7	107	1,386
Asset 7	1,700	1,700	DV	5	30	510	1,190
Asset 8	1,800	781	DV	12	13	101	679
Asset 9	1,900	1,487	DV	40	4	59	1,428
Asset 10	2,000	929	DV	8	12	111	817
Total		**10,904**				**1,385**	**9,520**

Table 3: Income tax depreciation schedule for year ending 30 June 2002

Asset	Cost ($)	Opening WDV ($)	Method	Life (years)	Rate %	Depreciation ($)	Closing WDV ($)
Asset 1	1,100	385	PC	15	13	143	242
Asset 2	1,200	0	PC	10	17	0	0
Asset 3	1,300	624	PC	20	13	169	455
Asset 4	1,400	686	PC	10	17	238	448
Asset 5	1,500	1,110	PC	20	13	195	915
Asset 6	1,600	1,280	DV	15	20	256	1,024
Asset 7	1,700	1,700	DV	5	30	510	1,190
Asset 8	1,800	320	DV	12	25	80	240
Asset 9	1,900	1,010	DV	40	10	101	909
Asset 10	2,000	235	DV	8	30	70	165
Total		**7,350**				**1,762**	**5,588**

Calculation

Worksheet 1: ACA calculation ($)

Step1				
Cost base (CB) of membership interests (indexed)			52,961	
Reduced cost base (RCB) of membership interests			50,487	
Market value (MV) of membership interests			56,552	
MV exceeds CB, so use CB				52,961
Step 2				
Add: Liabilities				
Provision for long service leave	1,393			
Less subsection 705-75(1) reduction (1,393 x 30%)	-418			
Reduction required by section 705-80 (note 1)	-975		0	
Provision for income tax			0	
Future tax liability (note 2)			1,180	1,180
Result after step 2				54,141
Step 3				
Add: Frankable undistributed owned profits		0		
Transitional rule for transitional entity				
Add: Unfrankable undistributed owned profits		0	0	
Result after step 3				54,141
Step 3A				
Adjust for Subdivision 126-B rollovers by non-resident		NA		0
Result after step 3A				54,141
Extra step on formation only				
Adjust for Subdivision 126-B rollovers by head company		NA		0
Result after formation rollover adjustment				54,141
Step 4				
Subtract: distributions of acquired profits			0	
Distributions of owned profits recouping owned loss			0	0
Result after step 4				54,141
Step 5				
Subtract: owned unused losses			640	
Exclude to extent step 3 amount reduced (note 3)			99	541
Result after step 5				53,600
Step 6				
Subtract: tax benefit from acquired transferred losses			0	
(acquired transferred losses x general company tax rate)		x 30%	0	0
Result after step 6				53,600
Step 7				
Subtract certain inherited deductions		NA		0
Result after step 7 is the ACA				**53,600**

Note 1: Where a joining entity has an accounting liability that is recognised for accounting purposes earlier than for income tax purposes (such as a provision for long service leave), section 705-80 requires a notional ACA calculation. If this results in a different amount for the ACA, the liability must be adjusted to the extent of the difference. In this case the notional ACA is $975 less than the ACA calculated without applying section 705-80. The provision for long service leave must therefore be reduced by this amount. See section C2-4-245 of this manual which shows how section 705-80 applies, including administrative short cuts.

Note 2: Under subsection 705-70(1), the future tax liability (FTL) of the joining entity in respect of the depreciating assets is counted at step 2. The amount to be counted is redetermined under subsection 705-70(1A) so that it equals the FTL to be carried by the head company. However, as Sub Co is a transitional entity, section 701-32 of the *Income Tax (Transitional Provisions) Act 1997* turns off subsection 705-70(1A). Therefore, the amount added at step 2 is $1,180.

Note 3: Step 5 excludes losses accrued to the group to the extent that they have reduced the accounting profits available for distribution: subsection 705-100(2). The balance of retained earnings prior to the year commencing 1 July 2001 was $99. This amount would have been counted at step 3 as it would have been payable as a fully franked dividend, but for the loss made in the 2001–02 year. The step 5 amount is reduced accordingly.

Retained cost base assets

Cash ($13,144) and trading stock ($6,693) retain their existing tax values. In this example Sub Co is a continuing majority owned entity, so items of trading stock are treated as retained cost base assets.

The remainder of the ACA after setting the tax cost of retained cost base assets is $33,763. This is allocated among the reset cost base assets (table 4). The tax cost setting amount (TCSA) for revenue-like assets, such as depreciating assets, is limited to the greater of their market value or terminating value (i.e. tax adjustable value at the joining time). Assets 11 to 19 are not revenue-like assets. For assets 11 to 19 the amounts in the last column are the final TCSAs. For assets 1 to 10, further calculations are required (see tables 5 and 6).

Table 4: Apportionment of ACA to reset cost base assets ($)

Asset	Cost	Terminating value	Market value	Apportionment	TCSA before reduction	Section 705-40 max. amount	Excess for revenue -like assets	TCSA after reduction
Depreciating assets								
1	1,100	242	658	33,763 x 658/38,870	571	658	0	571
2	1,200	0	360	33,763 x 360/38,870	313	360	0	313
3	1,300	455	975	33,763 x 975/38,870	847	975	0	847
4	1,400	448	840	33,763 x 840/38,870	730	840	0	730
5	1,500	915	1,187	33,763 x 1,187/38,870	1,031	1,187	0	1,031
6	1,600	1,024	1,386	33,763 x 1,386/38,870	1,204	1,386	0	1,204
7	1,700	1,190	1,190	33,763 x 1,190/38,870	1,034	1,190	0	1,034
8	1,800	240	679	33,763 x 679/38,870	590	679	0	590
9	1,900	909	1,428	33,763 x 1,428/38,870	1,240	1,428	0	1,240
10	2,000	165	817	33,763 x 817/38,870	710	817	0	710
Sub-total	**15,500**	**5,588**	**9,520**		**8,270**	**9,520**		**8,270**
Non-depreciating assets								
11	2,100	2,204	2,210	33,763 x 2,210/38,870	1,920	–	–	1,920
12	2,200	2,309	2,320	33,763 x 2,320/38,870	2,015	–	–	2,015
13	2,300	2,413	2,430	33,763 x 2,430/38,870	2,111	–	–	2,111
14	2,400	2,518	2,540	33,763 x 2,540/38,870	2,206	–	–	2,206
15	2,500	2,623	2,550	33,763 x 2,550/38,870	2,215	–	–	2,215
16	2,600	2,728	2,600	33,763 x 2,600/38,870	2,258	–	–	2,258
17	2,700	2,833	2,500	33,763 x 2,500/38,870	2,172	–	–	2,172
18	2,800	2,938	2,450	33,763 x 2,450/38,870	2,128	–	–	2,128
19	2,900	3,043	2,750	33,763 x 2,750/38,870	2,389	–	–	2,389
Good -will	0	0	7,000	33,763 x 7,000/38,870	6,080	–	–	6,080
Total			**38,870**		**33,763**			**33,763**

Table 5: Adjustment for over-depreciation using the Aggregate Method ($)

Step 1A. Potential for over-depreciation		
Total book written down value (BWDV)	9,520	
Less: total tax written down values (TWDV)	5,588	
Result of step 1A		3,932
Step 1B. Limit 1A to extent it could result in untaxed profits		
Result of step 1B (Result of 1A x 70%, i.e. 3,932 x 70%)		2,752
Step 1C. Reduce potential for untaxed profits still in retained earnings		
Subtract 1B x a/(a + b + c) from result of step 1B, where:		
a = unfrankable retained earnings (excluding transitional step 3)	0	
b = unfranked amount of prior dividends paid since 1987	1,135	
c = transitional additional step 3 ACA amount	0	
[2,752 x (0/0 + 1,135 + 0) = 0]		0
Result of step 1C		2,752
Step 1D. Remove double counting for unused losses		
Unused loss of $640 for the 2001–02 year		
$378 relates to over-depreciation		378
Result of step 1D		2,374
Step 1E. Limit to unfranked dividends plus transitional step 3 ACA		
Total unfranked dividends since 1987	1,135	
Add: transitional step 3 ACA amount	0	
Result of step 1E		1,135

Step 1F: The amount at step 1E is allocated in table 6 to each of the depreciating assets on a pro-rata basis according to the potential step-up of tax value.

Table 6: Allocation of over-depreciation aggregate adjustment ($)

Asset	TWDV (AV)	TCSA (table 4)	Potential step up	Pro-rata according to potential step up	Over-depreciation adjustment	Final TCSA
1	242	571	329	1,135 x 329/2,839	132	439
2	0	313	313	1,135 x 313/2,839	125	188
3	455	847	392	1,135 x 392/2,839	157	690
4	448	730	282	1,135 x 282/2,839	113	617
5	915	1,031	116	1,135 x 116/2,839	46	985
6	1,024	1,204	180	1,135 x 180/2,839	72	1,132
7	1,190	1,034	0	1,135 x 0/2,839	0	1,034
8	240	590	350	1,135 x 350/2,839	140	450
9	909	1,240	331	1,135 x 331/2,839	132	1,108
10	165	710	546	1,135 x 546/2,839	218	492
Total	**5,588**	**8,270**	**2,839**		**1,135**	**7,135**

Note that the over-depreciation adjustment must not reduce the TCSA below the depreciating asset's tax written down value (i.e. its adjustable value) at the joining time.

Example 2 – Annual Method

Facts

The facts are the same as for example 1. The taxpayer wishes to use the Annual Method outlined in figure 1 to estimate the total amount of reduction for over-depreciation.

Table 7: Known data

Asset	Cost $	Tax method	Tax depreciation rate (%)	Tax depreciation y/e 30.6.02 ($)	TWDV 30.6.02 ($)	Book method	Book depreciation rate (%)	Book depreciation y/e 30.6.02 ($)	BWDV 30.6.02 ($)
1	1,100	PC	13	143	242	PC	6.7	74	658
2	1,200	PC	17	0	0	PC	10	120	360
3	1,300	PC	13	169	455	PC	5	65	975
4	1,400	PC	17	238	448	PC	10	140	840
5	1,500	PC	13	195	915	DVM	7.5	96	1,187
6	1,600	DV	20	256	1,024	PC	6.7	107	1,386
7	1,700	DV	30	510	1,190	DVM	30	510	1,190
8	1,800	DV	25	80	240	DVM	13	101	679
9	1,900	DV	10	101	909	DVM	4	59	1,428
10	2,000	DV	30	71	165	DVM	12	111	817

Table 8: Calculating TWDV extrapolating backwards to acquisition time ($)

		TWDV	TWDVs calculated for these dates						
Asset	Cost	30.6.02	30.6.01	30.6.00	30.6.99	30.6.98	30.6.97	30.6.96	1.7.95
1	1,100	242	385	528	671	814	957	1,100	
2	1,200	0	0	0	0	0	0	0	0
3	1,300	455	624	793	962	1,131	1,300		
4	1,400	448	686	924	1,162	1,400			
5	1,500	915	1,110	1,305	1,500				
6	1,600	1,024	1,280	1,600					
7	1,700	1,190	1,700						
8	1,800	240	320	427	569	759	1,013	1,350	1,800
9	1,900	909	1,010	1,122	1,247	1,385	1,539	1,710	1,900
10	2,000	165	235	336	480	686	980	1,400	2,000
Total		**5,588**	**7,350**	**7,035**	**6,591**	**6,175**	**5,789**	**5,560**	**5,700**

Assets 1 to 5 were depreciated for tax purposes using the prime cost (PC) method. The TWDVs as at 30.6.01 were calculated by simply adding back the annual depreciation amount to the TWDV at 30.6.02. This method was used for each asset until its cost was reached. Note that no amount has been calculated for asset 2, as this asset had been written off for tax purposes before the joining time. Further work is necessary to work out the TWDVs for asset 2.

Assets 6 to 10 were depreciated using the diminishing value (DV) method. Asset 6's TWDV as at 30.6.01 was worked out by multiplying the TWDV at 30.6.02 by 100/80. The figure of 80 is 100 minus the depreciation rate of 20% – i.e. $1,024 x 100/80 = $1,280. For the next year back, the TWDV was worked out at $1,280 x 100/80. This method was used for each asset until its cost was reached.

Table 9: Calculating BWDV extrapolating backwards to acquisition time ($)

	BWDV	BWDVs calculated for these dates						
Asset	**30.6.02**	**30.6.01**	**30.6.00**	**30.6.99**	**30.6.98**	**30.6.97**	**30.6.96**	**1.7.95**
1	658	732	805	879	953	1,026	1,100	
2	360	480	600	720	840	960	1,080	1,200
3	975	1,040	1,105	1,170	1,235	1,300		
4	840	980	1,120	1,260	1,400			
5	1,187	1,283	1,388	1,500				
6	1,386	1,493	1,600					
7	1,190	1,700						
8	679	781	897	1,031	1,185	1,362	1,566	1,800
9	1,428	1,487	1,549	1,614	1,681	1,751	1,824	1,900
10	817	929	1,055	1,199	1,363	1,549	1,760	2,000
Total	**9,520**	**10,904**	**10,120**	**9,373**	**8,657**	**7,949**	**7,330**	

Table 9 uses the same methods used in table 8 to calculate the BWDVs.

Table 9 shows asset 2 was acquired on 1.7.95. We can now go back and work out the TWDVs for that asset, working forward from the acquisition time calculated in table 9.

Table 10: Calculating TWDV for asset 2 and adding to totals for table 8 ($)

		TWDV	TWDVs calculated for these dates						
Asset	**Cost**	**30.6.02**	**30.6.01**	**30.6.00**	**30.6.99**	**30.6.98**	**30.6.97**	**30.6.96**	**1.7.95**
2	1,200	0	0	180	384	588	792	996	1,200
Sub-total from table 8		5,588	7,350	7,035	6,591	6,175	5,789	5,560	
Total		**5,588**	**7,350**	**7,215**	**6,975**	**6,763**	**6,581**	**6,556**	

Table 11: Step 2A – Incremental increase in excess of book and tax written down values ($)

	30.6.02	30.6.01	30.6.00	30.6.99	30.6.98	30.6.97	30.6.96	Total
BWDVs from table 9	9,520	10,904	10,120	9,373	8,657	7,949	7,330	
TWDVs from table 10	5,588	7,350	7,215	6,975	6,763	6,581	6,556	
Excess	3,932	3,554	2,905	2,398	1,893	1,368	774	
Incremental increase	**378**	**649**	**507**	**505**	**525**	**594**	**774**	**3,932**

Table 12: Step 2B – Limit to extent it could result in untaxed profits ($)

	30.6.02	30.6.01	30.6.00	30.6.99	30.6.98	30.6.97	30.6.96
Result after step 2A	378	649	507	505	525	594	774
70% = result after step 2B	**265**	**454**	**355**	**353**	**368**	**416**	**542**

Table 13: Step 2C – Reduction for certain retained earnings ($)

	30.6.02	30.6.01	30.6.00	30.6.99	30.6.98	30.6.97	30.6.96
Result after step 2B table 12	265	454	355	353	368	416	542
D	0	0	0	0	0	0	0
E	0	0	218	264	137	355	161
F	0	0	0	0	0	0	0
2B x [d/(d+e+f)]	0	0	0	0	0	0	0
Result after step 2C	**265**	**454**	**355**	**353**	**368**	**416**	**542**

There were no undistributed profits at the joining time, so no amounts for 'd' and 'f' in the formula in table 13. Accordingly there is no adjustment for step 2C. The amounts for 'e' are based on an analysis of the unfranked dividends paid and summarised in table 14.

Table 14: Summary of dividends paid before the joining time

Dividend paid			Out of this year's profits		
Date	Franked $	Unfranked $	Year ending	Taxed $	Untaxed $
1.12.96	2,039	161	30.6.96	2,039	161
1.12.97	2,145	355	30.6.97	2,145	355
1.12.98	2,663	137	30.6.98	2,663	137
1.12.99	2,136	264	30.6.99	2,136	264
1.12.00	2,282	218	30.6.00	2,282	218
1.12.01	1,600	0	30.6.01	1,600	0

Table 15: Step 2D – Reduction for step 4 ACA amount attributable to over-depreciation ($)

	30.6.02	30.6.01	30.6.00	30.6.99	30.6.98	30.6.97	30.6.96
Result after step 2C	265	454	355	353	368	416	542
Step 4 ACA distributions attributable to over-depreciation	0	0	0	0	0	0	0
Result after step 2D	**265**	**454**	**355**	**353**	**368**	**416**	**542**

There were no distributions of profits subtracted at ACA step 4.

Table 16: Step 2E – Reduction for step 5 ACA amount attributable to over-depreciation ($)

	30.6.02	30.6.01	30.6.00	30.6.99	30.6.98	30.6.97	30.6.96
Result after step 2D	265	454	355	353	368	416	542
Step 5 ACA losses attributable to over-depreciation	265	0	0	0	0	0	0
Result after step 2E	**0**	**454**	**355**	**353**	**368**	**416**	**542**

Table 17: Step 2F – Reduction for distributions to individuals etc. not entitled to inter-corporate dividend rebate ($)

	30.6.02	30.6.01	30.6.00	30.6.99	30.6.98	30.6.97	30.6.96
Result after step 2E	0	455	354	353	368	416	542
Distributions traced to individuals etc.	0	0	0	0	0	0	0
Result after step 2F	**0**	**455**	**354**	**353**	**368**	**416**	**542**

All of the unfranked rebatable dividends were retained by the head company in this example.

Step 2G totals the year-by-year results after step 2F, i.e. $2,488.

Table 18: Step 2H – Limit to unfranked dividends plus transitional step 3 ACA ($)

Total unfranked dividends paid	1,135	
Add: transitional step 3 ACA amount	0	
Result of step 2H		**1,135**

The maximum adjustment for over-depreciation is limited to the step 2H amount of $1,135. This amount is allocated to the depreciating assets in table 19.

Table 19: Step 2I – Allocation of over-depreciation total adjustment under Annual Method ($)

Asset	TWDV (AV)	BWDV	Excess of BWDV over TWDV	Pro-rata according to excess of BWDV over TWDV	Over-depreciation adjustment	TCSA (table 4)	Final TCSA
1	242	658	416	1,135 x 416/3,932	120	571	451
2	0	360	360	1,135 x 360/3,932	104	313	209
3	455	975	520	1,135 x 520/3,932	150	847	697
4	448	840	392	1,135 x 392/3,932	113	730	617
5	915	1,187	272	1,135 x 272/3,932	79	1,031	953
6	1,024	1,386	362	1,135 x 362/3,932	104	1,204	1,099
7	1,190	1,190	0	1,135 x 0/3,932	0	1,034	1,034
8	240	679	439	1,135 x 439/3,932	127	590	463
9	909	1,428	519	1,135 x 519/3,932	150	1,240	1,090
10	165	817	652	1,135 x 652/3,932	188	710	522
Total	**5,588**	**9,520**	**3,932**		**1,135**		**7,135**

Note that the over-depreciation adjustment must not reduce the TCSA below the depreciating asset's tax written down value (i.e. its adjustable value) at the joining time.

The method of apportionment in table 19 is different to that used in table 6, as the Annual Method provides more detailed information, allowing a better estimate of the reduction amount than is afforded by the Aggregate Method.

Example 3

Estimating the proportion of unfranked dividends paid by listed public companies that reach entities not entitled to the inter-corporate dividend rebate

For the purpose of working out the amount to be excluded at step 2F of the short cut method for calculating the over-depreciation reduction amount, the ATO will accept an estimate worked out as follows:

1. Examine the largest 20 shareholders named in the public company's annual report, determine the category (in table 20) that each falls into and apply the proportions set out in the table to the share percentage held by each of these top 20 shareholders to arrive at a ratio for the total shareholding of the top 20.

2. Apply the ratio worked out in step 1 for the top 20 shareholders to the remaining shareholders to arrive at an estimated breakdown between entitled and not entitled for those remaining shareholders.

3. Add step 1 and step 2 amounts.

Table 20: Ratios for different shareholder categories for use in determining proportions of unfranked dividends to be treated as reaching entities that *are* and *are not* entitled to the inter-corporate dividend rebate

Shareholder entity category	Proportion of dividends paid to this category of entity treated as ultimately reaching recipients that *are* entitled to the inter-corporate dividend rebate	Proportion of dividends paid to this category of entity treated as ultimately reaching recipients that *are not* entitled to the inter-corporate dividend rebate
Public company	55%	45%
Life insurance company	25%	75%
Corporate unit trust	15%	85%
Public trading trust	15%	85%
Other trusts	15%	85%
Superannuation fund	0%	100%
Private company	0%	100%
Nominee	25%	75%
Individual	0%	100%
Non-resident	0%	100%
Exempt body	0%	100%

The final percentage for all shareholders in the 'not entitled' category after step 3 is treated as being the proportion of unfranked dividends that ultimately reached beneficial owners not entitled to the inter-corporate dividend rebate. The balance is treated as the proportion not reaching such beneficial owners.

The results under this method for a sample financial year may be used for other years, provided there has been no significant change in the shareholder mix. Where there has been a significant change, sampling will be necessary either side of the period of abnormal trading to ensure the samples are more representative of the mix of shareholder categories for those years.

The proportion of life companies, other public companies, trusts, and nominees treated as being entitled to the inter-corporate dividend rebate has been based on statistical analysis of shareholder types, retention of profits rates, and varying entitlements to the rebate depending on the type of entity involved.

Where a taxpayer is able to demonstrate that a higher percentage of dividends ultimately reaches beneficial shareholders who are not entitled to the inter-corporate dividend rebate, that higher percentage may be used at step 2F.

Note: This method for estimating the step 2F amount is only available for dividends paid by listed public companies.

Facts

Company X is a listed public company. It elects to consolidate, with S Co as one of its wholly owned subsidiaries. It received unfranked rebatable dividends from S Co before consolidation, attributable to profits made by S Co that were sheltered from tax by over-depreciation. Company X used these funds to pay unfranked dividends. Company X is unable to work out precisely the extent to which these dividends reached beneficial owners not entitled to the inter-corporate dividend rebate. This is due primarily to large shareholdings by nominees. Company X's largest 20 shareholders are listed in table 21. Shareholder 5 is a life insurance company.

Calculation

The shareholders are first categorised according to entitlement to the inter-corporate dividend rebate (table 21).

Table 21: Estimating the amount to be subtracted under step 2F

Shareholder	% held	Ratio of entitled to not entitled	Entitlement to inter-corporate dividend rebate: Entitled	Entitlement to inter-corporate dividend rebate: Not entitled
Top 20				
1. Nominee A	9.1	25:75	2.28	6.82
2. Nominee B	6.4	25:75	1.60	4.80
3. Nominee C	5.1	25:75	1.28	3.82
4. Individual X	2.2	0:100		2.20
5. Public company A (life insurance coy)	1.7	25:75	0.42	1.28
6. Public company B	1.5	55:45	0.80	0.70
7. Nominee E	1.2	25:75	0.30	0.90
8. Superannuation fund	1.0	0:100		1.00
9. Corporate unit trust	0.8	1:6	0.10	0.70
10. Nominee F	0.8	25:75	0.20	0.60
11. Non-resident 1	0.5	0:100		0.50
12. Public company D	0.4	55:45	0.22	0.18
13. Pooled development fund	0.2	0:100		0.20
14. Non-resident 2	0.1	0:100		0.10
15. Private company A	0.1	0:100		0.10
16. Trustee 1	0.1	1:6	0.01	0.09
17. Trustee 2	0.1	1:6	0.01	0.09
18. Non-resident 3	0.1	0:100		0.10
19. Public trading trust	0.1	1:6	0.01	0.09
20. Tax exempt body	0.1	0:100		0.10
Totals for top 20	**31.6**		**7.23**	**24.37**
Extrapolated to remaining shareholders	68.4		15.65	52.75
Totals for all shareholders	**100**		**22.88**	**77.12**

Shareholdings have been split between the entitled and not entitled categories in the proportions stated above. After this adjustment, the top 20 (31.6%) consists of 7.23% entitled to the inter-corporate dividend rebate under former section 46 or former section 46A of the ITAA 1936, and 24.37% not entitled to the rebate. The same proportions are applied to the remaining shareholders to get proportions of entitled (22.88%), and not entitled (77.12%). Unfranked dividends in this latter category are not counted in the tax deferral amount for over-depreciation under step 2F.

Example 4 Joining with retained profits but no step 3 amount using both methods

S Co is incorporated with contributed capital of $100,000 on 1 July 1998, and acquires various assets and operates a business. The company distributes all its retained profits in the each of the following years as franked and unfranked dividends, with the dividends franked to the extent of available franking credits. Unfranked dividends were rebatable to the shareholder under section 46 of *Income Tax Assessment Act 1936*. S Co recognises deferred tax liabilities (DTL) in respect of its over-depreciated assets and no DTL is recognised in relation to the asset revaluation reserve created. On 2 July 2002, all of the shares in S Co are acquired by H Co, the head company of a consolidated group, for $112,040. S Co's financial position at the joining time is as follows:

Table 22: S Co – Statement of financial position at the joining time ($)

Cash		54,680	Contributed capital	100,000
Depreciating assets (DA)			Asset revaluation reserve	10, 000
Cost	12,000			
Less Depreciation	3,200	8,800		
Other assets (*cost* 40,000)		50,000	Retained earnings	2,040
			Provision for tax	480
			DTL	960
		113,480		113,480

The tax and accounting depreciation schedules, deferred tax liability, accounting profit and dividends paid out summaries at the joining time are provided in tables 28 to 32. For simplicity, any transactions of S Co that occurred on 1 July 2002 are ignored in this example.

Table 23: Calculation of entry ACA ($):

Entry ACA calculation		
Step 1 – cost of membership interests		112,040
Step 2 – provision for tax	480	
– DTL after applying subsection 705-70(1A)	297*	777
Steps 3 to 7 N/A		
ACA		112,817
Tax cost setting amounts (TCSA)		
Retained cost base assets – cash		54,680
Remainder to be allocated to reset cost base assets		**58,137**

*S Co is not a transitional entity, so subsection 705-70(1A) applies to the DTL. Its detailed calculation is not provided in this example. There are examples at C2-4-242 detailing the application of subsection 705-70(1A) to DTLs.

Aggregate method in over-depreciation shortcuts

Table 24: Allocation of remainder of entry ACA to reset cost base assets ($)

Asset	AV	MV*	TCSA 1	OD reduction**	TCSA 2***
DA 1	800	2,400	2,373	451	1,922
DA 2	800	1,400	1,384	167	1,217
DA 3	2,400	3,200	3,164	219	2,945
DA 4	1,600	1,800	1,780	52	1,728
Other assets		50,000	49,436		
Total		**58,800**	**58,137**	**889**	**7,812**

*The market value in this example is the same as book value.

**The OD (over depreciation) reduction column is from the following table (table 25), step 1F.

***The TCSA 2 column amounts are the results of TCSA 1 amounts minus OD reduction amounts for relevant assets. The TCSA 2 amounts are the final TCSAs for the relevant assets.

Note that $49,436 is the TCSA of Other assets.

Table 25: Calculation of over-depreciation reduction using aggregate shortcut method ($)

Step 1A	Determine the potential for OD: Total BWDV	8,800	
	Less Total TWDV (AV)	5,600	3,200
Step 1B	Step 1A x 70%		2,240
Step 1C	Subtract 1B x a/(a+b+c) from Step 1B, where:		
	a = unfrankable retained profits		
	b = unfranked dividends paid post 30.6.87		
	c = transitional step 3 amount		
	2240 x 920*/(920+889+0) = 1,139	1,139	1,101
Step 1D	Remove double counting for unused losses	N/A	1, 101
Step 1E	Limit Step 1D result by sum of		
	(a) unfranked dividends	889	
	(b) transitional step 3 profits	0	889**

Step 1F: Estimate the over-depreciation reduction amount per asset

	Tax AV	TCSA 1	Step up***	OD reduction	TCSA 2
DA 1	800	2,373	1,573	451	1,922
DA 2	800	1,384	584	167	1,217
DA 3	2,400	3,164	764	219	2,945
DA 4	1,600	1,780	180	52	1,728
Total	**5,600**	**8,701**	**3,101**	**889**	**7,812**

*This is the amount of unfrankable retained profits as at the joining time. Of the retained profits $2,040, the liability to pay tax of $480 would mean $920 would not be frankable, had $2,040 been distributed.

**This is the total OD reduction. In Step 1F, it is apportioned according to the step up amounts for the relevant assets to calculate the reduction for each asset. For example, OD reduction for DA 1 = 889 x 1,573/3,101.

***The step up column amounts are the differences between the TCSA 1 column and the Tax AV column.

Table 26: Allocation of remainder of entry ACA to reset cost base assets ($)

Asset	AV	MV	TCSA 1	OD reduction*	TCSA 2**
DA 1	800	2,400	2,373	444	1,929
DA 2	800	1,400	1,384	167	1,217
DA 3	2,400	3,200	3,164	222	2,942
DA 4	1,600	1,800	1,780	56	1,724
Other assets		50,000	49,436		
Total		**58,800**	**58,137**	**889**	**7,182**

*The figures in this column are from table 27, Step 2I.

**The TCSA 2 column amounts are the final TCSAs for the relevant assets.

Note that $49,436 is the TCSA of Other assets.

Table 27: Calculation of over-depreciation reduction using annual shortcut method ($)

Financial year ending	30.6.99	30.6.00	30.6.01	30.6.02	Total
Step 2A					
Total book WDV	3,600	5,000	8,000	8,800	
Total tax WDV(AV)	3,200	4,000	6,000	5,600	
Difference	400	1,000	2,000	3,200	
Incremental increase (result)	400	600	1,000	1,200	
Step 2B					
Step 2A result x 70%	280	420	700	840	
Step 2C	Reduce step 2B by step 2B x d/(d+e+f), where:				
	d = untaxed, unfrankable profits of the year still on hand				
	e = unfranked dividends paid from that year's profits				
	f = transitional step 3 profits from that year				
Amount d	0	0	0	920	
Amount e*	256	219	414	0	
Amount f	0	0	0	0	
Sum of d+e+f	256	219	414	920	
Reduction	280 x 0/256 = 0	420 x 0/219 = 0	700 x 0/414 = 0	840 x 920/920 = 840	
Result after step 2C	280	420	700	0	
Step 2D to 2F N/A					
Step 2G Total of years	280	420	700	0	1400
Step 2H	Limit Step 2G result by sum of				
	(a) unfranked dividends paid:	889			
	(b) transitional step 3 profits:	0			889**

Step 2I	Tax AV	Book WDV	Excess of book over tax value	OD reduction	TCSA 1	TCSA 2***
DA 1	800	2,400	1,600	444	2,373	1,929
DA 2	800	1,400	600	167	1,384	1,217
DA 3	2,400	3,200	800	222	3,164	2,942
DA 4	1,600	1,800	200	56	1,780	1,724
Total	**5,600**	**8,800**	**3,200**	**889**	**8,701**	**7,812**

*These amounts are from table 32.

**This is the total OD reduction. In step 2I, it is apportioned according to the Excess of book over tax value column amounts for the relevant assets to calculate the reduction for each asset. For example, OD reduction for DA 2 = 889 x 600/3,200.

***TCSA 2 column amounts are the results of TCSA 1 amounts minus OD reduction amounts.

Table 28: Taxation depreciation schedule – depreciating assets depreciated using prime cost method for income tax purposes, at 20% per annum ($)

	DA 1	DA 2	DA 3	DA 4	Totals
Financial year ending (Y/E) 30 June 1999					
Cost	4,000				
Depreciation	800				
Ending AV	3,200				3,200
Y/E 30 June 2000					
Cost or AV start	3,200	2,000			
Depreciation	800	400			
Ending AV	2,400	1,600			4,000
Y/E 30 June 2001					
Cost or AV start	2,400	1,600	4,000		
Depreciation	800	400	800		
Ending AV	1,600	1,200	3,200		6,000
Y/E 30 June 2002					
Cost or AV start	1,600	1,200	3,200	2,000	
Depreciation	800	400	800	400	
Ending AV	**800**	**800**	**2,400**	**1,600**	**5,600**

Table 29: Accounting depreciation schedule – depreciating assets depreciated using prime cost method for accounting purposes, at 10% per annum ($)

	DA 1	DA 2	DA 3	DA 4	Total
Y/E 30 June 1999					
Cost	4,000				
Depreciation	400				
Ending book value	3,600				3,600
Y/E 30 June 2000					
Cost or book at start	3,600	2,000			
Depreciation	400	200			
Ending book value	3,200	1,800			5,000
Y/E 30 June 2001					
Cost or book at start	3,200	1,800	4,000		
Depreciation	400	200	400		
Ending book value	2,800	1,600	3,600		8,000
Y/E 30 June 2002					
Cost or book at start	2,800	1,600	3,600	2,000	
Depreciation	400	200	400	200	
Ending book value	**2,400**	**1,400**	**3,200**	**1,800**	**8,800**

Table 30: Deferred tax liability summary ($)

Financial year ending	30.6.99	30.6.00	30.6.01	30.6.02
Book value at end	3,600	5,000	8,000	8,800
Tax AV at end	3,200	4,000	6,000	5,600
Book less tax value	400	1,000	2,000	3,200
Tax rate	36%	36%	34%	30%
DTL balance	**144**	**360**	**680**	**960**

Table 31: Accounting profits summary ($)

Financial year ending	30.6.99	30.6.00	30.6.01	30.6.02
Income	6,000	6,000	6,000	6,000
Expenditure items				
Expenses	2,000	2,000	2,000	2,000
Depreciation	400	600	1,000	1,200
Provision for tax	1,152	1,008	680	480
DTL	144	216	320	280
Total	3,696	3,824	4,000	3,960
To retained earnings	2,304	2,176	2,000	2,040
Distributed Y/E 00	2,304			
Distributed Y/E 01		2,176		
Distributed Y/E 02			2,000	
Balance	**0**	**0**	**0**	**2,040**

Table 32: Dividends paid out summary ($)

Financial year ending	30.6.99	30.6.00	30.6.01	Total
Paid franked	2,048	1,957	1,586	5,591
Paid unfranked	256	219	414	889
Total dividend	**2,304**	**2,176**	**2,000**	**6,480**

Note: In this example, it is assumed that S Co only pays final dividends.

References

Income Tax Assessment Act 1936, former sections 46 and 46A

Income Tax Assessment Act 1997, section 40-85

Income Tax Assessment Act 1997, sections 705-50, 705-70, 705-75, 705-100; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2

Income Tax Assessment Act 1997, section 705-80; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Income Tax Assessment Act 1997, Subdivision 126-B

Income Tax Assessment Act 1997, subsection 705-90(10); as inserted by *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1, Part 7

Income Tax Assessment Act 1997, section 705-50 and subsection 995-1(1) as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010 (No. 56 of 2010),* Schedule 5, Part 6

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004, paragraphs 1.135 – 1.148

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No.1) Bill 2010, paragraphs 5.180 – 5.186.

Taxation Determination TD 2004/4 – Income tax: Is a dividend paid before 1 July 1987 an unfranked dividend for the purposes of section 705-50 of the *Income Tax Assessment Act 1997?*

Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006 (No. 101 of 2006), which repealed sections 46 and 46A of *the Income Tax Assessment Act 1936*

Revision history

Section C2-4-640 first published 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
10.12.04	Constraints on use of short cuts narrowed down so that the only depreciating assets excluded are grapevines and horticultural plants, p. 3.	Provided under Commissioner's administrative powers.
	Reference to new TD 2004/4, p. 7.	Clarification.
	Note on use of step 2F by a public company not using either Aggregate or Annual method, p. 8.	Clarification.
	Notes on use of steps 1F and 2I where *Law Administration Practice Statement PS LA 2004/12* is being applied in determining TCSAs for depreciating assets, pp. 5 and 8.	Clarification.
26.10.05	New information on determining the extent to which dividends have been paid out of profits sheltered from income tax, p. 2, and change to worksheet 1, step 3, p. 11.	Legislative amendments.
15.11.06	Additional fourth example.	For clarification and to correct errors.
	Corrections in Example 1 to the ACA calculation on the application of s. 705-80 and s.s. 705-70(1A). For simplicity, the capital contribution amount has been changed.	
	Minor number changes in tables 1, 3, 4, 6 and 19.	
	Updated references to inoperative provisions.	Legislative amendment.
26.6.07	Note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used, and to the cost setting rules to phase out over-depreciation deduction.	Reflect announcement on 8 May 2007 by Assistant Treasurer in media release no. 50.
6.5.11	Removal of note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used.	Legislative amendments.
	Removal of note on proposed changes to the cost setting rules to phase out over-depreciation deductions.	
	Minor changes to reflect changed wording in former section 705-50.	

Worked example

Limiting the tax cost setting amounts of revenue-like assets (step E)

Description

This example shows how the tax cost setting amount for a revenue-like asset is reduced at step E of the entry cost setting process where there has been an earlier resetting of the cost bases and reduced cost bases of pre-CGT membership interests in a joining entity because of a change in the underlying ownership of those interests. (Note that trading stock, depreciating assets and revenue assets are referred to in the consolidation legislation as 'assets held on revenue account' and 'revenue etc. assets'. In the reference manual, they are generally referred to as 'revenue-like' assets.)

Commentary

The tax cost setting amounts for revenue-like assets (i.e. trading stock, depreciating assets, and revenue assets) are limited to the greater of their terminating values or market values under section 705-40 of the *Income Tax Assessment Act 1997* (ITAA 1997). The tax cost setting amounts for depreciating assets may also be reduced for over-depreciation under section 705-50. Note that, effective from 1 July 2009, the over-depreciation adjustment in section 705-50 of the ITAA 1997 has been repealed, so it will no longer apply to over-depreciated assets of entities that become subsidiary members of a consolidated group on or after that date

→ *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010).

A further reduction may also apply to revenue-like assets if:

- the tax cost setting amount worked out for the asset exceeds its terminating value, and
- before consolidation, Division 149 of the ITAA 1997 or its predecessor reset the cost bases of pre-CGT membership interests in the joining entity at a higher value (because there was a change in majority ownership of the entity).

The entry ACA will need to be recalculated and reallocated. The first calculation and allocation of the ACA sets the tax cost setting amounts for all assets other than revenue-like assets. The second calculation and allocation of the ACA sets the tax cost setting amounts for revenue-like assets.

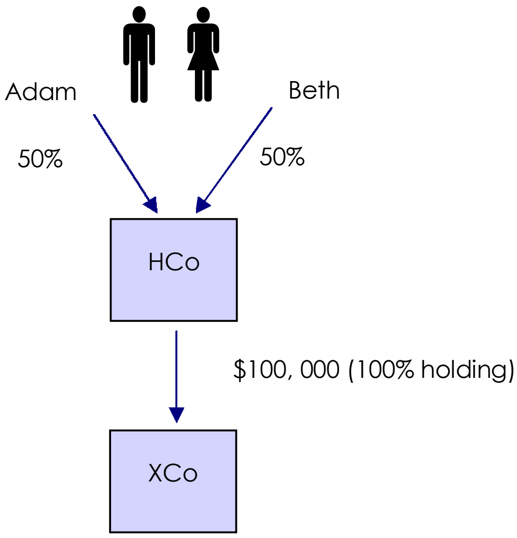
Those revenue-like assets will be given reduced tax cost setting amounts that remove the effect of the change in majority ownership on the cost bases of membership interests. The reduction amount gives rise to a capital loss for the head company and can be offset against capital gains over a minimum period of 5 income years. → section 104-500, ITAA 1997

Example

Facts

Adam and Beth incorporate HCo on 1 July 1985 with $100,000, each holding 50% of the shares. HCo then incorporates XCo with $100,000 (1,000 ordinary shares).

Figure 1



On 1 July 1985, XCo acquires Asset 1 for investment purposes. XCo's financial position at that time is as follows:

Table 1: XCo – financial position at 1 July 1985

Asset 1 (MV $30,000)	$30,000	Equity	$100,000
Cash	$70,000		
	$100,000		$100,000

MV = market value

XCo made profits every year to 30 June 2001. All profits were taxed but not distributed. Taxed profits total $200,000. Asset 1 was a pre-CGT asset. Assets 2 to 5 were acquired after 20 September 1985. Asset 2 was acquired for long-term investment. Assets 3 to 5 are held on revenue account.

On 30 June 2001 Adam and Beth decide to retire and sell their shares in HCo to an unrelated couple Ted and Alice for $370,000. XCo's financial position was as follows:

Table 2: XCo – financial position at 30 June 2001

Asset 1 (MV $70,000)	$30,000	Equity	$100,000
Asset 2 (MV $60,000)	$30,000	After tax profits	$200,000
Asset 3 (MV $40,000)	$50,000		
Asset 4 (MV $70,000)	$60,000		
Asset 5 (MV $70,000)	$70,000		
Cash	$60,000		
	$300,000		$300,000

MV = market value

As the majority underlying interests in XCo (and its assets) are not the same as they were before 20 September 1985, Division 149 applies at this time. The shares in XCo and Asset 1 cease to be pre-CGT assets. The first element in their cost base and reduced cost base is reset to their respective market values at that time. The market value of the shares was $370.00 each.

HCo elects to form a consolidated group on 1 July 2002. XCo's financial position at that time is as follows:

Table 3: XCo – financial position at 30 June 2002

Asset 1 (MV $70,000)	$30,000	Equity	$100,000
Asset 2 (MV $60,000)	$30,000	After tax profits	$220,000
Asset 4 (MV $70,000)	$60,000		
Asset 5 (MV $80,000)	$70,000		
Asset 6 (MV $80,000)	$80,000		
Cash	$50,000		
	$320,000		**$320,000**

MV: market value

Table 4: Working out tax cost setting amounts

	ACA 1	ACA 2
ACA calculation		
Step 1	370,000	100,000
For ACA 1 compare cost base (CB) $370 with reduced cost base (RCB) $370 and market value (MV) $410. As MV exceeds CB, use CB ($370 x 1,000 shares)		
For ACA 2 reduce CB and RCB by the loss of pre-CGT adjustment amount (both $270) before comparison. As MV exceeds the adjusted CB, use the adjusted CB of $100 ($100 x 1,000 shares)(see explanation below)		
Step 2		
Does not apply as there are no liabilities		
Step 3		
Add undistributed profits accrued to group only from the Division 149 change time*	20,000	20,000
Steps 3A – 4		
Do not apply		
Steps 5 - 7		
Do not apply as there are no losses or inherited deductions		
Entry ACA is	390,000	120,000
Subtract: Tax cost setting amount of retained cost base assets (i.e. cash)	50,000	50,000
Remainder of ACA (to be allocated to reset cost base assets)	340,000	70,000

* Section 705-105 of the ITAA 1997 modifies what is meant in subsection 705-90(7) by membership interests that the head company holds continuously. Where Division 149 has applied to the membership interests, those membership interests are taken not to have been held before the application of Division 149.

Table 5: Allocation of remainder of ACA 1 to reset cost base assets

Asset	Cost	Terminating value	Market value	Apportionment of remainder	Tax cost setting amount
Asset 1	30,000	70,000	70,000	70,000/360,000 x 340,000	66,111
Asset 2	30,000	30,000	60,000	60,000/360,000 x 340,000	56,666
Asset 4	60,000	60,000	70,000	70,000/360,000 x 340,000	66,111
Asset 5	70,000	70,000	80,000	80,000/360,000 x 340,000	75,556
Asset 6	80,000	80,000	80,000	80,000/360,000 x 340,000	75,556
Totals			**360,000**		**340,000**

Assets 4, 5 and 6 are revenue assets under section 977-50. There is no reduction to their tax cost setting amounts under section 705-40 of the ITAA 1997 as the tax cost setting amount worked out above does not in any case exceed the greater of the asset's terminating value or market value. However, these revenue assets are also 'revenue etc. assets' under paragraph 705-57(2)(c) of the ITAA 1997. As the tax cost setting amounts of Assets 4 and 5 worked out above exceed their respective terminating values, and the cost base and reduced cost base of membership interests in XCo were increased as a result of the operation of Division 149, the ACA must be recalculated.

In the second calculation (ACA 2 column in the ACA calculation above), the cost base and reduced cost base used in step 1 must be reduced by their respective loss of pre-CGT status adjustment amounts. For the cost base, the cost base of membership interests immediately before the Division 149 change time is compared with the cost base of those interests immediately after the change. The difference is the adjustment amount. The cost base before the change was $100 per share, and $370 after the change. The adjustment amount is $270. The same exercise is used to work out the adjustment for the reduced cost base ($370 less $100 is $270).

After subtracting for retained cost base assets (see above), the remainder of the second ACA is allocated to the reset cost base assets as follows:

Table 6: Allocation of remainder of ACA 2 to reset cost base assets

Asset	Cost	Terminating value	Market value	Apportionment of remainder	Tax cost setting amount
Asset 1	30,000	70,000	70,000	70,000/360,000 x 70,000	13,611
Asset 2	30,000	30,000	60,000	60,000/360,000 x 70,000	11,666
Asset 4	60,000	60,000	70,000	70,000/360,000 x 70,000	13,611
Asset 5	70,000	70,000	80,000	80,000/360,000 x 70,000	15,556
Asset 6	80,000	80,000	80,000	80,000/360,000 x 70,000	15,556
Totals			**360,000**		**70,000**

For assets that are not 'revenue etc.' assets under paragraph 705-57(2)(c), the tax cost setting amount worked out using ACA 1 is used. For 'revenue etc.' assets the tax cost setting amount worked out using ACA 2 is used, but not so as to reduce the tax cost setting amount for those assets below their terminating values.

Table 7: Application of section 705-57

Asset	Cost	Terminating value	TCSA from ACA 1	TCSA from ACA 2	TCSA after s. 705-57	CGT event L1 amount
Asset 1	30,000	70,000	66,111	13,611	66,111	
Asset 2	30,000	30,000	56,666	11,666	56,666	
Asset 4	60,000	60,000	66,111	13,611	60,000	6,111
Asset 5	70,000	70,000	75,556	15,556	70,000	5,556
Asset 6	80,000	80,000	75,556	15,556	75,556	0
Totals			**340,000**	**70,000**	**328,333**	**11,667**

The tax cost setting amounts to be used are the figures in the second last column. The sum of these and the CGT event L1 amounts (the last column) is $340,000. This is equal to the remainder of the ACA 1 step 1 amount after subtracting for retained cost base assets.

The reduction of $11,667 is converted into a capital loss (CGT event L1) available to be deducted over a minimum period of 5 income years starting with the income year in which formation occurs. → section 104-500, ITAA 1997

References

Income Tax Assessment Act 1997, sections 705-40 and 705-50; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2

Income Tax Assessment Act 1997, paragraph 705-57(2)(c); as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 3

Income Tax Assessment Act 1997, section 104-500; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 3

Income Tax Assessment Act 1997, Division 149

Income Tax Assessment Act 1997, section 977-50

Income Tax Assessment Act 1997, section 705-50 and subsection 995-1(1); as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 6

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5

Revision history

Section C2-4-710 first published 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
6.5.11	Minor changes to reflect the repeal of section 705-50, effective 1 July 2009.	Legislative amendment.
	Note added to table 4 to clarify step 3 amount.	For clarification.

Worked example

Pre-CGT factor for assets of a joining entity

Note:

These pre-CGT factor rules apply to an entity that joined a consolidated group before 10 February 2010 unless the head company makes a choice for the new pre-CGT proportion rules to apply. For details of the new pre-CGT proportion rules that apply from 10 February 2010 see → 'Pre-CGT status of membership interests in a joining entity – pre-CGT proportion rules', C2-4-813.

Description

This example shows how the pre-CGT status of the membership interests acquired by the group before 20 September 1985 is preserved by attaching a pre-CGT factor to each asset (other than current assets) of the joining entity. This only applies where an entity joins a consolidated group before 10 February 2010.

Commentary

The pre-CGT status of membership interests in a joining entity is an attribute of the assets of the group being joined (as opposed to being an attribute of the assets of the joining entity).

To preserve that status a pre-CGT factor is attached at the joining time to each of the joining entity's assets (other than current assets). This allows a proportion of the membership interests in a leaving entity to be treated as pre-CGT assets by reference to the pre-CGT factors attached to the assets that leave with it. (Note that the asset with the pre-CGT factor attached does not need to have belonged to the leaving entity when it joined, nor do any of the leaving entity's membership interests need to have been pre-CGT interests at that time.) → 'Pre-CGT membership interests in a leaving entity (with pre-CGT factor attached to assets)', C2-5-710

The pre-CGT factor that applies to each asset (other than current assets) is calculated as follows:

$$\frac{\sum \begin{array}{c}\text{Market value of each pre-}\\\text{CGT membership interests}\\\text{held by head company}\end{array} + \sum \begin{array}{c}\text{Market value of each membership}\\\text{interest held by a subsidiary member}\\\text{multiplied by its pre-CGT factor}\end{array}}{\sum \text{Market value of joining entity's assets other than current assets}}$$

Note: If the amount calculated in this way is more than 1, the pre-CGT factor will be 1.

In terms of membership interests in the joining entity, the pre-CGT assets of the members are the interests (such as shares) or rights those members have held continuously since 19 September 1985.

Note: Division 149 of the *Income Tax Assessment Act 1997* (previously Division 20, section 160ZZS of the *Income Tax Assessment Act 1936*) will apply under consolidation in that a greater than 50% continuity of underlying ownership must be maintained since 19 September 1985 to maintain the pre-CGT status of assets. The pre-CGT status is removed from the assets under existing law if this continuity of majority underlying ownership is not maintained.

→ Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraph 2.47

Where pre-CGT status is removed from assets under existing law, the cost bases of the affected assets are reset at their market values as at the time of the trigger event.

Further, a pre-CGT factor only attaches to assets that existed at the joining time, and if an asset is disposed of after the joining time (other than by the sale of an entity), its pre-CGT factor is lost to the group and the factor does not attach to any replacement asset.

Example 1

Facts

ACo acquired 60% of the shares in BCo before 20 September 1985. On consolidation the financial positions are as shown in tables 1 and 2.

Table 1: ACo – financial position at 1 July 2003

Shares (100 in BCo)	$100	Equity	$100

Table 2: BCo – financial position at 1 July 2003

Land (MV $500)	$50	Equity	$100
Asset 2 (MV $100)	$50		
	$100		$100

Notes: MV: = market value
Asset 2 is not a current asset.

Calculation

Pre-CGT factor for all assets (other than current assets)

Step 1

Work out the market value of the pre-CGT membership interests in the joining entity:

(Land, $500 + Asset 2, $100) x 60% = $360

Step 2

Work out the market value of all the joining entity's assets (other than current assets) at the joining time:

Land ($500) + Asset 2 ($100) = $600

Step 3

Work out the pre-CGT factor:

$360 (step 1) / $600 (step 2) = 0.6

Therefore, the pre-CGT factor to be attached to all of the joining entity's (BCo) assets other than current assets (Land and Asset 2 in this example) is 0.6.

Example 2

Facts

HCo acquired 60% of ACo in July 1985 for a consideration of $600. ACo's financial position at this time was as shown in table 3.

Table 3: ACo – financial position at 1 July 1985

Cash	$1,000	Equity	$1,000

On 30 June 2003 the remaining equity of ACo is acquired by HCo for $680 (40% of $1,700 – see step 1 below) with the financial position as shown in table 4.

Table 4: ACo – financial position at 30 June 2003

Cash	$200	Equity	$1,000
Land (MV $2,000)	$1,300	Liabilities	$500
	$1,500		$1,500

Note: MV = market value

Calculation

Pre-CGT factor for all assets (other than current assets)

Step 1

Work out the market value of the pre-CGT membership interests in ACo:

The market value of all the membership interests in ACo at the joining time is $1,700 (Cash of $200 plus market value of Land, $2,000, less Liabilities of $500). Therefore, the market value of the pre-CGT membership interests is $1,020 (60% of $1,700).

($200 + $2,000 – $500) x 60% = $1,020

Step 2

Work out the market value of all the joining entity's assets (other than current assets) at the joining time:

The market value of all the assets (for which a pre-CGT factor is to be worked out) that ACo holds at the joining time (Land) is $2,000.

Note: Cash is excluded by virtue of subsection 705-125(2) of the ITAA 1997.

Step 3

Work out the pre-CGT factor:

$1,020 (step 1) / $2,000 (step 2) = 0.51

Therefore, the pre-CGT factor to be attached to all of the joining entity's (ACo) assets other than current assets (Land in this example) is 0.51.

References

Income Tax Assessment Act 1997, section 705-125; as inserted by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1, and amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 3

Explanatory Memorandum to New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 5.108–113

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.111 to 5.142

Revision history

Section C2-4-810 first published (excluding drafts) 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
6.5.11	Changes to Commentary to reflect changes to the method of working out the proportion of the pre-CGT membership interests in a joining entity.	Legislative amendments.
15.7.11	Additional information added to Note on p. 1.	Clarification

Worked example

Pre-CGT status of membership interests in a joining entity – pre-CGT proportion rules

Description

This example shows how the pre-CGT status of the membership interests acquired by the group before 20 September 1985 is preserved by working out a pre-CGT proportion (measured by market value).

Commentary

Changes to the mechanism for preserving the pre-CGT status of membership interests in a joining entity apply to an entity that joins a consolidated group on or after 10 February 2010 → *Tax Laws Amendment (2010 Measures No. 1) Act 2010*, Schedule 5, Part 3; Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.111 to 5.142.

However, the head company of a consolidated group can make a choice to apply the changes to an entity that joins a consolidated group before 10 February 2010. The choice:

- must be made on or before 30 June 2011, or within such further time as the Commissioner allows, and
- must be made in writing.

This option to apply the changes to entities that joined before 10 February 2010 will allow consolidated groups that are adversely affected by the operation of the pre-CGT factor rules to take advantage of the changes, given the compliance cost implications of applying the changes retrospectively. Where no such choice is made, the pre-CGT factor rules on leaving will continue to apply → 'Pre-CGT membership interests in a leaving entity (with pre-CGT factor attached to assets)', C2-5-710; 'Calculating the pre-CGT membership interests in a multiple exit case (with pre-CGT factor attached to assets)', C2-5-715.

Pre-CGT proportion of membership interests in a joining entity

Where an entity joins a consolidated group on or after 10 February 2010 (or where a head company makes a choice to apply the pre-CGT proportion changes to an entity that joins before 10 February 2010), the pre-CGT status of membership interests in the joining entity is preserved by working out a pre-CGT proportion (measured by market value) → section 705-125, *Income Tax Assessment Act 1997* (ITAA 1997).

The pre-CGT proportion is calculated as follows:

$$\frac{\sum \text{Market value of each pre-CGT membership interest held by head company} + \sum \text{Market value of each pre-CGT membership interest held by a subsidiary member}}{\sum \text{Market value of each membership interest in the joining entity}}$$

Stated simply, the pre-CGT proportion formula is:

$$\frac{\text{Market value of pre-CGT membership interests}}{\text{Market value of all membership interests}}$$

When an entity leaves a consolidated group, its pre-CGT proportion is used to work out the number of membership interests held by members of the old group that are treated as pre-CGT assets → subsection 711-65(4), ITAA 1997; 'Calculating pre-CGT membership interests in a multiple exit case (with pre-CGT factor attached to assets)', C2-5-715.

Integrity rules

Division 149 of the ITAA 1997 (previously Division 20, section 160ZZS of the *Income Tax Assessment Act 1936*) will apply under consolidation in that a greater than 50% continuity of underlying ownership must be maintained since 19 September 1985 to maintain the pre-CGT status of assets. The pre-CGT status is removed from the assets under existing law if this continuity of majority underlying ownership is not maintained. → Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraph 2.47

Where pre-CGT status is removed from assets under existing law, the cost bases of the affected assets are reset at their market values as at the time of the trigger event.

Where an entity in which pre-CGT membership interests are held joins a consolidated group on or after 10 February 2010 (or the head company makes a choice to apply the pre-CGT proportion changes to an entity that joins before 10 February 2010), a new integrity rule will apply to the entity when it leaves the consolidated group. The new integrity rule applies if any of the assets the leaving entity brought into the group stopped being pre-CGT assets under Division 149 (or would have stopped being pre-CGT assets under Division 149 if they were pre-CGT assets just before this time) while held by the head company of the group. → section 711-70, ITAA 1997

If the new integrity rule applies, the leaving entity's pre-CGT proportion is taken to be nil at the leaving time → subsection 711-70(2), ITAA 1997. In addition, an adjustment may be made to the old group's allocable cost amount (ACA) for the leaving entity → subsection 711-70(3), ITAA 1997; Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.119 to 5.129.

If the new integrity rule does not apply, consideration needs to be given to the possible application of CGT event K6, where the post-CGT assets of the leaving entity are equal to or greater than 75% of the net value of the entity.

Where a pre-CGT proportion has been worked out on entry for a leaving entity, two modifications are made to the operation of CGT event K6 → subsections 711-75(2) and (3), ITAA 1997; Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.130 to 5.138.

Example 1

Facts

This example shows how the pre-CGT status of the membership interests acquired by the group before 20 September 1985 is preserved by working out a pre-CGT proportion (measured by market value).

On 20 May 1985, HCo acquires 60 shares in ACo. HCo acquires the remaining 40 shares in ACo on 1 March 2010. On 1 July 2010, HCo forms a consolidated group with ACo as its subsidiary member. At that time, the net market value of ACo was $800 (i.e. each share has a market value of $8).

Calculation

Pre-CGT proportion of membership interests in the joining entity (ACo)

At the joining time, the pre-CGT proportion of the membership interests in ACo is calculated using the formula:

$$\frac{\text{Market value of pre-CGT membership interests}}{\text{Market value of all membership interests}}$$

Step 1

At the joining time work out the market value of the pre-CGT membership interests in ACo, and the market value of all the membership interests in ACo.

The total number of shares in ACo is 100, of which 60 (i.e. 60%) were acquired pre-CGT. The market value of all the membership interests in ACo at the joining time (in this case at formation time) is $800. Therefore, the market value of the pre-CGT membership interests in ACo at that time is $480 (i.e. 60% of $800).

Step 2

Work out the pre-CGT proportion:

$480 / $800 = 0.60

Therefore, the pre-CGT proportion of HCo's membership interests in ACo is 60%.

Example 2

Facts

HCo acquired 30% of the equity in ACo in July 1985 for a consideration of $300. ACo's financial position at this time is shown in table 1.

Table 1: ACo – financial position at 1 July 1985

Cash	$1,000	Equity	$1,000

On 1 July 2002, HCo formed a consolidated group. On 30 June 2003, the remaining equity of ACo is acquired by HCo for $1190 (70% of $1,700 – see step 1 below) at which time ACo joined the group. ACo's financial position is shown in table 2.

Table 2: ACo – financial position at 30 June 2003

Cash	$200	Equity	$1,000
Land (MV $2,000)	$1,300	Liabilities	$500
	$1,500		$1,500

Note: MV = market value

On 30 June 2010, HCo makes a choice in writing to apply the pre-CGT proportion changes to ACo when it joined the group on 30 June 2003. Therefore, the pre-CGT status of membership interests in ACo is preserved by working out a pre-CGT proportion (measured by market value).

Calculation

Pre-CGT proportion of ACo

Step 1

At the joining time, work out the market value of the pre-CGT membership interests in ACo, and the market value of all the membership interests in ACo.

The market value of all the membership interests in ACo at the joining time is $1,700 (Cash of $200 plus market value of Land, $2,000, less Liabilities of $500). Therefore, the market value of the pre-CGT membership interests is $510 (30% of $1,700).

i.e. ($200 + $2,000 – $500) x 30% = $510

Step 2

Work out the pre-CGT proportion:

$510 / $1,700 = 0.30

Therefore, the pre-CGT proportion of HCo's membership interests in ACo is 30%.

References

Income Tax Assessment Act 1997, section 705-125; as inserted by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1, and amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 3

Explanatory Memorandum to New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 5.108–113

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.111 to 5.142

Revision history

Section C2-4-810 first published 6 May 2011.

Worked example

Pre-CGT factor for assets where subsidiary has membership interests in another member – formation before 10 February 2010

Note:

These pre-CGT factor rules do not apply to an entity that joins a consolidated group on or after 10 February 2010. For details of the new pre-CGT proportion rules that apply from 10 February 2010 see → 'Pre-CGT status of membership interests in a joining entity – pre-CGT proportion rules', C2-4-813.

Description

This example shows how, on formation of a consolidated group before 10 February 2010, the pre-CGT status of membership interests held directly and indirectly by the head company is preserved by attaching a pre-CGT factor to assets (other than current assets) held by subsidiary members of the group.

Commentary

The pre-CGT status of membership interests held directly by the head company (that is, in the first subsidiary) is preserved by attaching a pre-CGT factor to the assets (other than current assets) of the first subsidiary at the formation time.

If, on formation, the first subsidiary holds membership interests in another subsidiary member (the second subsidiary), the pre-CGT factor must first be worked out for the first subsidiary's assets before any pre-CGT factor can be worked out for the second subsidiary's assets. The market value of each membership interest owned by the first subsidiary in the second subsidiary is multiplied by the pre-CGT factor that was worked out and attached to the first subsidiary's assets. → section 705-165, *Income Tax Assessment Act 1997* (ITAA 1997)

This allows a proportion of the membership interests in a leaving entity to be treated as pre-CGT assets by reference to the pre-CGT factor of assets in the leaving entity. → 'Pre-CGT membership interests in a leaving entity (with pre-CGT factor attached to assets)', C2-5-710

Note: section 705-165 of the ITAA 1997 was repealed on 10 February 2010, which means that this process does not apply to groups forming on or after this date. → *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 3

Example

Facts

ACo, the future head company, was incorporated in 1983 with its sole asset being $300 in cash. On 1 July 1985, ACo paid $60 for 60% of BCo (which had been incorporated 1 July 1984 with a cash asset of $200).

Previously, on 30 January 1985, BCo had paid $160 for an 80% interest in CCo, with the other 20% being owned by a third party. (CCo had assets of Cash $100 and Land $100.) In 1999 CCo bought Asset 1 at a cost of $10.

The financial positions of ACo, BCo and CCo are shown in tables 1, 2 and 3.

Table 1: ACo – financial position at 1 July 1985

Cash	$240	Contributed capital	$300
Shares BCo	$60		
Total	$300	Total	$300

Table 2: BCo – financial position at 1 July 1985

Cash	$40	Contributed capital	$200
Shares CCo	$160		
Total	$200	Total	$200

Table 3: CCo – financial position at 1 July 1985

Cash	$100	Contributed capital	$200
Land (MV $100)	$100		
Total	$200	Total	$200

Note: MV = market value

On 1 July 2002, ACo acquires the 40% balance of BCo for $99.20. BCo acquires the 20% balance of the shares in CCo for $52 after borrowing $12 from an external source.

On 1 July 2002, ACo forms a consolidated group with the other companies. The group structure is shown in Figure 1, and their financial positions are shown in tables 4, 5 and 6.

Figure 1: Group structure at formation time

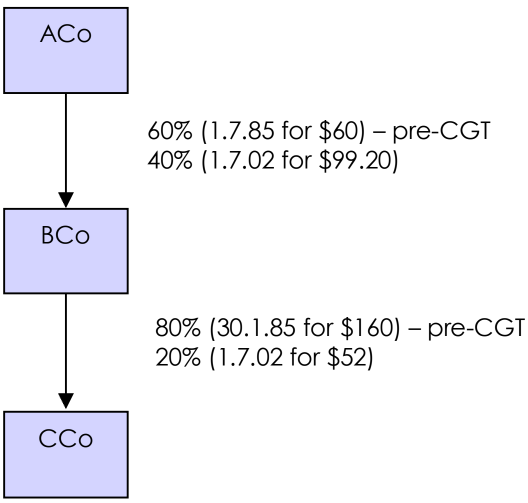


Table 4: ACo – financial position at 1 July 2002

Cash	$140.80	Contributed capital	$300
Shares BCo (MV $248)	$159.20		
Total	$300	Total	$300

Table 5: BCo – financial position at 1 July 2002

Shares CCo (MV $260)	$212	Contributed capital	$200
		Liability - bank loan	$12
Total	$212	Total	$212

Table 6: CCo – financial position at 1 July 2002

Cash	$90	Contributed capital	$200
Land (MV $150)	$100		
Asset 1 (MV $20)	$10		
Total	$200	Total	$200

Calculation

Pre-CGT factor For BCo's assets (other than current assets)

Step 1

Work out the market value of the pre-CGT membership interests (which are pre-CGT assets) that the head company ACo holds in BCo at formation time.

Market value of shares in BCo is $248 (MV of Shares in CCo, $260, less Liability of $12).

$248 x 60% = $148.80

Step 2

Work out the market value of all of BCo's assets (other than current assets), at the formation time:

MV of Shares in CCo is $260.

Step 3

Work out the pre-CGT factor:

$148.80 (step 1) / $260 (step 2) = 0.5723076

Therefore, the pre-CGT factor to be attached to all assets, other than current assets, (shares held by BCo in CCo) is 0.5723076.

Pre-CGT factor for CCo's assets (other than current assets)

Step 1

Multiply the market values of the membership interests held by BCo in CCo by their pre-CGT factors (worked out above):

Market value of Shares in CCo ($260) x 0.5723076 = $148.80

Step 2

Work out the market value of all of CCo's assets (other than current assets) at the formation time:

Land ($150) + Asset 1 ($20) = $170

Step 3

Work out the pre-CGT factor:

$148.80 (step 1) / $170 (step 2) = 0.8752941

Therefore, the pre-CGT factor to be attached to CCo's assets, other than current assets, (Land and Asset 1) is 0.8752941.

References

Income Tax Assessment Act 1997, section 705-165; as inserted by *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 3, and repealed by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 3

Explanatory Memorandum to New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, paragraphs 1.72-1.73

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.111 to 5.142

Revision history

Section C2-4-820 first published (excluding drafts) 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
6.5.11	Revisions to reflect changes to the method of working out the proportion of the pre-CGT membership interests in a joining entity.	Legislative amendments.

Worked example

Applying the continuing majority-owned entity test to multi-tiered structures

Description

This example shows how the continuing majority ownership test in subsections 701A-1(1) and 701A-1(2) of the *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A 1997) applies to entities in multi-tiered ownership structures.

Commentary

When an entity joins a consolidated group, its trading stock and any depreciating assets (including internally generated assets) are generally treated as reset cost base assets under Division 705.

However, where the entity is a 'continuing majority-owned entity', trading stock is a retained cost base asset and internally generated assets have a dual cost base. → subsections 701A-5 and 701A-10

This is an integrity measure to ensure that the cost setting rules do not provide unintended tax benefits to groups during the transition to consolidation. Without it, tax benefits could be realised as a consequence of resetting the value of trading stock held prior to consolidation, or providing a tax value for internally generated assets where the asset did not have a tax value prior to consolidation.

A 'continuing majority-owned entity' is an entity that was majority owned at all times by a person or persons from the start of 27 June 2002 until the entity became a subsidiary member of a consolidated group. (This period includes the joining date.) → paragraph 701A-1(b)

The integrity measures in sections 701A-5 and 701A-10 do not apply to an entity's trading stock and certain internally generated assets where there has been a change in the entity's majority owners after the start of 27 June 2002. That is, the integrity measures only apply to joining entities that were majority owned, either directly or indirectly through one or more interposed entities, from the start of 27 June 2002, and remained majority owned until the group consolidated.

In determining whether there was a change in the majority ownership of joining entities during this period it will be necessary to trace the ultimate beneficial owners, ignoring any entities interposed between the ultimate beneficial owners and the joining entity. In most cases it will be clear whether or not there has been a change in the majority ultimate beneficial ownership of an entity. However, where it may be difficult to determine this, the taxpayer or their adviser should approach the Tax Office with the aim of identifying an approach that will minimise compliance costs in tracing ownership.
→ Taxation Determination TD 2004/88

These integrity measures will continue to apply beyond the transitional period of 1 July 2002 to 30 June 2004.

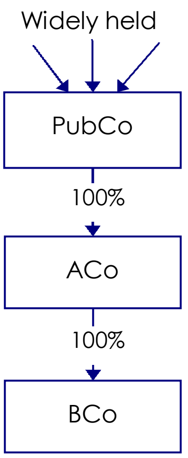
Example

Majority ownership test for multi-tiered structures (widely held ownership of head company)

Facts

As at 26 June 2002, PubCo, a publicly listed corporation on the Australian Stock Exchange, owns 100% of the shares in ACo, an Australian-resident company. On that date BCo, an Australian-resident company, is a wholly-owned subsidiary of ACo, and holds trading stock and internally generated assets.

Figure 1: PubCo group at 26.6.2002

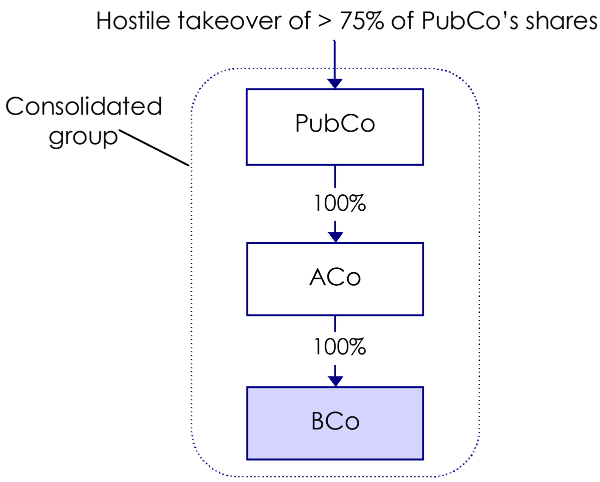


On 31 December 2002, a hostile takeover of more than 75% of PubCo's listed shares takes place, resulting in a change in majority ownership of PubCo.

On 1 July 2003, PubCo forms a consolidated group comprising itself as head company with subsidiary members ACo and BCo.

There are no changes to PubCo's membership interests in ACo and ACo's membership interests in BCo from 26 June 2002 until the consolidation time of 1 July 2003.

Figure 2: PubCo group on consolidation



Applying the test

From 26 June 2002 until 30 December 2002, PubCo was the majority owner of ACo. PubCo was also the majority owner of BCo during this period because it beneficially owned (indirectly through ACo), shares representing more than 50% of the market value of all the membership interests in BCo.

On 31 December 2002, a hostile takeover of PubCo resulted in a change in ownership of PubCo at the ultimate beneficial ownership level. Although there has been no change in PubCo's ownership of ACo or BCo, the test for majority ownership in section 701A-1 of the IT(TP)A 1997 requires a 'bottom-up' analysis (through widely held or public companies, including publicly listed companies) to the ultimate beneficial owners to determine whether or not the integrity measures apply.

Given the change in majority beneficial ownership has taken place at the ultimate beneficial ownership level, PubCo, ACo and BCo do not qualify as continuing majority-owned entities. As a result, the integrity measures do not apply to BCo's trading stock and internally generated assets for the purpose of cost setting.

References

Income Tax Assessment Act 1997, Division 705

Income Tax (Transitional Provisions) Act 1997, sections 701A-1, 701A-5, 701A-10, subsection 701A-1(1)

Explanatory Memorandum to the New Business Tax System (Consolidation and other measures) Bill (No. 1) 2002, paragraphs 1.118 – 1.141

Taxation Determination TD 2004/88 – Income tax: consolidation: does the continuing majority-owned entity test in subsections 701A-1(1) and 701A-1(2) of the *Income Tax (Transitional Provisions) Act 1997* require tracing through interposed entities to the ultimate beneficial owners to determine whether there has been a change in the majority ownership of an entity during the period from 27 June 2002 until the entity becomes a subsidiary member of a consolidated group?

Revision history

Section C2-4-855 first published 12 May 2004.

Further revisions are described below.

Date	Amendment	Reason
26.10.05	Reference to new taxation determination.	

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Increase for certain privatised depreciating assets (at exit ACA step 1)

Description

This example shows how the step 1 amount of the exit ACA may be increased for certain privatised assets leaving the group.

Commentary

To set the head company's cost of membership interests in a leaving entity, the exit ACA is calculated in five steps → 'Treatment of assets', C2-1. The step 1 amount is worked out by adding up the terminating values of the leaving entity's assets just before the leaving time.

There is an increase in the step 1 amount for certain privatised depreciating assets leaving the group that either:

- had their tax cost setting amount reduced under section 705-47 of the ITAA 1997 when an entity joined the group, or
- had their first element of cost reduced because of subsection 58-70(5) of the ITAA 1997 when they were acquired by the group.

The step 1 amount is increased by the amount of that reduction.

Example

Facts

(This example is based on that at C2-4-605.)

ACo is a wholly-owned subsidiary of HCo.

On 2 July 2001, ACo acquires a privatised depreciating asset in connection with a business from a tax exempt entity for $96. The asset has an effective life of 10 years.

Under section 58-65 of the ITAA 1997, ACo chooses to work out the first element of the privatised asset's cost using its notional written down value, which is calculated as $90.

ACo uses the prime cost method and for the 2001-02 income year deducts $9 for the decline in value (based on a cost of $90) under Division 40 of the ITAA 1997, leaving an adjustable value of $81 on 30 June 2002.

On 1 July 2002, HCo forms a consolidated group with ACo as a subsidiary member.

After ACo's ACA is calculated and allocated, the tax cost setting amount (TCSA) for the privatised asset is $86. No reduction at step C is necessary because the asset has a market value of $92.

However, at step D a reduction in the privatised depreciating asset's TCSA is required under section 705-47 of the ITAA 1997, because Division 58 of the

ITAA 1997 has directly affected ACo's deductions (by reducing the asset's cost from $96 to $90) and the asset's TCSA calculated up to this point ($86) exceeds its terminating value ($81). The TCSA for the privatised depreciating asset is reduced to its terminating value of $81, a reduction of $5 ($86 – $81).

HCo deducts $9 for the decline in value for the 2002-03 income year. This is worked out using paragraph 701-55(2)(c) of the ITAA 1997 and based on a cost of $81 and the remaining effective life of 9 years. The privatised depreciating asset has an adjustable value of $72 on 30 June 2003.

ACo leaves HCo's group on 1 July 2003 with the privatised depreciating asset.

ACo's exit ACA step 1 amount includes $72, being the terminating value of the privatised depreciating asset. This is increased by $5 (to $77) under subsection 711-25(3) of the ITAA 1997, because the asset had its TCSA reduced by $5 (from $86 to $81) under section 705-47 of the ITAA 1997 when ACo joined the group.

References

Income Tax Assessment Act 1997, subsection 711-25(3); as inserted by *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (83 of 2004), Schedule 2

Income Tax Assessment Act 1997, sections 711-20 and 711-25; as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 7, Division 1

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 2) Bill 2004, paragraphs 2.206 to 2.241

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.188 – 5.197

Revision history

Section C2-5-220 first published 11 March 2005.

Further revisions are described below.

Date	Amendment	Reason
6.5.11	Minor revisions to 'Commentary' to reflect changes that clarify the time when the leaving time cost setting provisions in Division 711 apply.	Legislative amendments.

Worked example

Adjustment for certain inherited deductions (exit ACA step 2)

Description

This example shows how, at step 2 of the allocable cost amount (ACA) calculation on exit, an amount is added for certain unclaimed deductions of the head company that become available to the leaving entity because of the exit history rule.

Commentary

The exit history rule provides that the tax history in relation to any asset, liability, business or registration for particular research and development activities that leaves the consolidated group with a leaving entity is inherited by that leaving entity. This tax history can include the history inherited by the head company as a result of the entry history rule.

An amount is added at step 2 on exit to ensure that the value of the deduction is reflected in the ACA.

The relevant deductions at this step are those for which the leaving entity becomes entitled under section 701-40 of the *Income Tax Assessment Act 1997* (ITAA 1997) as a result of it ceasing to be a subsidiary member of the consolidated group, other than a deduction for expenditure:

- that is, forms part of or reduces, the cost of an asset that becomes an asset of the leaving entity because subsection 701-1(1) of the ITAA 1997 (the single entity rule) ceases to apply
- to which section 110-40 of the ITAA 1997 (expenditure on assets acquired before 7.30pm on 13 May 1997) applies, or
- under section 43-15 of the ITAA 1997 (which relates to undeducted construction expenditure), if the joining entity acquired the asset to which the deduction relates at or before 7.30pm on 13 May 1997.

→ subsection 711-35(2)&(3), ITAA 1997

An unclaimed deduction for expenditure that would be included in the cost of an asset of the leaving entity, or would reduce it, is not included at step 2.

Unclaimed Division 43 deductions

Unclaimed deductions for allowable capital expenditure on assessable-income-producing buildings and other capital works under Division 43 of the ITAA 1997 that were previously available to the head company and become available to a leaving entity when it leaves a consolidated group do not increase the exit ACA at step 2. When an entity joins a consolidated group, unclaimed Division 43 deductions do not reduce the entry ACA at step 7, and when an entity leaves a group, unclaimed Division 43 deductions do not increase the exit ACA at step 2. → 'Adjustment for certain inherited deductions (ACA step 7)', C2-4-340

Amount added at step 2

For exits occurring on or after 10 February 2010, the amount added is obtained by multiplying all of the deductions covered in step 2 by the corporate tax rate. → *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 9; Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.245 to 5.246

For exits that occurred before 10 February 2010, the step 2 amount is worked out using the formula: Owned deductions + (Acquired deductions x Corporate tax rate).

Acquired deductions are those that were acquired deductions at step 7 of the entry ACA when an entity became a subsidiary member of the consolidated group. → 'Adjustment for certain inherited deductions (ACA step 7)', C2-4-340

Owned deductions are deductions that are not acquired deductions.
→ former subsection 711-35(1)

Example

Facts

On 1 July 2008 all of the membership interests in ACo are acquired by HCo, the head company of a consolidated group.

Before joining the consolidated group, ACo:

- purchased land on 1 July 1996 and then constructed an income producing building at a cost of $100,000, which gave rise to Division 43 deductions of $4,000 in each year; and
- borrowed $200,000 on 1 July 2007 to use in its business for which it incurred $20,000 borrowing costs claimable over 5 years under section 25-25 of the ITAA 1997. HCo's ACA for ACo was reduced by $4,800 ($16,000 x 0.3) at step 7 when ACo joined the consolidated group.

On 30 June 2010, the group sells its membership interests in ACo with the result that ACo leaves the consolidated group.

Table 1: ACo – financial position at 30 June 2010 ($'000)

Income producing property	200	Equity	102.4
Depreciating assets	100	Liability	200
Deferred tax asset	2.4		
	302.4		302.4

Note: The deferred tax asset is for unclaimed borrowing costs of $8,000 fully expensed in the accounts. The terminating value of the property is $200,000 and the cost of depreciating assets is $100,000.

Calculation

Step 1

Start with the sum of the terminating values of the leaving entity's assets, i.e. $300,000.

Step 2

This step is concerned with unclaimed deductions for which the leaving entity becomes entitled. The leaving entity becomes entitled to unclaimed deductions for borrowing expenses of $8,000 as a result of the exit history rule. No amount is added for the unclaimed deductions available under Division 43. Therefore, the amount added at step 2 is $2,400 ($8,000 x 0.3).

The result after this step is $302,400.

Step 3

There is no step 3 amount.

Step 4

Deduct ACo's liabilities of $200,000 that leave the group with ACo.

Step 5

The group's ACA for the leaving entity is $102,400.

References

Income Tax Assessment Act 1997, section 701-1; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *Tax Laws Amendment (2007 Measures No. 4) Act 2007* (No. 143 of 2007), Schedule 1

Income Tax Assessment Act 1997, section 701-40; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 11

Income Tax Assessment Act 1997, section 711-20; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2
- *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 21
- *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 7, Division 1

Income Tax Assessment Act 1997, section 711-25; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (No. 83 of 2004), Schedule 2
- *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 7, Division 1

Income Tax Assessment Act 1997, section 711-35; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 7, Division 1 and Part 9

Income Tax Assessment Act 1997, section 711-45; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2
- *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1

- *Tax Laws Amendment (2004 Measures No. 7) Act 2005* (No. 41 of 2005), Schedule 6
- *Financial Sector Legislation Amendment (Restructures) Act 2007* (No. 117 of 2007), Schedule 3
- *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Parts 7, 8, and 9.

Income Tax Assessment Act 1997, sections 711-40 and 711-55; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Income Tax Assessment Act 1997, section 110-40

Explanatory Memorandum to New Business Tax System (Consolidation) Bill No. 1, paragraph 5.142

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.188 – 5.197 and paragraphs 5.245 – 5.247

Revision history

Section C2-5-240 first published 15 November 2006.

Further revisions are described below.

Date	Amendment	Reason
26.6.07	Note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used, and proposed changes to the treatment of certain inherited deductions, p. 3.	Reflect announcement on 8 May 2007 by Assistant Treasurer in media release no. 50.
6.5.11	Changes to Commentary and Example to reflect modification of the step 2 calculation and to clarify the facts in the Example. Removal of note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used, and proposed changes to the treatment of certain inherited deductions. Changes to Commentary to reflect changes to the treatment of certain inherited deductions.	Legislative amendments.

Worked example

Adjustment for intragroup liabilities owed to a leaving entity on exit (in exit ACA step 3)

Description

This example shows how liabilities owed by members of the consolidated group to the leaving entity (intragroup liabilities) just before the leaving time are reflected at step 3 of the exit allocable cost amount (ACA) calculation.

Commentary

To set the head company's cost of membership interests in a leaving entity, the exit ACA is calculated in five steps → 'Cost setting on exit', C2-1-060. At step 3, an amount is added relating to any liabilities actually owed by members of the group to the leaving entity just before the leaving time.

The amount to be added is the market value at the leaving time of the leaving entity's assets that correspond to the liabilities owed to it by group members at the leaving time. However, where the market value of the corresponding asset held by the leaving entity is greater than its cost, the cost amount is used.

This element of the ACA is separately identified because, while an entity is a member of a consolidated group, liabilities it is owed by other members of the group are not recognised for income tax purposes.

Example

Facts

The head company HCo sells 5% of ACo on 30 June 2004, and ACo consequently leaves HCo's group. At the leaving time, ACo has a cash asset of $900 and an accounting asset that has not been identified for income tax purposes (a $100 loan to BCo, another member of the consolidated group). The market value of the loan is $100.

Calculation

Calculate ACo's exit ACA as follows:

Step 1

The terminating value of the cash asset is $900.

Step 2

Not applicable.

Step 3

The market value of the BCo's liability to ACo is $100. This amount is added to the result after step 2 ($900).

Steps 4

Not applicable.

Step 5

ACo's exit ACA is **$1,000**.

References

Income Tax Assessment Act 1997, section 711-40 and subsection 711-20(1); as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2
- *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 8

Revision history

Section C2-5-260 first published (excluding drafts) 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
26.6.07	Note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used.	Reflect announcement on 8 May 2007 by Assistant Treasurer in media release no. 50.
6.5.11	Removal of note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used. References to 'at the leaving time' changed to 'just before the leaving time'.	Legislative amendments.

Worked example

Pre-CGT membership interests in a leaving entity (with pre-CGT factor attached to assets)

Note:

The pre-CGT factor rules on leaving continue to apply where an entity in which pre-CGT membership interests were held joins a consolidated group before 10 February 2010 and the head company does not make a choice to apply the new pre-CGT proportion rules to that entity → 'Pre-CGT status of membership interests in a joining entity – pre-CGT proportion rules', C2-4-813.

Description

This example shows how a proportion of the membership interests in an entity leaving a consolidated group are treated as pre-CGT assets by reference to the pre-CGT factors of assets in the leaving entity.

Commentary

Where an entity joins a consolidated group before 10 February 2010 (and the head company does not make a choice to apply the pre-CGT proportion rules to that entity → 'Pre-CGT status of membership interests in a joining entity – pre-CGT proportion rules', C2-4-813), the pre-CGT status of membership interests in the joining entity is preserved by attaching a pre-CGT factor to its assets (other than current assets). → 'Pre-CGT factor for assets of a joining entity', C2-4-810

When an entity leaves a consolidated group with pre-CGT factors attached to some or all of its assets, a pre-CGT proportion of its membership interests is calculated as follows:

$$\frac{\sum \left(\text{Market value of each asset with a pre-CGT factor} \times \text{pre-CGT factor of asset} \right)}{\sum \text{Market value of all assets of the leaving entity}}$$

→ subsection 711-65(5), *Income Tax Assessment Act 1997* (ITAA 1997)

The result is then multiplied by the number of membership interests in the leaving entity (100 shares in the example below), to give the number of pre-CGT membership interests (rounded down to the nearest whole number or zero if the number is less than 1). → subsections 711-65(3) and (4), ITAA 1997

Note: The amendments to section 711-65 contained in *Tax Laws Amendment (2010 Measures No. 1) Act 2010,* Schedule 5, Part 3 have no effect where an entity leaves a consolidated group and pre-CGT factors are attached to some or all of its assets. This will occur where pre-CGT factors were calculated for an entity (in which pre-CGT membership interests were held) that joined the consolidated group before 10 February 2010 and the head company did not make a choice to apply the new pre-CGT proportion rules to that entity.

(Section 711-65 as it stood before *Tax Laws Amendment (2010 Measures No. 1) Act 2010* took effect is reproduced at the end of this worked example.)

Example 1

Facts

Of ACo's 100 shares in BCo, 60 are pre-CGT membership interests. The financial positions on consolidation are shown in tables 1 and 2.

Table 1: ACo – financial position at 1 July 2003

Shares (100 in BCo)	$100	Equity	$100

Table 2: BCo – financial position at 1 July 2003

Land (MV $500)	$50	Equity	$100
Asset 2 (MV $100)	$50		
	$100		$100

Notes: MV = market value
Asset 2 is not a current asset

The pre-CGT factor attached to Asset 2 and Land is 0.6. → 'Pre-CGT factor for assets of a joining entity', C2-4-810

BCo leaves the group on 30 November 2003, and market values have not changed in the interim.

Calculation

Pre-CGT proportion of BCo's membership interests on leaving

a) Calculate the leaving entity's pre-CGT proportion – using s. 711-65(5) of the ITAA 1997 (as it stood at 30 November 2003)

Step 1

Multiply the market values of assets by their pre-CGT factors:

Land: $500 x 0.6 = $300
Asset 2: $100 x 0.6 = $60

Step 2

Add the results of step 1 to give a result of $360.

Step 3

Work out the market value of all assets that the head company holds in the leaving entity:

Asset 2 ($100) + Land ($500) = $600

Step 4

$360 (step 2) / $600 (step3) = 0.6

Therefore, the pre-CGT proportion of BCo leaving the group is 0.6.

b) Calculate the number of pre-CGT membership interests – using s. 711-65(4) of the ITAA 1997 (as it stood at 30 November 2003)

100 shares x 0.6 = 60 shares

c) Round down to nearest whole number of pre-CGT membership interests – s. 711-65(3) of the ITAA *(if applicable)*

In this example the result (60 shares) does not change.

Therefore, 60 of the 100 shares in BCo disposed of are treated as pre-CGT membership interests. The remaining 40 shares will be subject to the CGT provisions.

Example 2

Facts

A consolidated group holds all the shares in ACo. The financial position of ACo at the joining time is shown in table 3.

Table 3: ACo – financial position at 30 June 2003

Cash	$200	Equity	$1,000
Land (MV $2,000)	$1,300	Liabilities	$500
	$1,500		$1,500

The pre-CGT factor attached to Land is 0.51. → 'Pre-CGT factor for assets of a joining entity', C2-4-810

After the joining time, additional liabilities are transferred in and machinery is acquired. Then on 31 December 2003, the group decides to dispose of all its membership interests in ACo. The financial position of ACo is shown in table 4.

Table 4: ACo – financial position at 31 December 2003

Machinery (MV $600)	$600	Equity (100 shares)	$1,000
Land (MV $3,000)	$1,300	Liabilities	$900
	$1,900		$1,900

Calculation

Pre-CGT proportion of ACo's membership interests on leaving

a) Calculate the leaving entity's pre-CGT proportion – using s. 711-65(5) of the ITAA 1997 (as it stood at 31 December 2003)

Step 1

Multiply the market value of Land by its pre-CGT factor:

$3,000 x 0.51 = $1,530

Note: The pre-CGT factor is attached to each of the joining entity's assets at the joining time (other than current assets). Machinery is an asset that has been acquired after the joining time and is therefore not included in step 1 because it does not have any pre-CGT factor attached.

Step 2

Add the results of step 1 to give a result of $1,530.

Step 3

Work out the market value of all assets that the head company holds in the leaving entity:

Land ($3,000) + Machinery $600) = $3,600

Step 4

$1,530 (step 2) / $3,600 (step 3) = 0.425

Therefore, the pre-CGT proportion of ACo leaving the group is 0.425.

b) Calculate the number of pre-CGT membership interests – using s. 711-65(4) of the ITAA 1997 (as it stood at 31 December 2003)

100 shares x 0.425 = 42.5 shares

c) Round down to nearest whole number of pre-CGT membership interests – s. 711-65(3) of the ITAA 1997 *(if applicable)*

= 42

Therefore, 42 of the 100 shares in ACo that are disposed of will be treated as pre-CGT membership interests.

The gain or loss on disposal of these 42 shares is treated as the sale of pre-CGT assets. Consideration would need to be given to the possible application of CGT event K6, where the post-CGT assets of the leaving entity are equal to or greater than 75% of the net value of the entity. The remaining 58 shares will be subject to the CGT provisions.

References

Income Tax Assessment Act 1997, section 711-65; as inserted by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1, and amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 3

Explanatory Memorandum to New Business Tax System (Consolidation) Bill 2002 (No. 1), paragraphs 5.147–153

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.111 to 5.142

Revision history

Section C2-5-710 first published (excluding drafts) 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
6.5.11	Significant revisions to reflect changes to the method of working out the proportion of the pre-CGT membership interests in a joining entity.	Legislative amendments.

Section 711-65 as it stood before *Taxation Laws Amendment (2010 Measures No. 1) Act 2010*

711-65 Membership interests treated as having been acquired before 20 September 1985 – simple case

When this section applies

(1) This section applies if:

(a) any of the assets (a *pre-CGT factor asset*), that the *head company of the old group holds at the leaving time because the leaving entity is taken by subsection 701-(1) to be a part of the head company, has a *pre-CGT factor under section 705-125; and

(b) section 711-70 (about the multiple exit of *subsidiary members) does not apply; and

(c) the leaving entity does not cease to be a subsidiary member of the old group where Subdivision 705-C (about the old group joining another consolidated group) applies.

Interests treated as if purchased before 20 September 1985

(2) If this section applies, a number of the *membership interests in the leaving entity that *members of the old group hold are taken to have been acquired before 20 September 1985.

Note: Because of the deemed acquisition of the membership interests, this section is the only basis on which any of these interests can be pre-CGT assets.

Number of pre-CGT membership interests

(3) The number is the result of the formula in subsection (4), rounded down to:

(a) the nearest whole number if the result is not already a whole number; or

(b) zero if the result is a number more than zero but less than one.

Formula

(4) The formula is:

Number of *membership interests in leaving entity held by *members of old group	x	Leaving entity's pre-CGT proportion

where:
leaving entity's pre-CGT proportion is the amount worked out under subsection (5).

Pre-CGT proportion

(5) Work out the leaving entity's pre-CGT proportion in this way:

Leaving entity's pre-CGT proportion

Step 1. For each *pre-CGT factor asset, multiply its *market value before the leaving time by its *pre-CGT factor.

Step 2. Add up all the results of step 1.

Step 3. Add up the *market values of all the assets that the *head company holds at the leaving time because the leaving entity is taken by section 701-1 to be a part of the head company.

Step 4. Divide the result of step 2 by the result of step 3.

Dealing with classes of membership interests

(6) If there are 2 or more classes of *membership interests in the leaving entity, this section operates separately in relation to each class as if the interests in that class were all the interests in the entity.

Allocation of the number to particular membership interests

(7) The *head company must choose which particular *membership interests comprise the number worked out under subsection (2).

Modification if leaving entity is a trust

(8) If the leaving entity is a trust, a *membership interest in it is not taken into account under this section unless the membership interest is either a unit or an interest in the trust.

Worked example

Pre-CGT membership interests in a leaving entity – pre-CGT proportion rules

Description

This example shows how a proportion of the membership interests in an entity leaving a consolidated group are treated as pre-CGT assets by applying a pre-CGT proportion (measured by market value) to the number of membership interests in a leaving entity.

Commentary

Changes to the mechanism for preserving the pre-CGT status of membership interests in a joining entity apply to an entity that joins a consolidated group on or after 10 February 2010. → *Tax Laws Amendment (2010 Measures No. 1) Act 2010*, Schedule 5, Part 3; Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.111 to 5.142

However, the head company of a consolidated group can make a choice to apply the changes to an entity that joins a consolidated group before 10 February 2010. The choice:

- must be made on or before 30 June 2011, or within such further time as the Commissioner allows, and
- must be made in writing.

This option to apply the changes from 1 July 2002 will allow consolidated groups that are adversely affected by the operation of the pre-CGT factor rules to take advantage of the changes, given the compliance cost implications of applying the changes retrospectively. Where no such choice is made, the pre-CGT factor rules on leaving will continue to apply → 'Pre-CGT membership interests in a leaving entity (with pre-CGT factor attached to assets)', C2-5-710; 'Calculating pre-CGT membership interests in a multiple exit case (with pre-CGT factor attached to assets)', C2-5-715.

Where an entity joins a consolidated group on or after 10 February 2010 (or the head company makes a choice to apply the changes to an entity that joins before10 February 2010), the pre-CGT status of membership interests is preserved by working out a pre-CGT proportion (measured by market value). → 'Pre-CGT status of membership interests in a joining entity – pre-CGT proportion rules', C2-4-813

Pre-CGT membership interests in a leaving entity where pre-CGT proportion is worked out on entry

Subject to integrity rules (see below), when an entity leaves a consolidated group, the number of its membership interests that are treated as pre-CGT assets is worked out as follows:

Number of membership interests in the leaving entity held by members of the old group	x	Leaving entity's pre-CGT proportion

→ subsection 711-65(4), *Income Tax Assessment Act 1997* (ITAA 1997)

The result gives the number of pre-CGT membership interests in the leaving entity (rounded down to the nearest whole number or zero if the number is less than 1). → subsection 711-65(3), ITAA 1997

Integrity rules

Division 149 of the ITAA 1997 (previously Division 20, section 160ZZS of the *Income Tax Assessment Act 1936*) applies under consolidation in that a greater than 50% continuity of underlying ownership must be maintained since 19 September 1985 to maintain the pre-CGT status of assets. The pre-CGT status is removed from the assets under existing law if this continuity of majority underlying ownership is not maintained. → Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraph 2.47

Where pre-CGT status is removed from assets under existing law, the cost bases of the affected assets are reset at their market values as at the time of the trigger event.

Where an entity joins a consolidated group on or after 10 February 2010 (or the head company makes a choice to apply the pre-CGT proportion changes to an entity that joins before10 February 2010), a new integrity rule will apply to a leaving entity. The integrity rule applies if any of the assets the leaving entity brought into the group stopped being pre-CGT assets under Division 149 (or would have stopped being pre-CGT assets under Division 149 if they were pre-CGT assets just before this time) while held by the head company of the group. → section 711-70, ITAA 1997

If the new integrity rule applies, the leaving entity's pre-CGT proportion is taken to be nil at the leaving time → subsection 711-70(2), ITAA 1997. In addition, an adjustment may be made to the old group's allocable cost amount (ACA) for the leaving entity. → subsection 711-70(3), ITAA 1997; Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.119 to 5.129

If the new integrity rule does not apply, consideration needs to be given to the possible application of CGT event K6, where the post-CGT assets of the leaving entity are equal to or greater than 75% of the net value of the entity.

Where a pre-CGT proportion has been worked out on entry for a leaving entity, two modifications are made to the operation of CGT event K6.
→ subsections 711-75(2) and (3), ITAA 1997; Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.130 to 5.138

Example 1

Facts

60 out of HCo's 100 shares in ACo are pre-CGT membership interests. On consolidation the financial positions are shown in tables 1 and 2.

Table 1: HCo – financial position at 1 July 2010

Shares (100 in ACo)	$100	Equity	$100

Table 2: ACo – financial position at 1 July 2010

Land (MV $500)	$50	Equity	$100
Asset 2 (MV $300)	$50		
	$100		$100

Note: MV = market value

At the joining time the pre-CGT proportion of HCo's membership interests in ACo is 0.6. → 'Pre-CGT status of membership interests in a joining entity – pre-CGT proportion rules', C2-4-813, Example 1

On 1 September 2010, HCo sells all its shares in ACo to a third party and ACo leaves the group.

Calculation

Pre-CGT proportion of ACo's membership interests on leaving

a) Calculate the number of pre-CGT membership interests in the leaving entity by using the pre-CGT proportion worked out on entry – s. 711-65(4) and s. 705-125 of the ITAA 1997

100 shares x 0.6 = 60 shares

b) Round down to nearest whole number of pre-CGT membership interests – s. 711-65(3) of the ITAA 1997 *(if applicable)*

In this example the result (60 shares) does not change.

Therefore, of the 100 shares in ACo disposed of, 60 are treated as pre-CGT membership interests. The remaining 40 shares will be subject to the CGT provisions.

Example 2

Facts

HCo, the head company of a consolidated group, owns all 100 shares in ACo. The financial position of ACo at the joining time is shown in table 3.

Table 3: ACo – financial position at 30 June 2003

Cash	$200	Equity	$1,000
Land (MV $2,000)	$1,300	Liabilities	$500
	$1,500		$1,500

On 30 June 2010, HC makes a choice in writing to apply the pre-CGT proportion changes from 1 July 2002 so that the pre-CGT status of membership interests in ACo is preserved by working out a pre-CGT proportion (measured by market value) at the joining time.

At the joining time, the pre-CGT proportion of HCo's membership interests in ACo is 0.30. → 'Pre-CGT status of membership interests in a joining entity – pre-CGT proportion rules', C2-4-813, Example 2

On 31 December 2010, HCo disposes of 80 shares in ACo to a third party and ACo leaves the group.

Calculation

Pre-CGT proportion of ACo's membership interests on leaving

a) Calculate the number of pre-CGT membership interests in the leaving entity by using the pre-CGT proportion worked out on entry – s. 711-65(4) and s. 705-125 of the ITAA 1997

100 shares x 0.30 = 30 shares

b) Round down to nearest whole number of pre-CGT membership interests – s. 711-65(3) of the ITAA 1997 *(if applicable)*

In this example the result (30 shares) does not change.

Of the 80 shares in ACo that are disposed of, HCo chooses to sell 20 shares that are treated as pre-CGT membership interests.

The gain or loss on disposal of these 20 shares is treated as the sale of pre-CGT assets. The remaining 60 shares will be subject to the CGT provisions.

HCo continues to hold 20 shares in ACo:

- 10 shares are pre-CGT assets
- 10 shares are post-CGT assets.

Example 3

Facts

HCo owns all the shares in CCo – which consist of 50 Class A shares and 50 Class B shares. The Class A shares are pre-CGT assets acquired by HCo before 20 September 1985.

On 1 July 2010, HCo forms a consolidated group and CCo is a subsidiary member of the group. The market value of CCo at the joining time is $500. The market value of each Class A share is $7, and the market value of each Class B share is $3.

The pre-CGT proportion of the membership interests in CCo is:

$$\frac{\text{\$350 (market value of pre-CGT membership interests)}}{\text{\$500 (market value of all membership interests)}}$$

= 0.70 (70%)

On 1 September 2010, HCo sells 80 shares (40 Class A and 40 Class B) that it holds in CCo to a third party, and CCo leaves the group.

Calculation

Pre-CGT proportion of CCo's membership interests on leaving

a) Calculate the number of pre-CGT membership interests in the leaving entity by using the pre-CGT proportion worked out on entry – s. 711-65(4), s. 705-125 and s. 711-65(6) of the ITAA 1997

The pre-CGT proportion is applied to each class of CCo's shares as if each class were all the shares held by HCo. → subsection 711-65(6), ITAA 1997

Class A shares: 50 shares x 0.70 = 35 shares
Class B shares: 50 shares x 0.70 = 35 shares

Therefore:

- 35 of the Class A shares are treated as pre-CGT membership interests
- 35 of the Class B shares are treated as pre-CGT membership interests.

b) Round down to nearest whole number of pre-CGT membership interests – s. 711-65(3) of the ITAA 1997 *(if applicable)*

In this example the result for each class of share does not change.

In relation to the 40 Class A shares sold – HCo treats 35 shares as pre-CGT membership interests. The remaining 5 shares will be subject to the CGT provisions.

In relation to the 40 Class B shares sold – HCo treats 35 shares as pre-CGT membership interests. The remaining 5 shares will be subject to the CGT provisions.

HCo continues to hold 10 Class A shares and 10 Class B shares in CCo, all post-CGT assets.

References

Income Tax Assessment Act 1997, section 711-65; as inserted by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1, and amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 3

Explanatory Memorandum to New Business Tax System (Consolidation) Bill 2002 (No. 1), paragraphs 5.147 – 153

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.111 – 5.142

Revision history

Section C2-5-713 first published 6 May 2011.

Worked example

Calculating pre-CGT membership interests in a multiple exit case (with pre-CGT factor attached to assets)

Note:

The pre-CGT factor rules on leaving continue to apply where an entity in which pre-CGT membership interests were held joined a consolidated group before 10 February 2010 and the head company has not made a choice to apply the new pre-CGT proportion rules to that entity. → 'Pre-CGT status of membership interests in a joining entity – pre-CGT proportion rules', C2-4-813

Description

This example shows how to calculate the number of membership interests in multiple exit entities held by

- members of the old group, or
- other multiple exit entities,

that are taken to have been acquired before 20 September 1985 for CGT purposes.

Commentary

When two or more entities (multiple exit entities) leave a consolidated group, the number of membership interests that are deemed to be pre-CGT assets are worked out on a 'bottom up' basis.

In the following example, subsections 711-65(3) to (6) of the *Income Tax Assessment Act 1997* (ITAA 1997) are first applied to work out the number of pre-CGT membership interests that BCo holds in CCo (the first entity). These pre-CGT assets of BCo will be assigned a pre-CGT factor of one for the purpose of working out the number of pre-CGT membership interests that ACo holds in BCo. → section 711-70, ITAA 1997

Where more than one entity holds membership interests in the first entity, the head company can choose which of the membership interests in the first entity will be pre-CGT assets, up to the maximum allowed under the formula in section 711-70 of the ITAA 1997.

Note: The amendments to section 711-65 and section 711-70 contained in *Tax Laws Amendment (2010 Measures No. 1) Act 2010,* Schedule 5, Part 3 have no effect where an entity leaves a consolidated group and pre-CGT factors are attached to some or all of its assets. This will occur where pre-CGT factors were calculated for an entity (in which pre-CGT membership interests were held) that joined the group before 10 February 2010 and the head company did not make a choice to apply the new pre-CGT proportion rules to that entity.

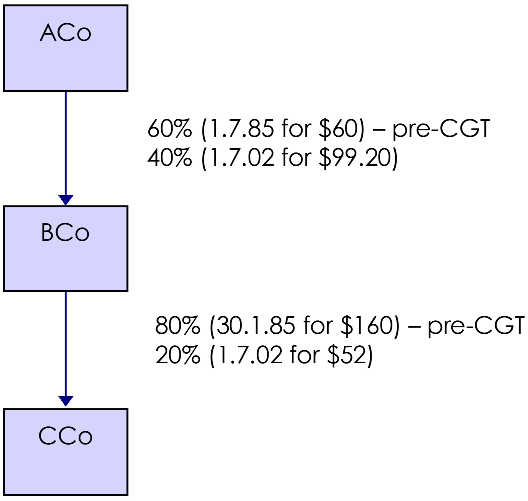
(Sections 711-65 and 711-70 as they stood before *Tax Laws Amendment (2010 Measures No. 1) Act 2010* took effect are reproduced at the end of this worked example.)

Example

Facts

On 1 July 2002, ACo forms a consolidated group with BCo and CCo as its subsidiaries. Total shareholding in both BCo and CCo is 100 shares each. The group structure at formation time, including the cost of membership interests, is shown in figure 1.

Figure 1: Group structure at formation time



Note: In this example CCo is the first entity.

On 30 June 2003, ACo sells 20% of its holding in BCo. The financial positions of ACo, BCo and CCo at this time are shown in tables 1, 2 and 3.

Table 1: ACo – financial position at 30 June 2003

Cash	$140.80	Contributed capital	$300
Shares in BCo (MV $248)	$159.20		
	$300	Total	$300

MV = market value

Table 2: BCo – financial position at 30 June 2003

Shares in CCo (MV $260)	$212	Contributed capital	$200
		Liability – bank loan	$12
Total	$212	Total	$212

Table 3: CCo – financial position at 30 June 2003

Cash	$90	Contributed capital	$200
Land (MV $150)	$100		
Asset 1 (MV $20)	$10		
Total	$200	Total	$200

Calculation

1. Work out the number of pre-CGT membership interests BCo holds in CCo

(a) Calculate leaving entity's pre-CGT proportion – using subsection 711-65(5) of the ITAA 1997 (as it stood at 30 June 2003)

Step 1

Multiply the market values of CCo's non-current assets by their pre-CGT factors. → 'Pre-CGT factor for assets where subsidiary has membership interests in another member – formation before 10 February 2010', C2-4-820

Land:	\$150 x 0.8752941	=	\$131.29
Asset 1:	\$20 x 0.8752941	=	\$17.51

Step 2

Add the results of step 1 to give a result of \$148.80.

Step 3

Work out the market value of all assets that the head company holds in the leaving entity:

Land (\$150) + Asset 1 (\$20) + Cash (\$90) = \$260

Step 4

\$148.80 (step 2) / \$260 (step 3) = 0.572307692

Therefore, the pre-CGT proportion of CCo leaving the group is 0.57.

(b) Calculate number of pre-CGT membership interests – using subsection 711-65(4) of the ITAA 1997 (as it stood at 30 June 2003)

100 shares x 0.572307692 = 57.2307692 shares

(c) Round down to nearest whole number of pre-CGT membership interests – subsection 711-65(3) of the ITAA 1997 *(if applicable)*

= 57

Therefore, of the 100 shares in CCo (a multiple exit entity), 57 are treated as pre-CGT.

2. Work out the number of pre-CGT membership interests ACo holds in BCo

(a) Calculate leaving entity's pre-CGT proportion – using subsection 711-65(5) of the ITAA 1997 (as it stood at 30 June 2003)

Step 1

Multiply the market value of the pre-CGT assets by the assigned factor of 1:

Pre-CGT shares in CCo: 57 shares x $2.60 (MV) x 1 = $148.20

Note: A pre-CGT factor of one is assigned to the asset (membership interests in CCo that were determined to be pre-CGT assets). The balance of the asset (post-CGT shares in CCo) is not included. → paragraphs 711-70(4)(b) and (c), ITAA 1997 (as those paragraphs stood at 30 June 2003)

Step 2

Add the results of step 1 to give a result of $148.20.

Step 3

Work out the market value of all assets that the head company holds in the leaving entity:

Shares in CCo = $260

Step 4

$148.20 (step 2) / $260 (step 3) = 0.57

Therefore the pre-CGT proportion of membership interests in BCo on leaving the group is 0.57.

(b) Calculate number of pre-CGT membership interests – using subsection 711-65(4) of the ITAA 1997 (as it stood at 30 June 2003)

100 shares x 0.57 = 57 shares

(c) Round down to nearest whole number of pre-CGT membership interests – subsection 711-65(3) of the ITAA 1997 *(if applicable)*

= 57

Therefore, of the 100 shares in BCo (a multiple exit entity), 57 are treated as pre-CGT.

References

Income Tax Assessment Act 1997, sections 711-65 and 711-70; as inserted by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1, and amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 3

Explanatory Memorandum to New Business Tax System (Consolidation) Bill 2002 (No. 1), paragraph 5.153

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.111 to 5.142

Revision history

Section C2-5-715 first published 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
6.5.11	Significant revisions to reflect changes to the method of working out the proportion of the pre-CGT membership interests in a joining entity.	Legislative amendments.

Section 711-65 as it stood prior to *Taxation Laws Amendment (2010 Measures No. 1) Act 2010*

711-65 Membership interests treated as having been acquired before 20 September 1985 – simple case

When this section applies

(1) This section applies if:

(a) any of the assets (a *pre-CGT factor asset*), that the *head company of the old group holds at the leaving time because the leaving entity is taken by subsection 701-(1) to be a part of the head company, has a *pre-CGT factor under section 705-125; and

(b) section 711-70 (about the multiple exit of *subsidiary members) does not apply; and

(c) the leaving entity does not cease to be a subsidiary member of the old group where Subdivision 705-C (about the old group joining another consolidated group) applies.

Interests treated as if purchased before 20 September 1985

(2) If this section applies, a number of the *membership interests in the leaving entity that *members of the old group hold are taken to have been acquired before 20 September 1985.

Note: Because of the deemed acquisition of the membership interests, this section is the only basis on which any of these interests can be pre-CGT assets.

Number of pre-CGT membership interests

(3) The number is the result of the formula in subsection (4), rounded down to:

(a) the nearest whole number if the result is not already a whole number; or

(b) zero if the result is a number more than zero but less than one.

Formula

(4) The formula is:

Number of *membership interests in leaving entity held by *members of old group	x	Leaving entity's pre-CGT proportion

where:

leaving entity's pre-CGT proportion is the amount worked out under subsection (5).

Pre-CGT proportion

(5) Work out the leaving entity's pre-CGT proportion in this way:

Leaving entity's pre-CGT proportion

Step 1. For each *pre-CGT factor asset, multiply its *market value before the leaving time by its *pre-CGT factor.

Step 2. Add up all the results of step 1.

Step 3. Add up the *market values of all the assets that the *head company holds at the leaving time because the leaving entity is taken by section 701-1 to be a part of the head company.

Step 4. Divide the result of step 2 by the result of step 3.

Dealing with classes of membership interests

(6) If there are 2 or more classes of *membership interests in the leaving entity, this section operates separately in relation to each class as if the interests in that class were all the interests in the entity.

Allocation of the number to particular membership interests

(7) The *head company must choose which particular *membership interests comprise the number worked out under subsection (2).

Modification if leaving entity is a trust

(8) If the leaving entity is a trust, a *membership interest in it is not taken into account under this section unless the membership interest is either a unit or an interest in the trust.

Section 711-70 as it stood before *Taxation Laws Amendment (2010 Measures No. 1) Act 2010*

711-70 Membership interests treated as having been acquired before 20 September 1985 – multiple exit case

(1) If 2 or more entities (multiple exit entities) cease to be *subsidiary members of the old group at the same time because of an event happening in relation to one of them (other than where Subdivision 705-C applies), a number of the *membership interests (*subject interests*) held in any multiple exit entity by:

(a) *members of the old group; or

(b) other multiple exit entities; or

(c) any combination of paragraphs (a) and (b);

are taken to have been acquired before 20 September 1985.

Numbers to be worked out first for bottom entities

(2) Numbers are to be worked out first for subject interests in multiple exit entities that do not themselves hold any of the subject interests in other multiple exit entities.

Numbers to be worked out progressively up to those subject interests held only by members of the old group

(3) If the holders of other subject interests are or include multiple exit entities, numbers must be worked out for the former subject interests before both the latter and any subject interests whose holders consist entirely of *members of the old group.

How to work out the numbers

(4) The number for subject interests in a particular multiple exit entity that is required to be worked out under subsection (2) or (3) is worked out by applying subsections 711-65(3) to (6) as if:

(a) a reference in those subsections to *membership interests that members of the old group hold in the leaving entity were a reference to the subject interests; and

(b) assets (previously numbered assets) of the multiple exit entity consisting of other subject interests for which a number has been worked out as required by subsection (2) or (3) of this section were assets that the *head company holds at the leaving time because the entity is taken by section 701-1 to be a part of the *head company; and

(c) each previously numbered asset were treated as having a *pre-CGT factor of 1.

Example: Companies A, B, C, D and E are all subsidiary members that leave the old group at the same time. Just before the leaving time, company A owned shares in company B and company C, and company B owned shares in companies D and E.

First, work out company A's number for membership interests in company C and company B's number for membership interests in companies D and E.

Next, work out company A's number for membership interests in company B, taking into account the number just worked out for company B's assets consisting of shares in companies D and E.

Finally, work out the old group's number for membership interests in company A, taking into account the numbers worked out for its assets consisting of shares in companies B and C.

Note: Because of the deemed acquisition of the membership interests, this section is the only basis on which any of the subject interests can be pre-CGT assets.

Allocation of the number to particular membership interests

(5) The *head company must:

(a) choose which particular *membership interests comprise any number worked out under this section; and

(b) if any *membership interest that is so chosen is held by a multiple exit entity—inform that entity of the fact.

Modification if leaving entity is a trust

(6) A *membership interest in a trust that is one of the multiple exit entities is not taken into account under this section unless the membership interest is either a unit or an interest in the trust.

Worked example

Consolidated and MEC groups – CGT rollover relief

Description

This example explains the circumstances under which CGT rollover relief under Subdivision 126-B of the *Income Tax Assessment Act 1997* (ITAA 1997) is available for asset transfers within wholly-owned groups.

Commentary

Broadly, CGT rollover relief for asset transfers within a wholly-owned group ceases on 30 June 2003 or when the group consolidates, whichever is earlier (in line with the end of the grouping provisions → 'Choosing', B1-1). However, after the introduction of consolidation, a limited form of CGT rollover relief is available for asset transfers within wholly-owned groups between:

- two foreign-resident companies, and
- a foreign-resident company and:
  - the head company of a consolidated group
  - the provisional head company of a multiple entry consolidated (MEC) group, or
  - a company that is not a member of a consolidatable group.

Note that the rollover could require an adjustment (step 3A) to an entity's allocable cost amount (ACA). → 'Pre-joining time rollover from foreign-resident company or a company that became the head company (ACA step 3A)', C2-4-270

→ Subdivision 126-B, ITAA 1997

CGT rollover relief remains available for a limited time beyond 1 July 2003 for asset transfers within wholly-owned groups headed by a company with a substituted accounting period (SAP) if certain conditions are satisfied. These conditions are explained later.

Example

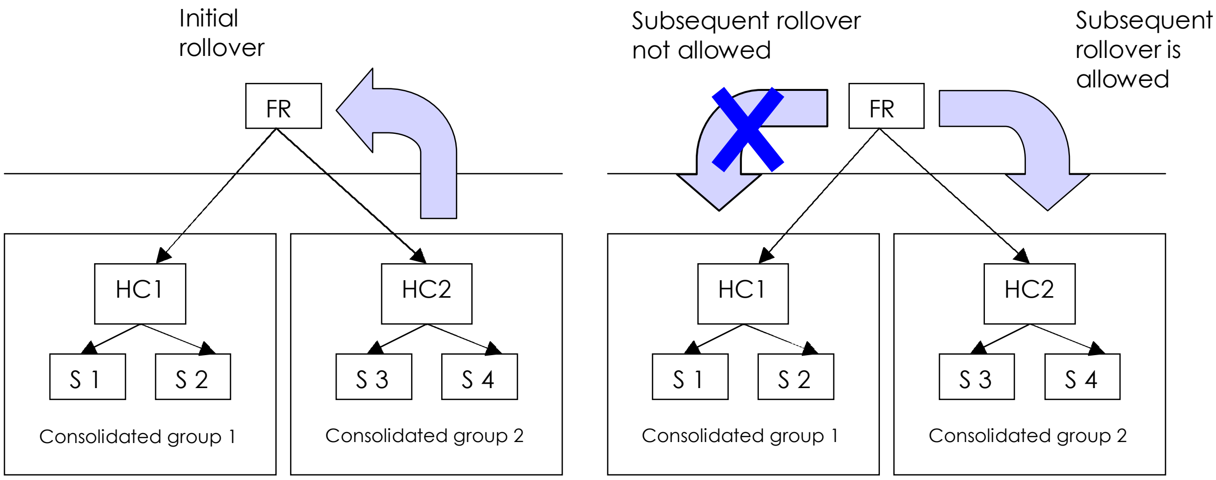
(a) Rollover between a foreign-resident company and a head company of a consolidated group

After consolidation, rollover relief will be available within a wholly-owned group for asset transfers between the head company of a consolidated group and a foreign-resident company.

An asset rolled over to a foreign-resident company (FR) by the head company (HC) of a consolidated group cannot be rolled over again to another Australian company by the foreign-resident company – it can only be rolled back to the same head company. (Note that due to the application of the single entity principle, the transfer of an asset involving a subsidiary member of a consolidated group is taken to be a transfer involving the head company of the group.)

In figure 1, HC2 transfers an asset to foreign resident FR and they choose rollover relief. Subsequent rollover relief will be available should the foreign resident FR transfer the asset back to HC2, but relief will not be available for a transfer to HC1.

Figure 1

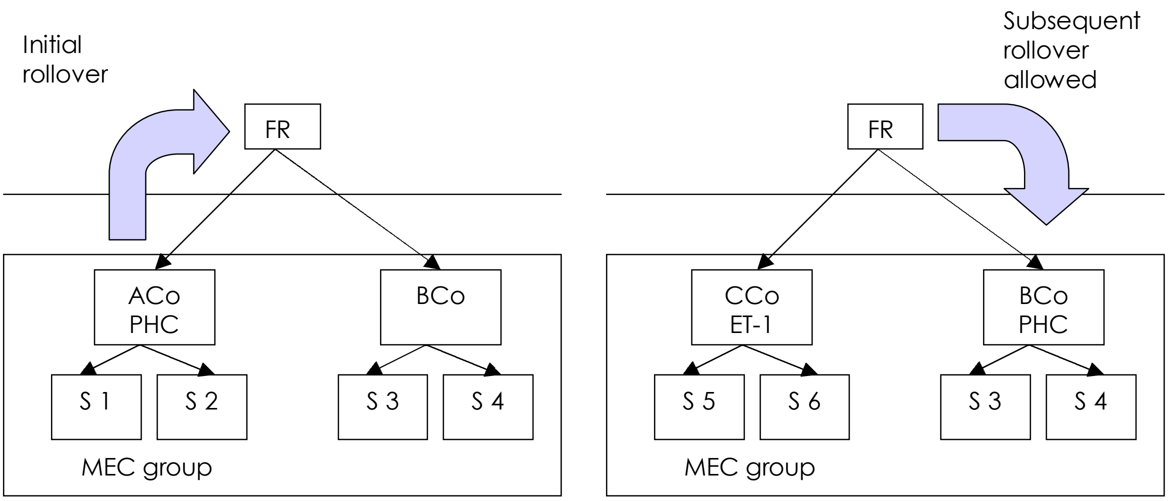


(b) Rollover between a foreign-resident company and a head company of a MEC group

This rule is relaxed for MEC groups to provide for possible changes in the provisional head company (PHC) of the group. If an asset is rolled over by the PHC of a MEC group to a foreign-resident company of the same wholly-owned group, that asset can subsequently be rolled back by the foreign-resident company to a different PHC of the same MEC group.

In figure 2, ACo, the PHC of the MEC group, rolls over an asset to foreign resident FR. ACo, S1 and S2 leave the MEC group and BCo is appointed PHC. CCo, S5 and S6 then join the MEC group. FR can roll over the asset to BCo, which is the new PHC of the same MEC group.

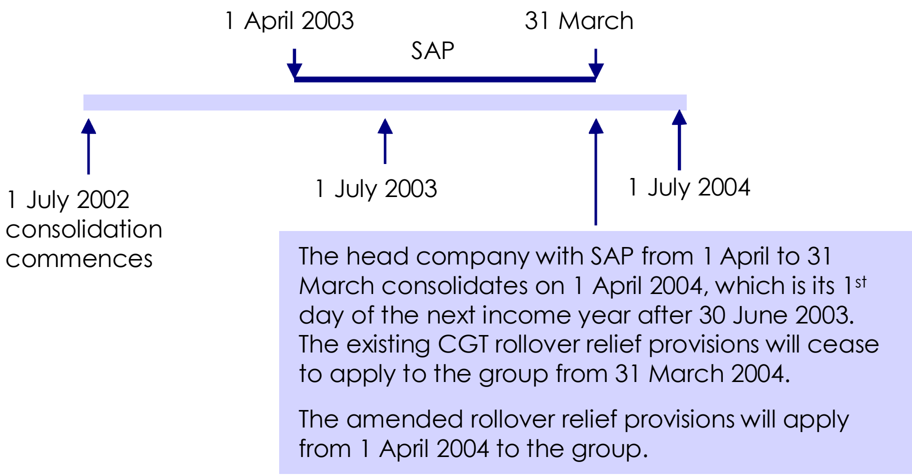
Figure 2



(c) Groups with substituted accounting periods (SAPs)

CGT rollover relief in its current form will be extended beyond 1 July 2003 for a group with a head company (or provisional head company) that has a SAP only if the group consolidates on the first day of the head company's next income year after 30 June 2003. The extension will be from 1 July 2003 to the date of consolidation.

Figure 3



For rollover relief in its current form to apply, each of the following conditions must be satisfied:

- the company from which the asset was rolled over must become a member of the consolidated group on the day it forms
- the company should not have been a member of another consolidated or MEC group, and
- the group must consolidate on the first day of its head company's next income year after 30 June 2003 and before 1 July 2004.

For SAP groups that consolidate on any other date, rollover relief in its current form will cease to apply on 1 July 2003.

Modifications to CGT event J1 – consolidated groups

Generally, CGT event J1 happens if there has been, under Subdivision 126-B, a rollover involving a CGT asset between two companies that are members of the same wholly-owned group, and the company that owns the CGT asset after the rollover stops being a wholly owned member of that group. The purpose of CGT event J1 is to reverse the benefit of the rollover.

An amendment to Subdivision 104-J of the ITAA 1997 ensures that CGT event J1 is not triggered if, after 30 June 2002, the company that owns the CGT asset after the rollover ceases to be a subsidiary member of a consolidated group (whether or not the company becomes a subsidiary member of another consolidated group at that time).

Pre-formation rollover after 16 May 2002 and transitional groups

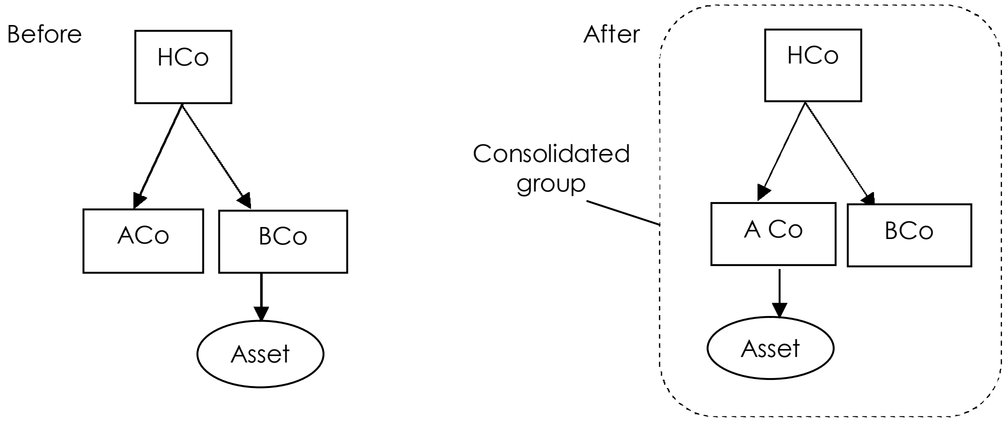
If there has been a rollover of an asset under Subdivision 126-B or under item 4 of the table in subsection 40-340(1) of the ITAA 1997, and:

- the rollover was after 16 May 2002
- the group consolidates after the rollover but before 1 July 2004, and
- because of the rollover, the tax values of the assets of the group are different from what they would have been if the rollover had not happened,

the rollover is disregarded for tax cost setting purposes on consolidation, with certain exceptions. → sections 701-35 and 719-163, *Income Tax (Transitional Provisions) Act 1997*

The rule is intended to prevent groups from using rollover relief to maximise their choices for the cost setting of their assets on consolidation.

Figure 4: Example: Subdivision 126-B asset rollover



BCo rolls over an asset to ACo after 16 May 2002.

HCo, ACo and, BCo form a consolidated group before 1 July 2004.

If the tax values of the assets of the group are now different to what they would have been had the rollover not taken place, the costs of the assets are reset as if the rollover had not taken place.

Exemption for restructuring purposes

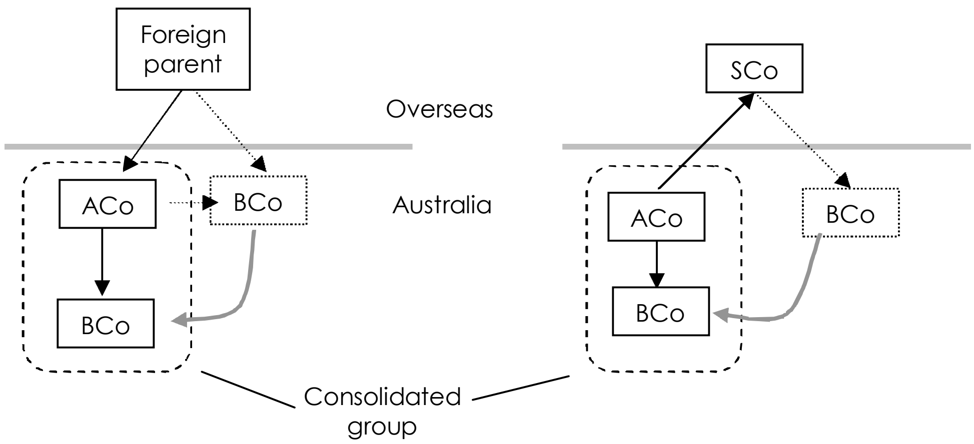
To enable a foreign-owned group that is restructuring to reset the cost of its assets on consolidation, an exception to the above rule exists where the following conditions are satisfied:

- the rollover asset is a membership interest in an entity
- the membership interest is rolled-over from a foreign-resident company to an Australian-resident company

- the entity whose membership interests were rolled-over becomes a subsidiary member of a consolidated or MEC group at the time of formation
- the group is a transitional group, and
- the entity is not an eligible tier-1 company of a MEC group or an entity in which a foreign-resident company or a non-resident trust holds membership interests.

Figure 5a: Subdivision 126-B: Eligible tier-1 company rolled under

Figure 5b: Subdivision 126-B: Foreign held subsidiary rolled under



In figure 5a, the foreign parent rolls over its membership interests in BCo to ACo after 16 May 2002.

ACo and BCo form a consolidated group after the rollover but before 1 July 2004.

In this case, the rollover of the membership interests is *not* disregarded when the cost of the assets of the group are reset.

In figure 5b, SCo, a foreign subsidiary of ACo, rolls over its membership interests in BCo to ACo after 16 May 2002. ACo and BCo form a consolidated group after the rollover but before 1 July 2004.

In this case, the rollover of the membership interests is *not* disregarded when the cost of the assets of the group are reset.

Exception where there is a demerger

There is also an exception if the rollover happens before a demerger and is in connection with the demerger, and

- either the originating company or the recipient company ceases to be a member of the 'demerger group' (as defined in section 125-65 of the ITAA 1997) because of the demerger, and
- the recipient company and the originating company do not both join the same transitional group.

References

Income Tax Assessment Act 1997, sections 104-182, 126-40 and 126-50; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 3

Income Tax Assessment Act 1997, sections 705-93, 705-147, and 705-227; as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010) Schedule 5, Part 5

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 13.9 – 13.16 and 13.25 – 13.32

*Income Tax (Transitional Provisions) Act 1997, s*ection 701-35; as amended by *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 7

Explanatory Memorandum to New Business Tax System (Consolidated, Value shifting, Demergers and Other Measures) Bill 2002, paragraphs 1.104 – 1.107

Income Tax (Transitional Provisions) Act 1997, sections 701-35 and 719-163; as amended by:

- *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 17
- *Tax Laws Amendment (2006 Measures No 4) Act 2*006 (No. 168 of 2006), Schedule 2

Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, paragraphs 5.75 – 5.88

Income Tax Assessment Act 1997, section 40-340

Explanatory Memorandum to Tax Laws Amendment (2006 Measures No. 4) Bill 2006

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.158 – 5.179

Revision history

Section C2-5-720 first published 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
6.5.11	Revisions to reflect changes to the pre-formation rollover (step 3A) provisions.	Legislative amendment.

Worked example

Continuing majority-owned entity and internally generated assets

Description

This worked example shows how the exit cost setting rules are modified where a leaving entity that was a continuing majority-owned entity takes certain internally generated assets with it.

Commentary

Where the head company of a consolidated group ceases to hold certain internally generated assets brought into the group by an entity that was a continuing majority-owned entity, the application of the cost setting rules is modified by section 701A-10 of the *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A). This section operates to prevent an unintended tax deferral. A joining entity is a continuing majority-owned entity where a person or persons continued to be majority beneficial owners (directly or indirectly) of it from the start of 27 June 2002 until the joining time.

An unintended tax deferral can occur where an internally generated asset is allocated a tax cost setting amount from which the head company can claim a deduction for a decline in value under Division 40 of the ITAA 1997 and some or all of the costs incurred in constructing or creating the asset were already deductible to the joining entity.

For the purposes of section 701A-10, an internally generated asset is an asset for which more than 50% of the total expenditure incurred in constructing or creating it was of a revenue nature and was deductible by the entity that constructed or created the asset.

An internally generated asset will be subject to reduced deductions for a decline in value under section 701A-10 where:

- it is a joining entity's depreciating asset that becomes a depreciating asset of the head company on consolidation
- it was in existence at the start of 27 June 2002
- the continuing majority-owned entity’s terminating value for the asset is less than the asset’s tax cost setting amount, and
- for each balancing event that occurred for that asset before the continuing majority-owned entity became a subsidiary member of the group, there was rollover relief under section 40-340 of the ITAA 1997.

Section 701A-10 ascribes a dual ‘cost’ to these internally generated assets on consolidation:

- when working out the decline in value under Division 40, the first element of the asset’s cost is taken to be equal to the entity's terminating value for the asset

- when a balancing adjustment event occurs or if the asset leaves the group with a leaving entity, the cost is the asset's tax cost setting amount less any decline in value that has since been calculated.

Where the head company ceases to hold the asset because an entity leaves the consolidated group, the leaving entity's exit ACA, worked out under section 711-30 of the ITAA 1997, is increased by the shortfall between:

- the deductions for the internally generated asset's decline in value up to the time when the balancing adjustment event occurs (worked out as if the tax cost setting amount was equal to the continuing majority-owned entity's terminating value for the asset), and
- the deductions that would have been worked out using the internally generated asset's actual tax cost setting amount.

Example

Note that 'termination value' (used in example 1.15) is different to 'terminating value'. The former is defined in the section 995-1 dictionary, by way of reference to section 40-300, and the latter is defined in section 711-30.

Facts

Melro Co, a continuing majority-owned entity, joins the Glam consolidated group on 1 July 2003. As a consequence, Glam (the head company) is taken to hold Melro's database application, an internally generated asset.

The tax cost setting amount of the database application is $200,000, which is greater than the $50,000 adjustable value of the asset in Melro's hands immediately before consolidation. (The $50,000 is the asset's terminating value.) Assuming the remaining effective life is 5 years, the prime cost method is used to calculate the decline in value, and the asset is used only for a taxable purpose, the Glam Group is allowed a deduction for the asset's decline in value of $10,000 for the income year ending 30 June 2004.

On 30 June 2004, Glam sells the shares in Melro, which therefore leaves the group. The only asset that Melro takes with it is the database application, the internally generated asset. Assume the market value of the shares in Melro is $180,000 (equal to the market value of the database application).

Calculation

Work out the implications of the internally generated asset leaving the consolidated group.

The Glam group's tax cost setting amount for the asset was $200,000. The asset's adjustable value just before leaving time is $160,000 – i.e. $200,000 - ($200,000/5 years) x 1 year.

Depreciation actually allowed to Glam group is restricted under paragraph 701A-10(2)(a) to the decline in value based on the adjustable value of the internally generated asset just before the joining time (i.e. $50,000). Therefore, only $10,000 ($50,000 / 5 years) is allowed for the income year ending 30 June 2004.

The exit ACA step 1 amount before the adjustment under paragraph 701A-10(2)(b) is $160,000 (the terminating value of the asset, which is its adjustable value in the hands of Glam group just before the leaving time). This is different to the adjustable value of $50,000 that Glam group was limited to in determining the depreciation deduction it could actually claim.

Under paragraph 701A-10(2)(b), the exit ACA is increased by the shortfall between the notional depreciation that would have been allowable to Glam based on an adjustable value equal to the tax cost setting amount of $200,000 and the amount actually allowed based on the terminating value of $50,000 at Melro's joining time (i.e. $40,000 - $10,000 = $30,000).

The final exit ACA is therefore $190,000 ($160,000 + $30,000). This becomes the cost base and reduced cost base of shares. If all of the shares were sold at the market value of $180,000, the Glam group would get a net capital loss of $10,000. This matches the net result when the asset is sold directly, as per example 1.15 of the Explanatory Memorandum accompanying the New Business Tax System (Consolidation and Other Measures) Bill (No.1) 2002.

References

Income Tax (Transitional Provisions) Act 1997, section 701A-10; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 9

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No.1) 2002, paragraphs 1.151-1.152

Income Tax Assessment Act 1997, section 711-30; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Income Tax Assessment Act 1997, section 40-340

Income Tax Assessment Act 1997, section 995-1

Revision history

Section C2-5-810 first published 2 December 2002.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Effect of Subdivision 165-CC for steps 1 and 2 of the ACA calculation at formation and joining times

When the head company chooses to consolidate, or an entity joins an existing consolidated group, it is necessary to determine the cost setting amount for the assets the head company is taken to hold under the single entity principle. The method chosen to set the cost of the assets will depend on a number of factors, including whether the group is formed during or after the transitional period.

Whenever the allocable cost amount (ACA) method is used to calculate the cost setting amount for the head company's first-tier subsidiaries' assets, it may be necessary to make certain adjustments to take account of Subdivision 165-CC changeover times (all legislative references are to the ITAA 1997 unless otherwise stated).

For example, Division 715 modifies the reduced cost bases of the head company's membership interests at step 1 and intragroup liabilities at step 2 of the ACA calculation where there was a Subdivision 165-CC changeover time before formation or joining time and an adjusted same business test (SBT) is failed.

Broadly, if an adjustment is necessary, the reduced cost base of the interests is reduced to market value – but only to the extent of the residual unrealised net loss (RUNL) balance of the entity that owns the interests.

The purpose of the adjustments is to ensure that inappropriate amounts are not pushed down onto the value of the assets under the cost setting rules on consolidation.

The same adjustments can also apply to the membership interests and intragroup liabilities of a chosen transitional entity in a formation case.

The Division 715 provisions may apply to the consolidation cost setting rules in sections 705-65 and 705-75 where the head company (or a chosen transitional entity during the transitional period) has failed the adjusted SBT and had a changeover time at or before the formation or joining time. The reduced cost bases of membership interests at step 1 and intragroup liabilities (e.g. intragroup debt) at step 2 of the ACA calculation may be reduced.

There are no reductions to the reduced cost bases of membership interests or liabilities of a head company (or a chosen transitional entity) at formation or joining time where the entity has not had a changeover time at or before consolidation.

To ensure that potential losses from any 'unrealised assets' and Subdivision 170-D deferred loss amounts from a changeover time are appropriately dealt with, Division 715 modifies the approach taken in Subdivision 165-CC where a consolidated group forms or entities enter or leave such a group.

Application of Subdivision 715-A to steps 1 and 2

Subdivision 165-CC has ongoing application to the head company of a consolidated group but not to entities within such a group. It will be necessary for the head company to determine if a Subdivision 165-CC changeover time at or before formation or joining times will have any impact on the calculation of ACAs.

Adjustments may be required where there was such a changeover time and:

- the head company fails the adjusted SBT set out in paragraphs 715-50(1)(d) and 715-55(1)(d), and
- there are membership interests or liabilities in the joining entity that are *165-CC tagged assets* at the relevant time → section 715-30.

The same adjustments can apply to the membership interests and liabilities of chosen transitional entities at formation.

Same business test adjusted for consolidation purposes

In the consolidation environment the SBT under subsections 715-50(1)(d) and 715-55(1)(d) has regard to the trial year before the formation or joining time and the time just before the changeover time. The trial year is defined in section 707-120 and is usually from 12 months before the formation or joining time to just after those times. It is assumed that the entity carried on at and just after the joining time the same business that it carried on just before the joining time.

Examples

In the following examples it is assumed that the head company or a chosen transitional entity has each had a relevant changeover time and failed the SBT.

Head company formation

Adjustment 1

The reduced cost base of the head company's membership interest in a subsidiary at formation time may be reduced if it is relevant to the step 1 amount.

The amount of the step 1 reduction will depend on the market value of the membership interest at formation time and the formation RUNL (that is, the RUNL amount of the head company just before formation time).

The reduced cost base is adjusted to the market value at formation time but only to the extent of the formation RUNL amount.

Following this adjustment the formation RUNL amount is reduced. If there is any amount of formation RUNL amount remaining after the step 1 reductions, adjustment 2 may be necessary.

Adjustment 2

If after the step 1 adjustments are completed some formation RUNL amount remains, and the reduced cost base of an asset constituted by an intragroup liability is the relevant amount for step 2 purposes (subsection 705-75(2)), then the reduced cost base of that asset may also be adjusted. The reduction to the step 2 amount will depend on:

- the remaining amount of the formation RUNL, and
- the market value of the asset that is the liability.

The step 2 amount is adjusted to the market value but only to the extent of the formation RUNL.

Following that adjustment the formation RUNL is reduced by that amount.

(If necessary the step 2 amount may be adjusted even though there was no step 1 adjustment.)

Other consequences

Where the above adjustments are completed and the head company has some remaining formation RUNL as well as 165-CC tagged assets or Subdivision 170-D deferred loss amounts, a loss denial pool of the head company may be created if the formation time is not a changeover time for the head company.

Chosen transitional entity (CTE) – formation

The rules described above apply in the same way to a subsidiary that is a chosen transitional entity when a consolidated group forms.

Adjustments may be made to the reduced cost bases of a CTE's membership interests and assets that represent intragroup liabilities in a non-chosen subsidiary at formation time. The adjusted reduced cost bases can form part of the CTE's ACA for the non-chosen subsidiary members.

There may also be further consequences if a formation RUNL balance remains after any such adjustments. A separate loss denial pool in respect of each subsidiary may be created in the head company (section 715-70). For this consequence to arise there must also be remaining 165-CC tagged assets or Subdivision 170-D deferred losses and the formation time cannot be a changeover time.

Head company – entity joins existing group

Where an entity joins an existing consolidated group there may be consequences for the head company of that group if the SBT, as adjusted for consolidation, is failed. There can be reductions for membership interests or assets that constitute intragroup liabilities of the head company in the entity where the reduced cost bases of the interests are used for ACA purposes and those interests were Subdivision 165-CC tagged assets for the most recent changeover time for the head company.

In these circumstances, the same adjustments 1 and 2 are used as for the head company formation case outlined above.

It is important to note that in these circumstances the trial year for the head company SBT ends immediately after the joining time for the joining entity and starts 12 months before that time. The RUNL just before joining time for the head company is reduced by the adjustments made to the reduced cost bases of membership interests and assets relating to liabilities. When the RUNL balance is reduced to nil, no further adjustments are necessary. There are no consequences for other 165-CC tagged assets of a joining company. However, a loss denial pool in respect of Subdivision 170-D deferred loss amounts that relate to 165-CC tagged assets of the joining company at a changeover time may be formed in the head company.

Note also that a subsidiary entity becoming a member of an already formed consolidated group cannot be a chosen transitional entity.

References

Income Tax Assessment Act 1997:

- Division 705
- Subdivisions 165-CC, 170-D

New Business Tax System (Consolidation and Other Measures) Act 2003 (No. 16 of 2003), Division 715, Schedule 7

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 11

Revision history

Section C2-6-110 first published 28 May 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Effect of Subdivision 165-CC where an entity leaves a consolidated group

When an entity ceases to be eligible to be a member of a consolidated group – referred to in this section as a leaving entity – Division 715 of the ITAA 1997 may require adjustments to the adjustable values of certain assets that leave the group or the creation of a loss denial pool in the leaving entity. In some cases the head company must fail an adjusted same business test (SBT) to trigger the adjustments.

Broadly, whether adjustments to adjustable values or creating a loss denial pool are necessary will depend on whether the:

- head company has a RUNL at the leaving time (leaving RUNL) from a Subdivision 165-CC changeover time that happened during the period of consolidation but before leaving time, and whether one or more of the assets at that changeover time are in the leaving entity
- head company has one or more loss denial pools and some or all of the assets in the pool leave with the leaving entity, and
- leaving time is a changeover time for the leaving company.

There are no continuing implications under Subdivision 165-CC for the head company in respect of assets that it held at its last changeover time during consolidation and that leave the group in the leaving entity.

RUNL from changeover time during consolidation period

If the head company has a RUNL from a changeover time that occurred during the period of consolidation, it will – in certain circumstances – have to choose a method of adjusting the adjustable values of the leaving assets or create a loss denial pool. The head company must make such a choice where the following occurs:

- the leaving time is not a changeover time for a leaving company, or the leaving entity is a trust
- the head company's last changeover time was at or after the group came into existence and before the leaving time
- just before the leaving time the head company owned at least one 165-CC tagged asset (as defined in section 715-30) that it owned at the latest changeover time
- one or more of the assets (leaving assets) in the above point become assets of the leaving entity at leaving time (because the single entity principle ceases to apply)
- the head company's leaving RUNL at the subsidiary's leaving time is greater than nil, and
- the head company fails the adjusted SBT → section 715-95(3).

Where the adjusted SBT is passed there are no consequences for the head company or the leaving entity. If the leaving entity is a company, a subsequent Subdivision 165-CC changeover time will be determined using the head company's reference time and assuming that all the membership interests in the leaving entity have been held by the head company from the reference time to immediately before the leaving time.

The head company makes the choice about the method used to adjust the adjustable values of the leaving assets or create a loss denial pool and must notify the leaving entity. Any adjustments to the adjustable values are done 'just before leaving time'. The tax cost setting process for membership interests in the leaving entity process may use the adjusted reduced cost bases of leaving entity assets in Division 711 → section 711-20(2).

The head company must choose which method is to be used within six months of the leaving time, or within a further period allowed by the Commissioner, and provide a notice to the leaving entity within a month of that choice being made. Where no choice is made, the head company will be treated as having made the first choice.

First choice: Adjustable values of leaving assets are reduced to nil

The head company may choose to reduce the adjustable value of each leaving asset to nil. This choice will take effect just before the leaving time. Where this choice is exercised the leaving RUNL (i.e. the final *RUNL* at leaving time) of the head company is not reduced.

The effects of the choice on assets with different characteristics are set out in the table in section 715-145. Very broadly, the adjustable value to be reduced just before leaving time will depend on the character of the asset. For example, if the asset is a revenue asset the adjustable values to be adjusted are its reduced cost base and the amount that would be subtracted in calculating a profit or loss.

Second choice: Head company's RUNL is applied to reduce the adjustable value of loss assets

Where this choice is made the head company's leaving RUNL is effectively applied to reduce the adjustable values of leaving assets that are loss assets. Broadly, to determine if the asset is a loss asset a notional gain or loss is calculated by comparing the market value of the asset just before the leaving time with its adjustable value. The adjustable value is then reduced to the asset's market value to reduce potential losses but the reduction cannot exceed the leaving RUNL.

Third choice: A loss denial pool is created in the leaving entity

The head company may choose that a loss denial pool be created in the leaving entity. Note that a loss denial pool can be created in a leaving entity that is a trust.

This choice can only be made if every asset that is a *165-CC tagged asset* that the head company owned just before the leaving time and that it owned at its most recent changeover time leaves in the leaving entity.

Where this choice is made the loss denial pool consists of the leaving assets and the loss denial balance for that pool is equal to the head company's leaving RUNL.

Leaving entity cancels loss denial pool

Provided a choice is made within six months after the loss denial pool is created in the leaving entity (or within a further period allowed by the Commissioner), the leaving entity may choose to be treated as if the head company had made the first or second choice above. If this choice is made the loss denial pool will cease to exist just after the leaving time and at the leaving time the adjustable value of each CGT asset in the pool is reduced to what it would have been at that time if the head company had instead made the choice now specified by the leaving entity.

Leaving assets are in head company loss denial pool

Where a subsidiary member (company or trust) of a consolidated group leaves the group with an asset that was in a loss denial pool of the head company, provided that the leaving time is not a changeover time for the leaving entity if it is a company, the head company must make one of three choices. The first two choices are broadly the same as the choices discussed above. That is:

- The adjustable values of leaving assets may be reduced to nil. The reduction has effect just before leaving time and the balance of the head company's loss denial balance is not reduced because of the choice made → 715-125.
- The head company's leaving RUNL is effectively applied to reduce the adjustable values of leaving assets that are loss assets. Broadly, to determine if the asset is a loss asset a notional gain or loss is calculated by comparing the market value of the asset just before the leaving time with its adjustable value. The adjustable value is then reduced to the asset's market value to reduce potential losses but the reduction cannot exceed the leaving RUNL.

The third choice is only available where every asset that was in the loss denial pool just before the leaving time is a leaving asset. A loss denial pool consisting of each of these leaving assets is created in the leaving entity at the leaving time. This loss denial pool is distinct from any other loss denial pool of the leaving entity. Further, when the loss denial pool is created, its loss denial balance must equal the loss denial balance of the head company's loss denial pool as reduced by any previous reductions → sections 715-130 and 715-160.

The head company's loss denial pool ceases to exist when the leaving entity's loss denial pool is created. The leaving entity can choose to cancel this pool under certain circumstances.

Leaving time is a changeover time for leaving company

If the leaving entity is a company, Subdivision 165-CC will apply to it after the leaving time. The leaving entity determines if the leaving time is a changeover time using the head company's reference time and assuming that all the leaving company's membership interests were held by the head company from its reference time to immediately before the leaving time.

If the leaving time is a changeover time for the loss company, Subdivision 165-CC applies normally to the company except that the continuity period relevant to the SBT in Subdivision 165-CC is taken to end just after the leaving time.

Example

In 2003 there is a changeover time for the head company of a consolidated group. At changeover there was an unrealised net loss of $5 million on assets X, Y and Z. A subsidiary member, ACo, subsequently leaves the group with assets X and Y (no changeover time on leaving). The adjusted SBT is failed and there is a leaving RUNL for the head company. Because ACo did not leave the consolidated group with all of the remaining changeover time assets the head company may do one of the following:

- Reduce the adjustable values of the assets to their market values just before the leaving time. The sum of the reductions cannot exceed the leaving RUNL. In these circumstances the head company's leaving RUNL is reduced by the amount of the reductions.
- Reduce the adjustable values of assets X and Y to nil.

References

Income Tax Assessment Act 1997, Subdivisions 165-CC, 170-D

New Business Tax System (Consolidation and Other Measures) Act 2003 (No. 16 of 2003), Division 715, Schedule 7

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 11

Revision history

Section C2-6-120 first published 28 May 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Effect of Subdivision 165-CD for consolidated groups

The purpose of Subdivision 165-CD of the ITAA 1997 is to prevent loss duplication on certain direct and indirect interests in a company that has an alteration time and has realised and unrealised losses at that time.

In a consolidated environment, the effect of Subdivision 715-B is that under the single entity rule (extended for Subdivision 165-CD purposes) only the head company can have an alteration time.

This section provides an overview of the impact a Subdivision 165-CD alteration time may have in a consolidated environment, including:

- the impact of an alteration time that happens before formation of a consolidated group
- the impact of an alteration time where it occurs during consolidation
- the consequences of a company leaving a consolidated group, whether or not the leaving time is an alteration time, and
- the consequences where the leaving entity is a trust.

Broadly, Subdivision 165-CD can apply where an alteration time occurs in relation to a loss company. An alteration time can occur when certain changes in the control or ownership of the loss company occur or the liquidator of a loss company declares that shares in the company are worthless.

Notice of alteration time

Subsections 165-115ZC(4) and (5) of the ITAA 1997 require an entity that has a controlling stake in the loss company, or the loss company itself, to give a notice to associates that have a relevant interest in the loss company. The notice must contain information on the alteration time and the nature and extent of the loss company's losses.

The purpose of the notice is to ensure that recipients have sufficient information to comply with their obligations under Subdivision 165-CD. However, the recipient entity is required to comply with this Subdivision even if it does not receive the notice.

The notice requirements in section 165-115ZC(4) and (5) of the ITAA 1997 are modified during the consolidation transitional period by section 165-115ZC(5) of the IT(TP)A 1997.

→ sections 165-115ZC of the ITAA 1997 and 165-115ZC of the IT(TP)A 1997; paras 1.168– 1.182 of the Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2005

Alteration time before formation

When a consolidated group forms there is generally no need to adjust membership and debt interests of the head company or a chosen transitional entity that are direct or indirect interests in a company that had an alteration time before formation. This will be the case where Subdivision 165-CD has applied using the individual asset method to make adjustments to the adjustable values of those interests.

However, where the global method of asset valuation for Subdivision 165-CD purposes has been used to determine the unrealised losses, there is a special rule in subsections 705-65(3A) and 705-75(3) that may require further adjustments to membership and debt interests in a joining entity.

Also, formation time adjustments to interests (e.g. membership and debt interests) held in a chosen transitional entity are not required because the allocable cost amount method is not used to calculate the tax value of its assets.

The comments above also apply to membership interests and debts the head company has in a joining entity where they are direct or indirect interests in a company that had an alteration time.

Alteration time during consolidation

Division 715 ensures that the loss integrity principles in Subdivision 165-CD apply to consolidated groups by extending the scope of the single entity rule in section 701-1(1) and the entry history rule in section 715-5 for all the purposes of Subdivision 165-CD. The broad effects of this extension of the single entity principle are that:

- only the head company of a group can have a Subdivision 165-CD alteration time, and
- only interest in the head company will be subject to reductions and other consequences under Subdivision 165-CD.

The head company will be the only loss company for Subdivision 165-CD purposes. However, because the loss company calculation embraces the single entity principle it will be necessary to include the assets and losses of all of its subsidiaries in the calculation.

Either the individual asset method or global method of working out the adjusted unrealised loss in Subdivision 165-CD can be used to work out whether the head company is a loss company.

Where the head company meets the loss company criteria, adjustments are made to the direct and indirect interests of certain controlling entities in the head company. Although no adjustments are made to membership interests in each subsidiary, there can be consequences when entities leave the consolidated group.

Company leaving a consolidated group

When a leaving entity has an alteration time and is a loss company – section 715-255

Where a company leaves a consolidated group it will be necessary to ensure that loss duplication is appropriately prevented when recognition of the membership interests in the leaving entity are resumed under Division 711.

Step 1: Determine if there has been an alteration time for the leaving entity

(A) Ownership or control of a leaving entity has altered since the head company's last alteration time, or formation

Broadly, if there is a change in ownership of 50% or more or a change in control of a leaving entity since the later of the head company's last alteration time or formation, the leaving entity has an alteration time at the leaving time as set out in section 715-245.

(B) The head company has had an alteration time but ownership and control of the leaving entity has not altered since

Broadly, where the head company has had at least one alteration time since the group formed, and there have not been changes in ownership of 50% or more or changes in control of the leaving entity since that time, the leaving time is taken to be an alteration time.

For the purpose of determining the leaving entity's next alteration time after it leaves the group, the reference time under subsections 165-115L(2) or 165-115M(2) is the time just after the most recent alteration time for the head company before the subsidiary left the group.

Step 2: Determine whether the leaving company is a loss company

A leaving company is considered to be a loss company:

- Where the leaving time is an alteration time as outlined in step 1(A), the leaving company is a loss company if it has an adjusted unrealised loss in respect of the assets it leaves with (section 715-245).
- Where the leaving time is an alteration time as outlined in step 1(B), the leaving company is a loss company if the head company had an adjusted unrealised loss at its most recent alteration time. Only assets held by the head company at its most recent alteration time and that leave with the leaving company are taken into account in working out the adjusted unrealised loss.

Consequences of the leaving entity being a loss company

Where the leaving entity has an alteration time at the leaving time and it is a loss company, the head company must choose whether to:

- reduce the cost setting amount of membership interests just before leaving to nil, or

- reduce the cost setting amount of the membership interests just before the leaving time by making an adjustment worked out under section 165-115ZB as modified by subsection 715-255(3).

The head company's choice must be made within six months after the leaving time, or a further period allowed by the Commissioner. After the relevant period and unless it can be established otherwise the head company is taken to have chosen to reduce the cost setting amounts just before the leaving time to nil.

Where a member of the group holds non-membership equity interests in the leaving entity, those assets are treated as if they are membership interests in the leaving entity, but of a different class to any other membership interest in the leaving entity.

Reference time of a leaving company if no alteration time occurs when it leaves a consolidated group – section 715-260

Where the head company has not undergone an alteration time since formation of the group and before a particular subsidiary leaves the group, and the leaving time is not an alteration time for the leaving entity, section 715-260 sets out how the leaving entity determines its first post-leaving alteration time and the associated reference time. To facilitate the process the additional assumptions in section 715-290 must also be made.

Trust leaving a consolidated group

The assets and losses of a trust that is a member of a consolidated group are subject to Subdivision 165-CD because they are treated as those of the head company under the single entity rule.

When a trust leaves a consolidated group it is treated as a company at that time and is deemed to have an alteration time.

The trust is treated as a loss company at the leaving time if it has an adjusted unrealised loss at that time.

Where the trust is a *loss company* the head company must make a choice about the reductions it will make in respect of the membership interests in the trust.

Broadly, just before leaving time the head company can choose to reduce the cost setting amount of the interests to nil (subsection 715-270(6)) or make an adjustment under section 165-115ZB as modified by section 715-270(7).

If a choice is not made within six months or further period allowed by the Commissioner, it is assumed that the head company's choice was to reduce the tax cost setting amounts to nil.

Note that non-membership equity interests are treated as membership interests, but will be treated as a different class of membership interests.

References

Income Tax Assessment Act 1997:

- Divisions 705, 701
- Subdivision 165-CD

New Business Tax System (Consolidation and Other Measures) Act 2003 (No. 16 of 2003), Subdivision 715-B

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 11

Income Tax Assessment Act 1997, section 165-115ZC; as amended by *Taxation Laws Amendment (2004 Measures No. 6) Act* (No. 23 of 2005), Schedule 1, Part 6

Income Tax Assessment Act 1997, subsections 715-255(6) and 715-270(10); as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 2010), Schedule 5, Part 20

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5

Income Tax (Transitional Provisions) Act 1997, section 165-115ZC; as amended by *Taxation Laws Amendment (2004 Measures No. 6) Act* (No. 23 of 2005), Schedule 1, Part 6

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004, paragraphs 1.168 – 1.182

Revision history

Section C2-6-130 first published 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on proposed changes to consolidation rules.	Proposed legislative amendments.
26.10.05	Changes to notice requirements, p. 1.	Legislative amendment.
6.5.11	References to non-membership equity interests, p. 4.	Legislative amendment.

Effect of Subdivision 165-CC for MEC groups

Section 715-75 of the ITAA 1997 extends the single entity principle and the entry history rule in sections 701-1 and 701-5 for the purposes of Subdivision 165-CC, including where the Subdivision applies to MEC groups. To take the special structure of MEC groups into account, additional changeover times and new reference times are provided by Subdivision 719-T to ensure that Subdivision 165-CC applies appropriately to MEC groups.

Note

How Subdivision 715-A applies the principles in Subdivision 165-CC to consolidated groups is discussed in:

- 'Effect of Subdivision 165-CC for steps 1 and 2 of the ACA calculation at formation and joining times', C2-6-110
- 'Formation time treatment of assets owned by head company from a pre-consolidation changeover time', C2-6-510
- 'Pre-formation changeover times – application of Subdivision 165-CC at formation (transitional period)', C2-6-520
- 'Treatment of assets owned by head company at both formation time and pre-consolidation changeover time (no changeover time at formation)', C2-6-530.

The modifications and adjustments discussed in these sections apply equally to MEC groups and should be read in conjunction with this section.

Subdivision 719-T provides for certain modifications to allow MEC groups to work out when the head company has a changeover time under Subdivision 165-CC.

These modifications are discussed below.

Modifications to the reference time

The reference time used to work out if the head company of a MEC group has a changeover time under sections 165-115C or 165-115D (change in ownership or control tests) is modified as follows:

- if a changeover time has not occurred in respect of the head company since the group came into existence, the reference time is when the group came into existence
- otherwise, the reference time is the time just after the last changeover time for the head company.

Assumptions about beneficial ownership

To facilitate the application of the change in ownership or control tests in Subdivision 165-CC to the head company of a MEC group, it is assumed that while the MEC group exists the top company beneficially owns all the membership interests in the head company and controls it. This assumption is made regardless of who actually owns the interests. It is also assumed that those interests remain unchanged → subsection 719-700(4).

Additional changeover times

Generally, the head company of a MEC group will not have a changeover time because of a change in ownership or control of membership interests in the eligible tier-1 (ET-1) companies of a MEC group, or in entities interposed between the top company and the ET-1 companies. However, in certain situations a head company of a MEC group can have a changeover time as a result of events involving such interests and entities → section 719-705. These additional changeover times ensure the integrity of the system.

The head company of a MEC group will have a changeover time under section 719-705 when:

- a potential MEC group ceases to exist and just before it ceases to exist both the membership of the potential MEC group and the membership of the MEC group were the same
- something happens in relation to membership interests in one or more of these entities:
  - an ET-1 company of the top company
  - an entity interposed between an ET-1 company and the top company

  and the event does not cause the relevant potential MEC group to cease to exist, but it does cause the identity of the top company of the potential MEC group to change
- a MEC group ceases to exist because there is no ET-1 company in the group eligible to be the provisional head company.

References

Income Tax Assessment Act 1997:

- Subdivision 165-CC
- sections 701-1 and 701-5

New Business Tax System (Consolidation and Other Measures) Act 2003 (No. 16 of 2003), Division 715, Subdivision 719-T, Schedule 7

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 11

Revision history

Section C2-6-140 first published 28 May 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Effect of Subdivision 165-CD for MEC groups

Subdivision 715-215 of the ITAA 1997 extends the single entity principle and the entry history rules in sections 701-1 and 701-5 to enable the principles in Subdivision 165-CD to apply to multiple entry consolidated (MEC) groups. To take the special characteristics of MEC groups into account, additional alteration times are provided by Subdivision 719-T to ensure that appropriate adjustments under Subdivision 165-CD can be made.

Modified reference and alteration times

To enable Subdivision 165-CD to apply appropriately, Subdivision 719-T provides a number of modifications. These include:

- modifications to the reference times in sections 165-115L and 165-115M to enable the head company of a MEC group to work out if it has an alteration time under Subdivision 165-CD
- additional alteration times for the head company where:

  (a) a potential MEC group ceases to exist and just before that time the potential MEC group's membership was the same as the membership of the MEC group

  (b) something happens in relation to certain membership interests in one or more of the following entities:

  – a member of a MEC group that is an ET-1 company of the top company

  – an entity interposed between an ET-1 company and the top company

  and the event does not cause the relevant potential MEC group to cease to exist, but it does cause the identity of the top company of the potential MEC group to change

  (c) the MEC group ceases because there ceases to be a provisional head company, and

  (d) an event that triggers pooling happens.

To facilitate the application of Subdivision 165-CD, Subdivision 719-T:

- requires that while the MEC group exists an assumption is made that the top company beneficially owns and controls all the membership interests in the head company regardless of which entity actually owns the interests (→ subsection 719-720(5)), and
- deems a number of occurrences to be alteration times for the purposes of Subdivision 165-CD.

Subdivision 165-CD applies where an alteration time occurs in respect of a loss company. There can be an alteration time for Subdivision 165-CD purposes where certain changes in control or ownership in a loss company occur or a liquidator of a loss company declares that shares in the company are worthless. The additional alteration times for MEC groups ensure the integrity of the system by facilitating appropriate adjustments to certain membership and debt interests of entities that are direct and indirect interests in the top company of a MEC group and, where Subdivision 719-K applies, to 'pooled' interests.

Modifications

The following changes enable sections 165-115L and 165-115M in Subdivision 165-CD to apply on their normal terms to MEC groups.

Modification 1

Section 719-720 overrides the reference times in subsections 165-115L(2) and 165-115M(2) for the purpose of working out if the head company of a MEC group has an alteration time under Subdivision 165-CD. The broad effect is that a change in ownership or control of a head company will be determined using the reference time in subsection 719-720(2) and the assumptions in subsection 719-720(5). Broadly, the effect of the assumption is that the top company beneficially owns and controls the head company.

Subsection 719-720(2), redefines the reference time for the head company as:

- when the group came into existence – for the purpose of working out the head company's first alteration time after formation, or
- just after the head company's last alteration time – in all other cases.

The alteration times resulting from this modification will only be relevant for direct and indirect equity or loan interests in the top company of a MEC group that are relevant equity interests or relevant debt interests in the head company of that group just before alteration time.

Additional alteration times

Additional alteration times for the head company of a MEC group are provided in section 719-725 and are based on the change in ownership rules in section 719-280.

Modification 2

(a) Certain potential MEC groups cease to exist

The head company has an alteration time when a potential MEC group ceases to exist if, just before the group ceased to exist, the potential MEC group's membership was the same as the membership of the MEC group.

The alteration times resulting from this modification will only be relevant for direct and indirect equity or loan interests in the top company of a MEC group that are relevant equity interests or relevant debt interests in the head company of that group just before alteration time. (Note that modification 3 below may also apply to adjust 'pooled' interests under Subdivision 719-K.)

(b) The head company of a MEC group has an alteration time where something happens to certain membership interests in ET-1 companies and interposed entities

An alteration time for the head company of a MEC group occurs where:

- something happens to the membership interests in an ET-1 company of the top company or an entity interposed between an ET-1 company and the top company, and
- the potential MEC group (whose membership is the same as the MEC group) does not cease to exist, but there is a change in the identity of the top company of the potential MEC group.

The alteration times resulting from this modification will only be relevant for direct and indirect equity or loan interests in the top company of a MEC group that are relevant equity interests or relevant debt interests in the head company of that group just before alteration time. (Note that modification 3 below may also apply to adjust 'pooled' interests under Subdivision 719-K.)

(c) An alteration time occurs where a MEC group ceases to exist because there ceases to be an entity eligible to be the provisional head company.

The alteration times resulting from this modification will only be relevant for direct and indirect equity or loan interests in the top company of a MEC group that are relevant equity interests or relevant debt interests in the head company of that group just before alteration time. (Note that modification 3 below may also apply to adjust 'pooled' interests under Subdivision 719-K.)

Modification 3 – pooling triggered

There is also an alteration time if an event that triggers pooling occurs. The alteration time is just before the thing happens that triggers pooling. In these circumstances, the usual adjustments under sections 165-115ZA and 165-115ZB of Subdivision 165-CD do not apply.

The cost setting rules in Subdivision 719-K are used in reducing the reduced cost base of the pooled interests. Note that it is only pooled interests that are affected by this alteration time – all other interests in the group are unaffected.

Broadly, what would, apart from section 719-735, be a pooled cost amount for the purpose of the formulas in section 719-570(1) and (2), is reduced by the amount of the head company's overall loss under section 165-115R or 165-115S at the alteration time. Note that paragraph 719-735(2)(a) only affects the application of those formulas because of subsection 719-570(3) (to work out the reduced cost base of a membership interest). Note also that the usual 10% relevant equity interest rule does not apply.

Note that in some circumstances direct and indirect equity and loan interests in MEC groups not covered by the above provisions may be covered by the loss reduction method – for example, equity interests held by the top company in an entity interposed between it and an ET-1 company of the MEC group.

→ ''Application of the loss reduction method to consolidated and MEC groups', C2-6-160

References

Income Tax Assessment Act 1997:

- Division 705
- Subdivisions 165-CD and 719-K

New Business Tax System (Consolidation and Other Measures) Act 2003 (No. 16 of 2003), Schedule 11 Division 715 and Subdivision 719-T

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 11

Revision history

Section C2-6-150 first published 28 May 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Subdivision 165-CD widely held company concession for an eligible tier-1 company that is head company of a consolidated or MEC group

Description

This example outlines the modifications to the inter-entity loss multiplication rules in Subdivision 165-CD of the *Income Tax Assessment Act 1997* (ITAA 1997) for:

- the head company of a consolidated group that is itself an eligible tier-1 company (a foreign-owned consolidated group), and
- the head company of a multiple entry consolidated (MEC) group.

Under the modifications to Subdivision 165-CD, the head company of a MEC group or foreign-owned consolidated group can be treated as not having a relevant equity interest or relevant debt interest in a loss company, if the top company is widely held and does not have such an interest in the loss company.

Where the head company does not have a relevant equity interest or relevant debt interest in a loss company at a particular time, Subdivision 165-CD does not apply. For example, the adjustments set out in sections 715-255 and 715-270 of the ITAA 1997 do not need to be made to the tax cost setting amount of membership interests of the leaving entity just before the leaving time if the leaving entity is a loss company at the leaving time. The head company is not prevented from realising the loss on the membership interests.

Amendments to Subdivision 165-CD and Part 3-90 of the ITAA 1997 reduce compliance costs and make it easier for widely held companies to claim capital losses or deductions on the disposal of direct or indirect interests in loss companies. The amendments apply from 1 July 2002.

→ 'Effect of Subdivision 165-CD for MEC groups', C2-6-150; 'Effect of Subdivision 165-CD for consolidated groups', C2-6-130

Commentary

If one or more entities are interposed between individual shareholders and a company with realised or unrealised losses (a loss company), the company's losses could be reflected in the value of shares and loans held between such entities (inter-entity interests). The inter-entity loss multiplication rules ensure that the economic losses of companies do not get inappropriate multiple tax recognition when inter-entity interests are sold or otherwise realised.

The inter-entity loss multiplication rules do not apply to a company if it satisfies the exceptions in subsections 165-115X(3) or 165-115Y(4) of the ITAA 1997. However, widely held companies have difficulty in satisfying these exceptions, and as a result the losses of a loss company receive no tax recognition at all in some circumstances.

The modifications make it easier for a widely held company to recognise a capital loss or deduction on the disposal of a direct or indirect interest in a loss company by treating the company as not having a relevant equity interest or a relevant debt interest in the loss company in most cases.

A 'widely held company' is defined in subsection 995-1(1) of the ITAA 1997 to mean broadly:

- a company whose shares are listed for quotation in the official list of an approved stock exchange, or
- a company that has more than 50 members, but not if 20 or fewer persons have rights to at least 75 per cent of the value of the shares in the company or at least 75 per cent of the voting power or dividend rights of the company.

The three conditions that must be satisfied in order for the loss multiplication rules in Subdivision 165-CD of the ITAA 1997 to apply (→ subsection 165-115K(1), ITAA 1997) are:

- an alteration time happens in respect of a company (→ sections 165-115L, 165-115M, 165-115N, 165-115P and 165-115Q), and
- the company is a loss company at the alteration time, and
- an entity has a relevant equity interest (→ section 165-115X) or relevant debt interest (→ section 165-115Y) in the loss company immediately before the alteration time.

Where a widely held company does not have a relevant equity interest or relevant debt interest in a loss company, one of the three conditions will not be satisfied and Subdivision 165-CD will not have effect.

A widely held company will not have a relevant equity interest or relevant debt interest in a loss company at a particular time except in two circumstances.

The **first** is where an entity has a controlling stake in the loss company (→ section 165-115Z, ITAA 1997), and that entity also has a direct or indirect interest in, or is owed a debt by, the widely held company in respect of which:

- the entity could, if a CGT event happened in respect of the interest or debt make a capital loss (other than one that would be disregarded) that reflects any part of the loss company's overall loss, or
- the entity has deducted or can deduct, or could deduct at a later time, an amount in respect of the cost of the acquisition, or a net loss on the disposal, of the interest or debt, where the deduction reflected or would have reflected, or would reflect, any part of the loss company's overall loss.

The **second** is where an entity that had a direct or indirect interest in, or was owed a debt by, the widely held company at an earlier time, and had a controlling stake in the loss company at the earlier time:

- made a capital loss (other than a capital loss that was disregarded) because a CGT event happened in respect of the interest or debt where the capital loss reflected any part of the loss company's overall loss, or
- has deducted or could have deducted at an earlier time, or could deduct at a later time, an amount in respect of the cost of the acquisition, or net loss on the disposal, of the interest or debt, where the deduction reflected or would have reflected, or would reflect, any part of the company's overall loss.

→ Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.334 – 5.339

Consolidated group

Subdivision 715-B of the ITAA 1997 modifies how the inter-entity loss multiplication rules apply to the head company of a consolidated group.

Amendments to Subdivision 715-B of the ITAA 1997 apply where:

- the head company of a consolidated group is an eligible tier-1 company (→ section 719-15, ITAA 1997) of a top company (→ section 719-20, ITAA 1997), and
- the top company is a widely held company.

In these circumstances, the head company of the consolidated group does not have a relevant equity interest or relevant debt interest in a loss company at a particular time if the widely held top company does not have such an interest in the loss company at that time.

→ section 715-265, ITAA 1997

To ensure that any loss allowed to the head company of the consolidated group is not also recognised by other entities holding certain interests in the head company, the loss reduction method (LRM) applies in relation to:

- direct or indirect equity or loan interests in the head company, and
- external indirect equity or loan interests in the head company.

Generally, where the LRM applies, the loss realised for income tax purposes is reduced to nil, with the effect that the loss is cancelled.

→ 'Application of the loss reduction method to consolidated and MEC groups', C2-6-160; section 715-610, ITAA 1997

Example 1

Facts

TCo is a foreign-resident company that satisfies the requirements to be a top company.

TCo is a widely held company and none of the entities that hold interests in, or are owed a debt by, TCo have a controlling stake in LossCo.

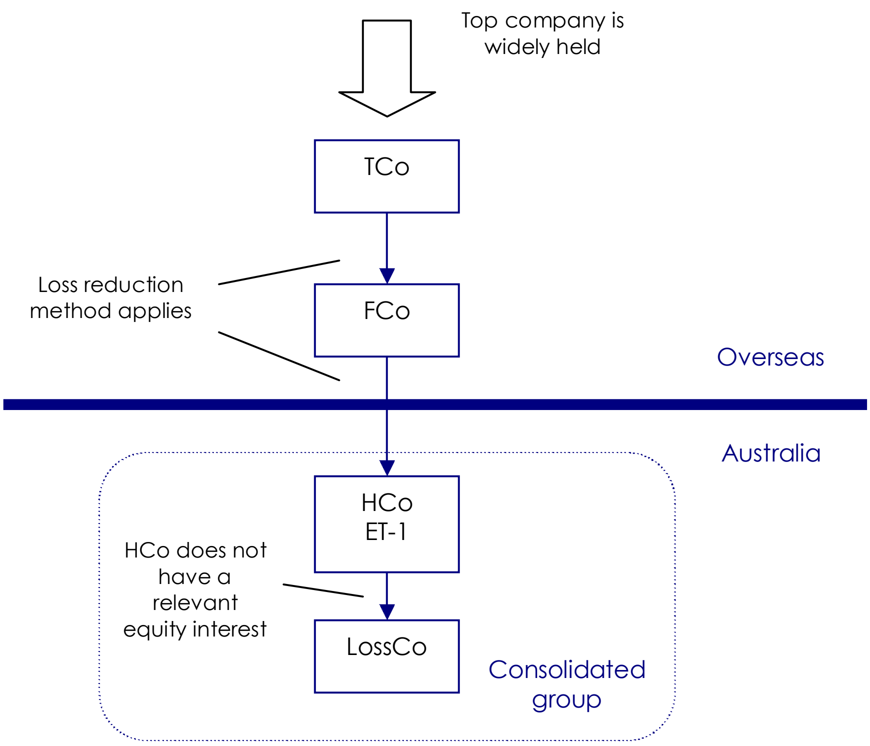
FCo is a foreign-resident company wholly owned by TCo.

HCo is head company of the consolidated group and it is wholly owned by FCo.

LossCo is a subsidiary member of the consolidated group and is a loss company for the purposes of Subdivision 165-CD.

HCo disposes of its shares in LossCo to an entity outside the consolidated group.

Figure 1: Consolidated group example



Application

TCo is a widely held company, and none of the entities that hold direct or indirect interests in, or are owed a debt by, TCo have a controlling stake in LossCo. Therefore, TCo does not have a relevant equity interest in LossCo at the time HCo disposes of the membership interests in LossCo to a company that is not a member of the consolidated group.

As widely held TCo does not have a relevant equity interest in LossCo, the head company, HCo, does not have a relevant equity interest in LossCo at the time HCo disposes of LossCo to an entity outside the group. Therefore, adjustments under section 715-255 of the ITAA 1997 do not need to be made to the tax cost setting amount of the membership interests in LossCo just before the leaving time, with the result that the loss is available to the head company HCo.

The loss reduction method in section 715-610 of the ITAA 1997 applies to TCo's interests in FCo and FCo's interests in HCo if the realisation of these interests results in a loss for income tax purposes.

MEC group

Subdivision 719-T of the ITAA 1997 clarifies how the inter-entity loss multiplication rules in Subdivision 165-CD apply to MEC groups.

The head company of a MEC group is ultimately wholly owned by a top company and therefore it cannot meet the definition of a widely held company. However, section 719-740 of the ITAA 1997 modifies the operation of the inter-entity loss multiplication rules where the top company of a MEC group is a widely held company. In these circumstances, the head company of the MEC group does not have a relevant equity interest or relevant debt interest in a loss company at a particular time if the widely held top company does not have such an interest in the loss company at that time.

Example 2

Facts

TCo is a foreign-resident company and is the top company of a MEC group.

TCo is a widely held company, and none of the entities that hold interests in, or are owed a debt by, TCo have a controlling stake in LossCo.

FCo is a foreign resident company wholly owned by TCo.

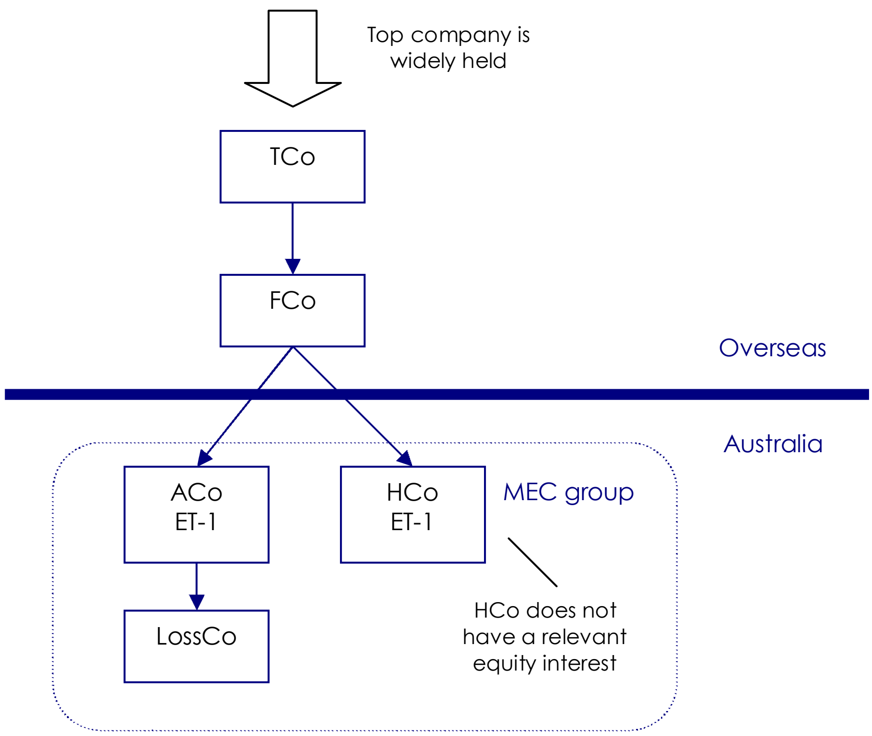
HCo is the head company of a MEC group.

ACo is an eligible tier-1 company and a subsidiary member of the MEC group.

LossCo is a subsidiary member of a MEC group and is a loss company for the purposes of subdivision 165-CD.

HCo disposes of its shares in LossCo to an entity outside the MEC group.

Figure 2: MEC group example



Application

TCo is a widely held top company of a MEC group, and none of the entities that hold direct or indirect interests in, or are owed a debt by, TCo have a controlling stake in LossCo. Therefore, TCo does not have a relevant equity interest in LossCo at the time the membership interests in LossCo are disposed of to a company that is not a member of the MEC group.

As widely held TCo does not have a relevant equity interest in LossCo, the head company, HCo, does not have a relevant equity interest in LossCo at the time LossCo leaves the MEC group. Therefore, adjustments under section

715-255 of the ITAA 1997 do not need to be made to the tax cost setting amount of the membership interests in LossCo just before the leaving time, with the result that any loss is available to the head company.

References

Income Tax Assessment Act 1997, Sections 719-740 and 715-265; as inserted by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010) Schedule 5, Part 16

Income Tax Assessment Act 1997, Sections 165-115X, 165-115Y, 715-230 (note 1), 715-255, 715-270, 715-450 (note) and 715-610; as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010) Schedule 5, Part 16

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5, paragraphs 5.325 – 5.348

Supplementary Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 2, paragraphs 2.26 – 2.32

Revision history

Section C2-6-155 first published 6 May 2011.

Application of the loss reduction method to consolidated and MEC groups

The loss reduction method (LRM) applies to consolidated and multiple entry consolidated (MEC) groups because it is not feasible to require such groups to determine the effect on market values of losses or value shifts involving group members.

Broadly, the LRM applies to deny most losses realised on certain direct and indirect equity or loan interests in members of consolidated and MEC groups – the loss integrity measures (LIM) and the general value shifting regime (GVSR) do not apply to these interests.

→ 'General value shifting regime (GVSR)', C2-6-170

Coverage of the LRM

An entity's direct or indirect equity or loan interests in a member of a consolidated or MEC group is only covered by the LRM when the entity, during the period it owned the interest:

- was head company of the group
- was an associate of the head company
- controlled the head company (for value shifting purposes), or
- was an associate of an entity that controlled the head company (for value shifting purposes).

Equity or loan interests are not covered by the LRM if they are:

- direct or indirect equity or loan interests in the head company of a consolidated group (except where the head company of a consolidated group is an eligible tier-1 company of a top company)
- equity interests that are pooled interests in relation to a MEC group
- direct or indirect equity or loan interests in the top company of a MEC group, or
- membership interests in, or liabilities owed by, an entity leaving the group.

Such interests are covered by the rules relating to ITAA 1997 Subdivision 165-CD, Division 727 or the consolidation rules (e.g. Division 711).

→ 'Effect of Subdivision 165-CD for consolidated groups', C2-6-130

→ 'Effect of Subdivision 165-CD for MEC groups', C2-6-150

→ 'Pooling of external membership interests', C10-2-420

→ 'An eligible tier-1 company leaving a MEC group', C10-2-430

→ 'Subdivision 165-CD widely held company concession for an eligible tier-1 company that is head company of a consolidated or MEC group', C2-6-155

→ subsection 715-610(2), ITAA 1997

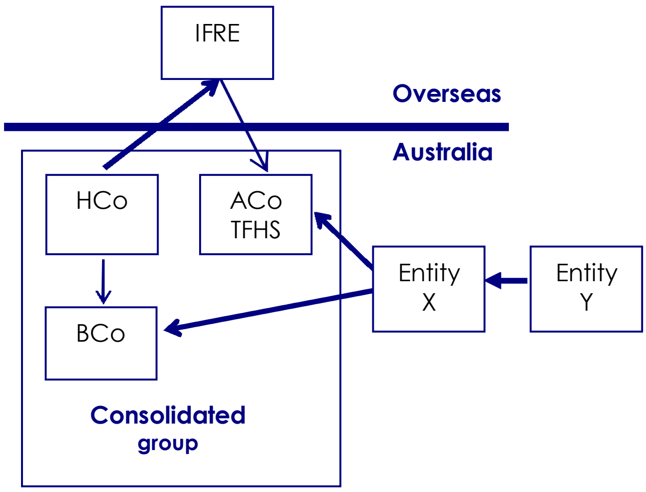
Interests affected

Interests that can be affected by the LRM (when owned by a relevant entity) include:

- loan interests in a subsidiary member of a group or in an eligible tier-1 company of a MEC group
- equity or loan interests in an entity that itself has a loan interest in a subsidiary member or eligible tier-1 company
- direct and indirect equity or loan interests in entities with pooled interests in eligible tier-1 companies of a MEC group, as well as interests in entities interposed between such entities and the top company of the MEC group
- rights and options in subsidiary members of a consolidated or MEC group, and
- direct and indirect equity or loan interests in an interposed foreign resident entity (IFRE) that are related to a transitional foreign-held subsidiary member (TFHS) of the group.

The bold arrows in figures 1 and 2 show the interests to which the LRM applies.

Figure 1: Application of the LRM to a consolidated group

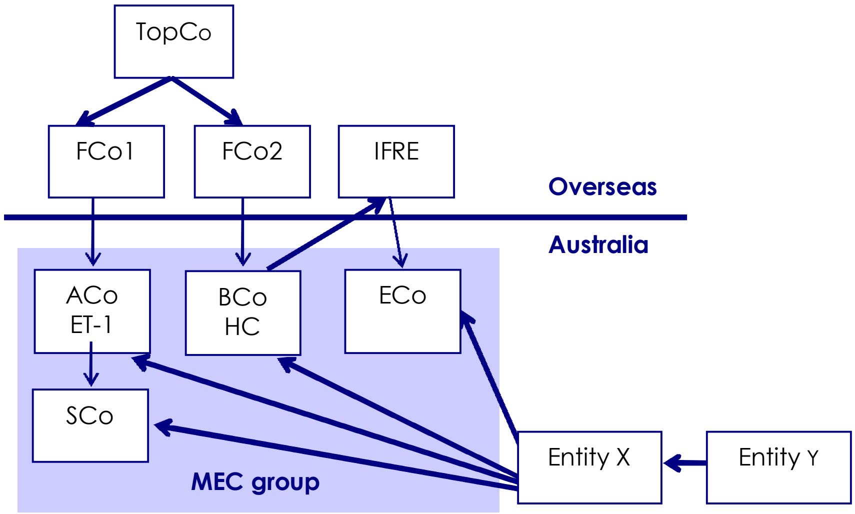


Entity X holds loan interests in ACo and BCo, who are subsidiary members of the consolidated group. ACo is also a TFHS.

Entity Y has shares in Entity X.

Y controls the head company (for value shifting purposes) and X is an associate of Y.

Figure 2: Application of the LRM to a MEC group



Entities X and Y hold direct and indirect loan interests in BCo, the head company of the MEC group, and in ACo, ECo and SCo, subsidiary members of the MEC group.
X and Y control the head company (for value shifting purposes) or are associates of an entity that controls the head company.

References

Income Tax Assessment Act 1997, Subdivision 715-H and Subdivision 719-T; as amended by New Business Tax System (Consolidation and Other Measures) Act 2003 (No. 16 of 2003), Schedule 7

Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 11

Income Tax Assessment Act 1997, Sections 727-355 and 727-520; as amended by *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 15

Explanatory Memorandum to New Business Tax System (Consolidation and Value Shifting, Demergers and Other Measures) Bill (No. 2) 2002, Chapters 8 and 11

Income Tax Assessment Act 1997, Subdivision 715-H and subsections 165-115X, 165-115Y, 715-230, 715-255, 715-270 and 715-450; as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010) Schedule 5, Part 16

Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5, paragraphs 5.325 – 5.348

Supplementary Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 2, paragraphs 2.26 – 2.32

Revision history

Section C2-6-160 first published 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
27.10.03	Amend format of figure 2 – LRM does not apply to IFRE's interests in ECo.	Formatting error.
6.5.11	New reference to case where head company is an eligible tier-1 company, p. 1.	Legislative amendment.

General value shifting regime (GVSR)

The general value shifting regime (GVSR) contained in Divisions 723, 725 and 727 of the *Income Tax Assessment Act 1997* (ITAA 1997) includes rules for created rights, and direct and indirect value shifting. These rules replace the previous value shifting rules in Divisions 138, 139 and 140 of the ITAA 1997.

Broadly, the new Divisions apply from 1 July 2002 to all entities including those with substituted accounting periods. The previous rules continue to apply to value shifts that happened before 1 July 2002.

The single entity rule means that the GVSR has no impact for interests within consolidated and MEC groups during consolidation. Value shifting integrity issues are addressed by the methods used to reconstruct the cost bases of interests in entities leaving the group (e.g. under Division 711). Generally, direct and indirect interests held by non-group members in a consolidated or multiple entry consolidated (MEC) group are not subject to the provisions of Part 3-90. Such interests are subject to the GVSR or the loss reduction method.

New GVSR rules

New rules have been introduced so that the GVSR applies appropriately when a consolidated or MEC group is involved in a value shift – for example, when a head company transfers an asset to an associated non-group member for less than its market value. These rules include the loss reduction method.

→ ''Application of the loss reduction method to consolidated and MEC groups', C2-6-160

The effect of the single entity rule is that intragroup value shifts are disregarded for the purposes of determining the tax liability or losses of the head company. Value shifting integrity is generally achieved within a consolidated or MEC group by the combined operation of the single entity rule and cost setting (including pooling) rules. For example, the cost setting reconstruction rules for membership interests and loans when an entity leaves a consolidated group relate to assets that leave with the entity (disregarding assets that have left the entity in a value shifting transaction).

Broadly speaking, Divisions 723, 725 and 727 have no impact on intragroup value shifts.

The indirect value shifting rules in Division 727 do not deal with the effects of value shifts on interests in group members when the value shift is between the group and a related entity and the effects are subject to consolidation rules. There may, however, be an effect when a shift in value out of the group impacts on the value of interests in the group that are held by a non-consolidated controller of the group (e.g. a non-resident that directly owns a resident head company).

Consolidated groups

The single entity rule and entry history rule have been extended for the purposes of the GVSR. Two of the consequences for the indirect value shifting rules are that the head company is the only group entity that can be a losing entity or gaining entity, and it will be considered to have provided or received any economic benefits.

Indirect value shifting rules apply normally in most situations. However, only interests in the head company of the consolidated group are affected by these rules. Other interests are covered by the loss reduction method or Division 711 (e.g. those in a transitional foreign-held subsidiary).

Generally, the GVSR does not apply to interests covered by the loss reduction method.

MEC groups

The single entity rule and entry history rule have been extended for the purposes of the GVSR.

Indirect value shifting rules apply normally in most situations. However, only interests in the top company of the MEC group, and pooled interests in the eligible tier-1 companies, can be affected by these rules. Other interests are covered by the loss reduction method or Division 711 (e.g. interest in a transitional foreign-held subsidiary). The method of making adjustments to pooled interests has also changed.

Generally, the GVSR does not apply to interests covered by the loss reduction method.

Example: indirect value shift involving a MEC group

Figure 1 shows an example of an indirect value shift involving a MEC group.

In the example, entity X holds 80% of the equity interests in TopCo and YCo. It also controls (for value shifting purposes) the head company and YCo.

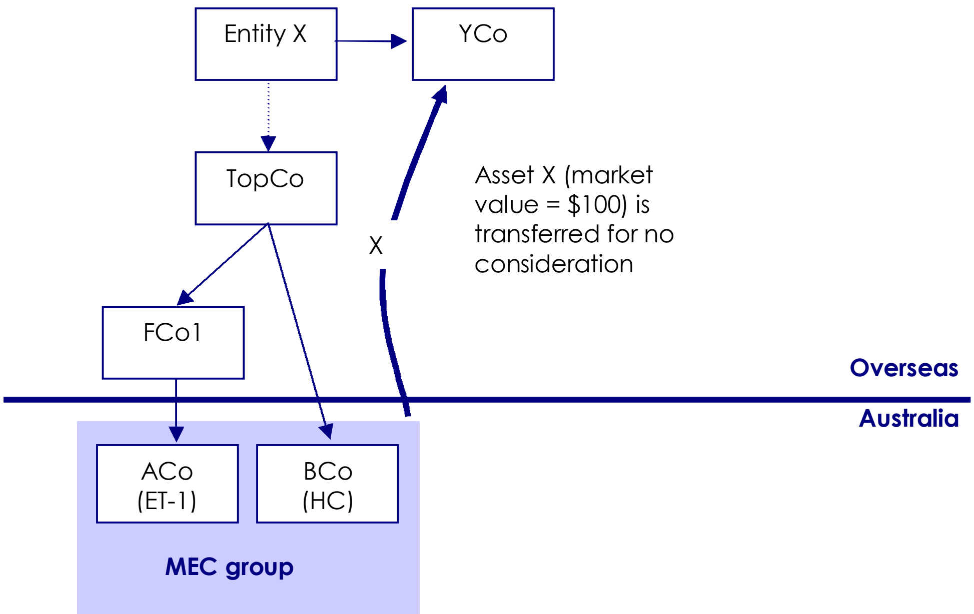
Assume there is an indirect value shift of $100 from BCo to YCo.

The modified indirect value shifting rules will apply to:

- the interests of entity X in TopCo and YCo
- TopCo's interests in BCo, and
- FCo1's interests in ACo.

The loss reduction method will apply to TopCo's interests in FCo1.

Figure 1: Indirect value shift involving a MEC group



References

The 'GVSR guide' web page at **www.ato.gov.au** contains:

- overviews
- fact sheets
- legislation, and
- press releases.

Income Tax Assessment Act 1997, Part 3-90

Income Tax Assessment Act 1997, Divisions 723, 725 and 727; as amended by *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002)

Income Tax Assessment Act 1997, sections 715-410, 715-415 and 719-755; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 7

Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 11, paragraphs 11.125 to 11.144

Explanatory Memorandum to New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, Chapter 11

Revision history

Section C2-6-170 first published 28 May 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Formation time treatment of assets owned by head company from a pre-consolidation changeover time

Where a head company chooses to form a consolidated group and that formation time is not a changeover time under Subdivision 165-CC of the ITAA 1997, it will be necessary for the head company to determine if it still owns assets or Subdivision 170-D deferred losses from its most recent changeover time. Where the head company still owns the relevant assets or amounts, Division 715 may cause a loss denial pool to be created in the head company.

Note

For additional information see:

- 'Effect of Subdivision 165-CC for steps 1 and 2 of the allocable cost amount calculation at formation and joining times', C2-6-110
- 'Effect of Subdivision 165-CD for MEC groups', C2-6-150
- 'Pre-formation changeover times – application of Subdivision 165-CC at formation (transitional period)', C2-6-520
- 'Treatment of assets owned by head company at both formation time and pre-consolidation changeover time (no changeover time at formation)', C2-6-530.

Commentary

A loss denial pool can only be created if the conditions in section 715-60 are satisfied. Very broadly, these conditions are:

- the formation is not changeover time
- the head company owned at least one 165-CC tagged asset at the formation time that it owned at the relevant changeover time
- the asset is not a membership interest held in a member of the group or a right or option (including a contingent right or option), created or issued by a member of the group, to acquire such a membership interest, or constituted by a liability owned to the head company by a member of the group
- the head company's final residual unrealised net loss (RUNL) just before the formation time (reduced by any relevant reductions under sections 715-50 and 715-55) is greater than nil, and
- the head company fails the adjusted same business test (SBT) outlined in section 715-60.

The SBT is that the head company does not satisfy the test for:

- the period consisting of the head company's trial year, and
- the time just before the changeover time.

When a loss denial pool is created it consists of those CGT assets described above – that is, when a head company loss denial pool is created for its own assets at formation time it only consists of assets it owned at its last changeover time and that are not membership interests in, or constitute debts owed to the head company by, another member of the group. In addition, Subdivision 170-D deferred loss amounts are added to the pool in certain circumstances → section 715-355.

If there are no assets for section 715-60 purposes but there is a Subdivision 170-D deferred amount (→ subsections 715-355(3) and (4)), a loss denial pool may be created.

The pool's loss denial balance equals the head company's final RUNL just before formation time. Note, however, that the balance may be reduced if Division 715 applies to 165-CC tagged assets of the head company that are relevant to the tax cost setting process (membership interests at step 1, and intragroup debt at step 2). Sections 715-50 and 715-55 discuss how the tax cost amount of those assets is reduced and how the reductions affect the balance of the loss denial pool.

This loss denial pool is distinct from any other loss denial pool of the head company. For example, it is separate from a pool that might be created where the assets of a chosen transitional entity become those of the head company → section 715-70.

Example

On 3 December 2001, the head company had a changeover time under Subdivision 165-CC. The five assets held at changeover time yield an unrealised net loss of $6 million for the head company. This is the unrealised net loss of the company at that time.

Asset 4 was sold in June 2002 for $1 million. The RUNL balance became $1 million ($6 million – $5 million).

Table 1: Assets held by the head company at the changeover time

Asset	Cost base or reduced cost base of assets	Market value at changeover time	Notional gain or loss at changeover time
Asset 1	$8 million	$10 million	$2 million
Asset 2	$5 million	$3 million	($2 million)
Asset 3	$4 million	$3 million	($1 million)
Asset 4	$6 million	$1 million	($5 million)
Asset 5	$1 million	$1 million	$0
Total			**($6 million)**

Note that these assets are *not* membership interests or intragroup debt interests.

On 1 July 2002, the head company chooses to form a consolidated group. There is no new Subdivision 165-CC changeover time for the head company or its subsidiaries at that time.

The head company still holds assets 1, 2, 3 and 5 at that time. Upon consolidating, the head company must determine whether the SBT is passed for the trial period and the time just before the changeover time on 3 December 2001. If the SBT is passed, no loss denial pool is required to be established and there are no further Subdivision 165-CC implications for the consolidated group in respect of the 3 December 2001 changeover time.

If the SBT is failed, the head company will have a loss denial pool consisting of assets 1, 2, 3, and 5 and a loss denial balance of $1 million. Later, when one of those assets is sold at a loss the amount in the loss denial pool will reduce any loss claim*. If, for example, asset 3 is later realised for a $2 million capital loss, that loss will be denied to the extent of the balance of the pool*. That is, $1 million of the $2 million loss is allowed, the remaining $1 million of the loss is denied and the loss denial pool is reduced to zero and ceases to exist.

References

Income Tax Assessment Act 1997:

- Division 705
- Subdivisions 165-CC, 170-D

New Business Tax System (Consolidation and Other Measures) Act 2003 (No. 16 of 2003), Division 715, Schedule 7

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 11

Revision history

Section C2-6-510 first published 28 May 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

* Note that there is no further same business testing on realisation of each asset because that test has already been failed at formation time.

Worked example

Pre-formation changeover times – application of Subdivision 165-CC at formation (transitional period)

Description

This example illustrates what happens when the head company, a chosen transitional entity and a non-chosen subsidiary each had a pre-formation changeover time and when, at formation time, they still own '165-CC tagged assets' or have a '170-D deferred loss' (→ *Income Tax Assessment Act 1997* (ITAA 1997)) in relation to that changeover time.

The example relates to the formation of a consolidated group within the transitional period. It is assumed that none of the entities has a changeover time at formation time.

Commentary

At formation time, a head company retains the existing tax values of its assets. The head company applies the allocable cost amount (ACA) to determine the tax cost of assets of a non-chosen subsidiary (NCS). When a consolidated group is formed during the transitional period (1 July 2002–30 June 2004), the head company may choose, subject to certain requirements, that one or more of its entities be a chosen transitional entity (CTE). As with the head company, the tax costs of a CTE's assets are not reset under the ACA method, but existing tax values of its assets are retained. → ''Treatment of assets', C2-1

If a CTE has membership interests in a non-chosen subsidiary, the effect is that the CTE proceeds in the same manner as a head company, using the ACA method to determine the tax costs of the assets of the non-chosen subsidiary.

The ACA may need to be adjusted when the head company's most recent changeover time was before formation, and at formation time:

- the head company has membership interests (MI) or intragroup liabilities (IGL) in a subsidiary member, or has 165-CC tagged assets that it owned at the changeover time (170-D deferred losses are also relevant)
- the head company has a formation residual unrealised net loss (final RUNL) just before the joining time (→ paragraph 715-50(1)(c) and section 715-35), and
- a same business test is failed.

If some of the head company's membership interests or intragroup liabilities are in a non-chosen subsidiary, the amount of the ACA that the head company can allocate to the assets of the non-chosen subsidiary is adjusted (assuming the reduced cost bases of these interests and liabilities are relevant at step one for the MIs and step 2 for IGLs). The head company's formation RUNL is reduced by any MI and IGL adjustments.

If the head company has other 165-CC tagged assets or 170-D deferred losses, a loss denial pool (LDP) of the head company is created with a loss denial balance (LDB) equal to the formation RUNL (reduced by any MI and IGL adjustments).

→ ''Treatment of assets owned by head company at both formation time and pre-consolidation changeover time (no changeover time at formation)', C2-6-530

→ ''Effect of Subdivision 165-CC for steps 1 and 2 of the ACA calculation at formation and joining times ', C2-6-110

A chosen transitional entity retains the tax values of its assets even when the head company has some membership interests or intragroup liabilities in it. The ACA method is not used to reset the tax cost of the CTE's assets. As no MI or IGL adjustments are made, the head company's formation RUNL is not reduced.

If a chosen transitional entity has a pre-formation changeover time, the consequences for the CTE at formation can be the same as those for the head company (discussed above). A separate LDP of the head company (not of the CTE) can be created .

A further LDP of the head company can be created if a non-chosen subsidiary has a pre-formation changeover time, and at formation time:

- it has one or more 170-D deferred losses (relevant to the changeover time)
- its formation RUNL is not nil, and
- a same business test is failed.

A LDP of the head company is created consisting of only the 170-D deferred losses (section 715-360). The loss denial balance of the LDP is equal to the formation RUNL. If a non-chosen subsidiary has 165-CC tagged assets (including membership interests and/or intragroup liabilities in other group members) relating to the changeover time, but no 170-D deferred losses, no LDP is created. There are no MI or IGL adjustments, and there are no further implications for the non-chosen subsidiary's 165-CC tagged assets.

Example

Facts

On 1 July 2002, HC, the head company of a wholly-owned group, chooses to form a consolidated group. Subsidiary members of the group are:

- chosen transitional entities, PCo and YCo, and
- non-chosen subsidiaries, CCo, DCo, TCo and XCo.

Formation time is not a changeover time and HC, CCo, DCo and PCo each had a changeover time before formation. At formation time, each company still owns 165-CC tagged assets that they owned at the pre-formation changeover time. 170-D deferred losses in relation to the changeover times also still exist for all companies (except DCo). Each company has a formation RUNL and failed the relevant same business test.

HC's 165-CC tagged assets include membership interests in CCo, and membership interests and intragroup liabilities in DCo. PCo's 165-CC tagged assets include membership interests in XCo and YCo. Similarly, DCo's 165-CC tagged assets include membership interests in PCo and TCo.

Calculation

Figure 1 shows the consequences for a head company, its chosen transitional entities and non-chosen subsidiaries when they own assets at formation time that were owned at a pre-formation changeover time. It also illustrates when MI and IGL adjustments under the ACA method may need to be made, when a LDP of the head company may be created and when a 170-D deferred loss can be attached to a LDP.

Head company

HC's membership interests and intragroup liabilities in CCo and DCo are loss interests at formation (i.e. their market value is less than their reduced cost base). As CCo and DCo are non-chosen subsidiaries, HC applies the ACA method to reset the tax costs of their assets.

When HC is calculating the ACA to be allocated to the assets of CCo, a step 1 adjustment is made to reduce the reduced cost base of HC's membership interests in CCo.

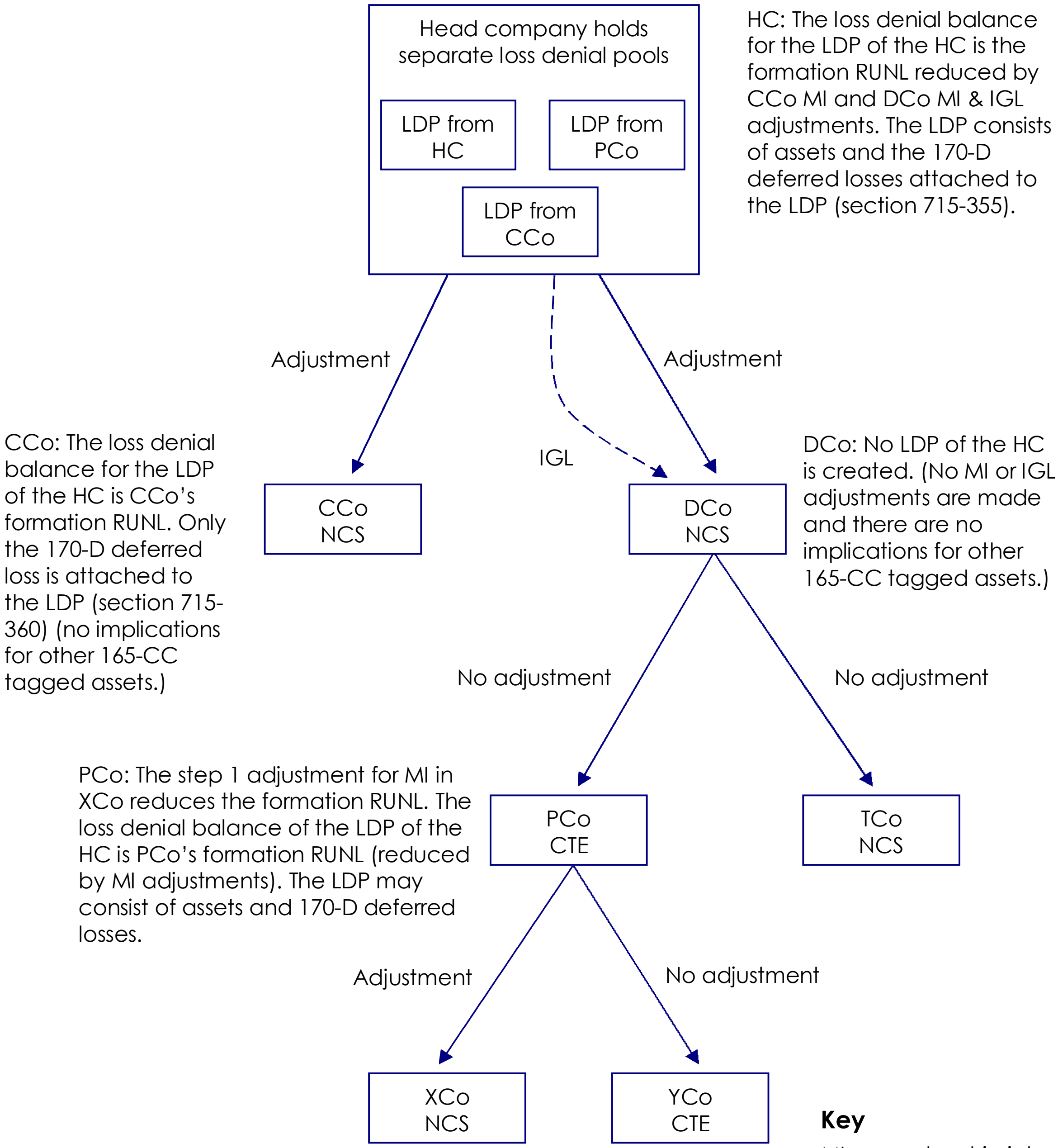
When HC is calculating the ACA to be allocated to the assets of DCo, a step 1 adjustment is made to reduce the reduced cost base of the membership interests HC holds in DCo. The intragroup liabilities to be added at step 2 may also be reduced.

Note that both the step 1 and step 2 adjustments reduce the reduced cost bases to market value at formation time, but the total adjustments cannot be greater than the formation RUNL.

The head company's formation RUNL is reduced by the same amount as any adjustments to the membership interests in CCo and the membership interests and intragroup liabilities in DCo.

A LDP of the head company is created if the formation RUNL (reduced by any MI and IGL adjustments) is greater than nil. The LDP consists of the 165-C tagged assets of HC (other than membership interests and intragroup liabilities in CCo and DCo) and the loss denial balance is the adjusted formation RUNL. 170-D deferred losses relating to HC's pre-formation changeover time would also be attached to the LDP by section 715-360.

Figure 1: Assets owned at a pre-formation changeover time



MI and IGL adjustments

CTE	→	NCS	Yes
NCS	→	CTE	No
NCS	→	NCS	No
CTE	→	CTE	No
HC	→	CTE	No
HC	→	NCS	Yes

Key

MI = membership interests
IGL = intragroup liability
CTE = chosen transitional entity
LDP = loss denial pool
NCS = non-chosen subsidiary
RUNL = residual unrealised net loss

Note: Higher level push-down of ACA is assumed to have addressed any integrity issues at the lower level, in most cases.

PCo: chosen transitional entity

Because PCo is a chosen transitional entity, it follows a similar process to that of the head company. PCo's membership interests in XCo and YCo are loss interests at formation.

PCo must apply the ACA to its non-chosen subsidiary XCo. A step 1 adjustment will reduce the reduced cost base of the membership interests. This reduces the amount that PCo can allocate to the assets of XCo. PCo's formation RUNL will be reduced to take into account this adjustment.

PCo does not apply the ACA to the assets of its other subsidiary, YCo. As YCo is a chosen transitional entity, the existing tax values of its assets are retained. As there are no MI adjustments in relation to PCo's interests in YCo, there will be no adjustment to PCo's formation RUNL.

A further LDP of the head company is created if PCo's formation RUNL (reduced by any MI adjustments) is greater than nil. The LDP consists of the 165-CC tagged assets of PCo (other than membership interests in XCo and YCo) and the loss denial balance is the adjusted formation RUNL. 170-D deferred losses relating to PCo's pre-formation changeover time would also be attached to the LDP by section 715-360.

CCo: non-chosen subsidiary

Another LDP of the head company is created with the 170-D deferred losses attached (section 715-360). The loss denial balance for the LDP is CCo's formation RUNL. There are no implications for CCo's 165-CC tagged assets.

DCo: non-chosen subsidiary

As DCo has no 170-D deferred losses no LDP is created. There are no further implications for DCo's 165-CC tagged assets.

Separate loss denial pools created in the head company

At formation, the head company of the consolidated group will have three separate LDPs, one from HC, one from CCo and one from PCo.

References

Income Tax Assessment Act 1997, Subdivisions 165-CC and 170-D

Income Tax Assessment Act 1997, Division 715; as amended by *New Business Tax System (Consolidated and Other Measures) Act 2003* (No. 16 of 2003), Schedule 7

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 11

Revision history

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Worked example

Treatment of assets owned by head company at both formation time and pre-consolidation changeover time (no changeover time at formation)

Description

This example deals with the treatment of assets owned by the head company at both formation time and a pre-consolidation changeover time, under Subdivision 165-CC of the *Income Tax Assessment Act 1997* (ITAA 1997).

It explains the calculation of the head company's residual unrealised net loss (RUNL) just before formation time, the 'formation RUNL' (→ section 715-35, ITAA 1997) and the creation of a loss denial pool (LDP) of the head company at formation time. It sets out the assets and amounts ('170-D deferred losses') of the head company that are used to calculate its unrealised net loss (UNL) for a pre-consolidation changeover time and explains how those assets and amounts are treated at formation time.

The loss denial pool consists of certain assets and amounts of the head company. The total of those assets and amounts is the loss denial balance (LDB). If the assets or amounts result in a loss or deduction to the head company, they can be reduced by an amount not exceeding the value of the LDB. This example also shows how losses are applied to reduce the LDB.

The example is based on the following assumptions:

- CGT assets acquired for less than $10,000 are included → subsection 165-115A(1B), ITAA 1997
- the maximum net asset value test is exceeded → section 152-15
- the global method is not chosen → subsection 165-115E(2), and
- the head company does not have a changeover time at or after formation.

→ ''Effect of Subdivision 165-CC for steps 1 and 2 of the ACA calculation at formation and joining times ', C2-6-110
→ ''Pre-formation changeover times – application of Subdivision 165-CC at formation (transitional period)', C2-6-520

Commentary

When the formation time for a consolidated group is not a changeover time, the head company may need to work out its formation RUNL. Normally, the calculation of a RUNL is only required when there is a loss or deduction on an asset owned at the changeover time.

The head company determines whether the same business test (SBT) is satisfied for its trial year and just before its changeover time. If the SBT is satisfied, the pre-consolidation changeover time has no further implications for the head company at or after formation. If the SBT is failed, a LDP of the head company may be created.

Broadly, a LDP of the head company can only be created if:

- the formation time is not a changeover time for the head company
- there was a pre-consolidation changeover time, and
- the head company still owns at least one '165-CC tagged asset', or has a '170-D deferred loss', at formation time.

The 165-CC tagged assets and 170-D deferred losses make up the LDP.

The loss denial balance for the head company's LDP is the remaining formation RUNL after membership interests (MI) and intragroup liability (IGL) adjustments .

As losses and deductions on the assets and amounts are realised, they leave the LDP and the loss denial balance is reduced. A LDP will cease to exist when there are no further assets or 170-D deferred losses in the pool, or when the loss denial balance has been reduced to nil.

Example

Facts

On 3 December 2001, a head company of a wholly-owned group had a 165-CC changeover time (i.e. a pre-consolidation changeover time). Figure 1 shows the assets, including a 170-D deferred loss, held by the head company at the changeover time. Table 1 shows the unrealised net loss calculation. Note that an intragroup debt interest is referred to as an intragroup liability.

Figure 1: Assets of the head company at changeover time

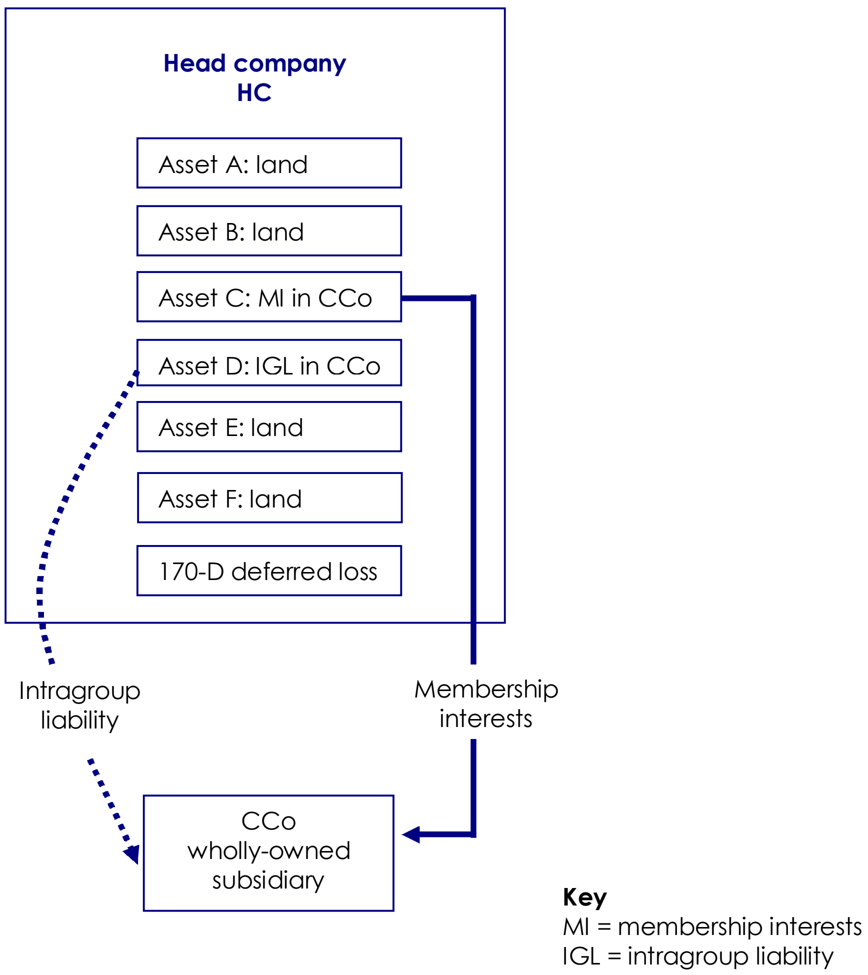

Table 1: Calculation of the pre-consolidation changeover time unrealised net loss ($)

Asset	Type	Cost base	Reduced cost base	Market value at changeover time	Unrealised net loss
A	Land	10,000		12,000	2,000
B	Land		9,000	6,000	(3,000)
C	MI in CCo		7,000	3,000	(4,000)
D	IGL in CCo		6,000	4,000	(2,000)
E	Land		11,000	10,000	(1,000)
F	Land		18,000	15,000	(3,000)
170-D amount					(1,000)
Balance					**(12,000)**

Note: Subdivision 165-CC covers 170-D deferred losses of a company at a changeover time → paragraph 165-115A(1A)(b) and subsection 165-115E(1), method statement, step 5.

On 1 July 2002, HC, the head company of a wholly-owned group, chooses to form a consolidated group with itself as head company. CCo is a subsidiary member of the group.

Formation time is not a changeover time for the head company. At formation time, HC still has 165-CC tagged assets and a residual unrealised net loss from the changeover time before consolidation. The 165-CC tagged assets of HC include a 170-D deferred loss and membership interest and intragroup liabilities in CCo.

Calculation

The following explains the impact of various realised losses on the head company's formation RUNL and loss denial pool. Table 2 summarises these effects.

Asset B: realised at a loss before consolidation at changeover time market value

Before consolidation, in June 2002, asset B is realised at a loss of $3,000.

Formation of a consolidated group – no changeover time at formation

On 1 July 2002, the head company and its subsidiaries form a consolidated group – there is no changeover time at formation. The head company of the wholly-owned group becomes head company of the consolidated group.

Calculation of the formation RUNL (section 715-35)

At formation time, the head company calculates a formation RUNL, taking into account the unrealised net loss at changeover time and reducing it by losses on 165-CC tagged assets realised between changeover and formation time. The formation RUNL is $9,000 ($12,000 – $3,000), which must be reduced by any step 1 MI and step 2 IGL adjustments to the ACA to be allocated to CCo's assets. Note that these adjustments cannot exceed the formation RUNL.

Head company determines whether the same business test (SBT) is satisfied

The head company also determines whether the SBT is satisfied. If it is satisfied, the pre-consolidation changeover time has no further implications for the head company. If the SBT is failed, a LDP of the head company may be created. In this example, HC determines that the SBT is failed.

Asset C: adjustment for MI reduces formation RUNL (section 715-50)

HC has membership interests in CCo, a non-chosen subsidiary. At step 1 of the ACA, the reduced cost base of the membership interests that form part of the ACA that HC allocates to CCo's assets is reduced from $7,000 to the market value at formation ($4,500). The $9,000 formation RUNL is reduced by the same amount to $6,500. Note that market value at formation is used, not market value at the changeover time.

MI and IGL adjustments are only made when they are loss interests, not gain interests.

Asset D: adjustment for IGL reduces formation RUNL (section 715-55)

HC has an intragroup liability in CCo, a non-chosen subsidiary. The reduced cost base of the IGL is reduced from $6,000 to the market value at formation ($2,500). At step 2, the reduced IGL of $2,500 is added as a liability that forms part of the ACA that HC can allocate to CCo's assets. The $6,500 formation RUNL is reduced by the same amount, to $3,000.

Note that the ACA would not apply if CCo was a chosen transitional entity, and no MI or IGL adjustments would be made to the formation RUNL.

Loss denial pool of head company created– assets and 170-D deferred loss

A LDP of the head company is created and the loss denial balance of $3,000 is the formation RUNL (after the MI and IGL adjustments → section 715-60). The LDP is created at formation and consists of assets A, E and F. The 170-D deferred loss of $1,000 is attached under section 715-355.

Asset E: realised loss is less than the unrealised loss at changeover time (section 715-160)

Asset E is realised in October 2002 at a loss of $500. The $500 loss is denied (there is no further SBT as it was previously failed). The loss denial balance is reduced by $500 to $2,500. Assets and amounts in the LDP are now A, F and the 170-D deferred loss.

170-D deferred loss revived (section 715-365)

In December 2002, the 170-D deferred loss is revived and the amount of $1,000 is denied. The loss denial balance is reduced by $1,000 to $1,500, with assets A and F remaining in the LDP.

Asset A: gain asset at changeover time is realised at a loss (section 715-160)

Asset A, a gain asset at changeover time, is realised in January 2003 with a capital loss of $2,000. The loss is only denied to the extent of the loss denial balance ($1,500) – the remaining $500 is subject to normal rules.

Asset F: remaining asset when the loss denial balance becomes nil

Asset F is the remaining asset but, as the loss denial balance is nil, the loss denial pool ceases to exist. If asset F is later realised at a loss, the loss will be subject to the normal rules.

Table 2: Head company formation RUNL and loss denial pool reduction

Formation RUNL (with MI and IGL adjustments)	Events affecting loss denial pool	Loss denial balance
$12,000 UNL at changeover time		
($3,000) asset B realised loss		
$9,000 formation RUNL reduced by:		
($2,500) asset C – MI adjustment		
($3,500) asset D – IGL adjustment		
$3,000 formation RUNL	**Loss denial pool created**	$3,000
	Asset E realised $500 loss	$2,500
	Subdivision 170-D amount of $1,000 revived	$1,500
	Asset A realised $2,000 loss	$0
	Loss denial pool ceases to exist	

Note: The head company of the wholly-owned group became the head company of the consolidated group. The formation RUNL of $3,000 is equal to the $3,000 loss denial balance of the head company's loss denial pool. The assets in the loss denial pool are assets A, E and F and the 170-D deferred loss attached under section 715-355.

References

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Worked example

All assets in head company's loss denial pool become assets of leaving entity

Description

This example examines the situation when an entity leaves a consolidated group taking with it all the assets in a particular loss denial pool (LDP) of the head company. The example is based on the following assumptions:

- one or more loss denial pools of the head company were created at formation
- the head company has not had a Subdivision 165-CC changeover time (under the *Income Tax Assessment Act 1997* (ITAA 1997)) during consolidation, and
- neither the head company nor the leaving entity has a changeover time when the entity leaves the group.

The head company (HC) chooses that a loss denial pool of the leaving entity is created with a loss denial balance (LDB) equal to HC's loss denial balance.

The example illustrates the depletion of the leaving entity's loss denial pool and loss denial balance after it leaves the consolidated group.

→ ''Effect of Subdivision 165-CC where an entity leaves a consolidated group', C2-6-120

Commentary

When a consolidated group forms, it may be necessary to create one or more loss denial pools of the head company. If the head company has not had a changeover time during consolidation, there may still be assets in a loss denial pool that a leaving company or trust may take with it when it leaves the consolidated group (provided there is no changeover time at the leaving time). In these circumstances, the head company must choose between three options for dealing with those assets (→ section 715-120, ITAA 1997):

- reduce adjustable values of all such assets to nil
- apply the loss denial balance to reduce the adjustable values of those assets that are loss assets, or
- create a loss denial pool in the leaving entity.

The third choice can only be made when every asset that was in a particular LDP of the HC just before leaving time leaves with the leaving entity. HC has 6 months to make its choice and a further month, after the choice is made, to notify the leaving entity in writing that a LDP has been created in the leaving entity at leaving time. HC must specify the loss denial balance at that time. The Commissioner has the power to extend the period in which the choice can be made and notice given.

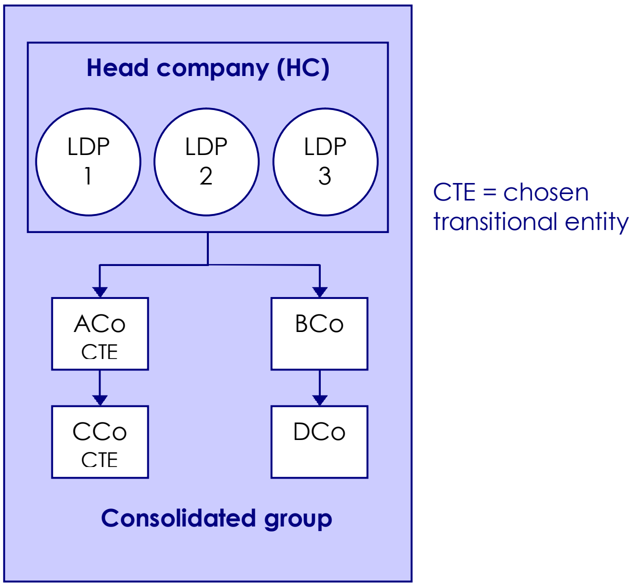
The LDP of the leaving entity consists of all the leaving assets. Its loss denial balance is equal to that of the head company. The LDP of the head company ceases to exist when the LDP of the leaving entity is created.

Example

Facts

A consolidated group is formed on 1 July 2002 with a head company, HC, and subsidiaries, ACo, BCo, CCo and DCo. ACo and CCo are chosen transitional entities → 'Pre-formation changeover times – application of Subdivision 165-CC at formation (transitional period)', C2-6-520. Formation was not a changeover time for the head company and, at that time, HC, ACo and CCo had '165-CC tagged assets' and residual unrealised net losses from changeover times before consolidation. ACo also had a '170-D deferred loss' related to its changeover time. At formation, the three companies– HC, ACo and CCo – failed the same business test and three separate loss denial pools of the head company were created.

Figure 1: Consolidated group at formation



LDP 2 of the head company at formation consists of assets W, X, Y and Z and a 170-D deferred loss. Its loss denial balance is $5,000.

On 30 March 2003, DCo leaves the consolidated group and takes all the assets remaining in LDP 2. DCo does not have a changeover time when it leaves and HC chooses that a LDP of DCo be created.

Calculation

The following explains the creation of the LDP of leaving entity DCo and the impact of various realised losses on the LDP after the entity leaves the consolidated group. Table 1 summarises the effects on the LDP created in DCo at leaving time.

1 December 2002 – asset W realised at a gain of $2,000 during consolidation

During consolidation, asset W is realised and a capital gain of $2,000 is made. Asset W leaves the head company's LDP but, as a gain is realised, the loss denial balance remains unchanged at $5,000.

30 March 2003 – DCo leaves the consolidated group

DCo leaves the consolidated group, taking with it all remaining assets in LDP 2 of the head company. Just before the leaving time, assets X, Y and Z and a 170-D deferred loss remain in HC's LDP2 and the loss denial balance is $5,000.

Treatment of 170-D deferred loss in a LDP at leaving time

Like other losses, 170-D deferred losses (including those in LDPs) cannot leave a consolidated group with a leaving entity. They remain with the head company.

LDP created in leaving entity DCo at leaving time (section 715-135)

All the assets that were in HC's LDP 2 just before the leaving time leave with DCo. The assets leave HC's LDP when they become assets of the leaving entity. HC chooses the third of the available options and creates a LDP in the leaving entity, DCo. The assets and loss denial balance ($5,000) of the new LDP are the same as those of the head company's LDP 2 (see table 1). When the LDP is created in DCo, the head company's LDP 2 ceases to exist.

HC has 6 months after leaving time to make the choice to create the LDP in the leaving entity, and a further month after the choice is made to notify DCo that a LDP has been created at leaving time and to advise DCo of the loss denial balance at that time.

29 October 2003 – asset X realised at a loss

Asset X realises a $2,000 capital loss that is denied → section 715-160. Asset X leaves DCo's LDP and the loss denial balance is reduced by $2,000 to $3,000.

Note that a same business test is not required for realised losses on assets in a loss denial pool as the test has already been failed.

15 February 2004 – asset Y realised at a loss

Asset Y realises a capital loss of $3,000 that is not allowed. Asset Y leaves DCo's LDP and the loss denial balance is reduced by $3,000 to nil.

Loss denial balance becomes nil

When the loss denial balance becomes nil, the LDP ceases to exist. Asset Z, the remaining asset, is no longer attached to a LDP and any loss, deduction or gain, when it is realised will be subject to normal rules.

DCo may choose to cancel the LDP

Within 6 months, or a further period allowed by the Commissioner, of the LDP being created in the leaving entity (DCo), DCo may choose to cancel the LDP created by HC. Either of the other two choices are available to it – the first under section 715-125, or the second under section 715-130. Both of these options will result in the adjustable values of leaving assets being reduced. DCo's LDP will cease to exist just after the leaving time. HC's LDP still ceases to exist at the leaving time (as it did under the third choice).

Table 1: LDP created in DCo at leaving time – reduction

Events affecting LDP assets	Loss denial balance
	$5,000
X – $2,000 loss realised 29.10.03 – asset leaves LDP	$3,000
Y – $3,000 loss realised 15.2.04 – asset leaves LDP	$0
Z – remaining asset	
Loss denial pool ceases to exist	**$0**

References

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C3: **Losses**

Losses

About this section

Section C3 provides technical detail on the process of transferring and using losses. It comprises:

- a technical introduction to the treatment of losses under consolidation
- a high-level worked example of the loss transfer and utilisation process
- a series of smaller, more detailed worked examples describing the different tests, calculations and scenarios that may arise.

For a brief description of the consolidation loss provisions see Part B of the Consolidation Reference Manual (→ 'Transferring and using losses', B2-3).

Section contents

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Treatment of losses

Note

The diagram on page 2 provides an overview of the consolidation loss provisions.

One of the principles recommended by *A tax system redesigned* is that a company or trust entering a consolidated group should be able to bring its losses into the group.

The consolidation provisions are not designed to facilitate the earlier or greater use of those losses. Rather, they ensure that the tax system does not stand in the way of commercial group restructures. The loss rules complement the consolidation regime.

Unrestricted transfer of losses to the head company of a consolidated group and subsequent unrestricted utilisation of these losses would be too costly to the revenue. Accordingly, the amount of losses that can be transferred to the head company of a consolidated group is restricted by ensuring that entities seeking to transfer losses pass, at the transfer time, modified versions of the general tests for utilising losses.

The rate at which transferred losses can be used by the head company of a consolidated group is generally restricted to approximate the rate of use that the joining entity would have experienced had it remained outside of the consolidated group. A concessional method for the use of transferred losses has been developed in respect of eligible company losses made in an income year ending on or before 21 September 1999 (the date of release of the Ralph Report) and transferred when the group first consolidates in the transitional period – that is, between 1 July 2002 and 30 June 2004.

An additional concession, available to groups that consolidate during this period, allows the head company to elect to exclude from the group for a period certain entities with unrecouped foreign losses → worked example 'Transitional foreign loss makers', C3-4-550; Division 701D, IT(TP)A 1997

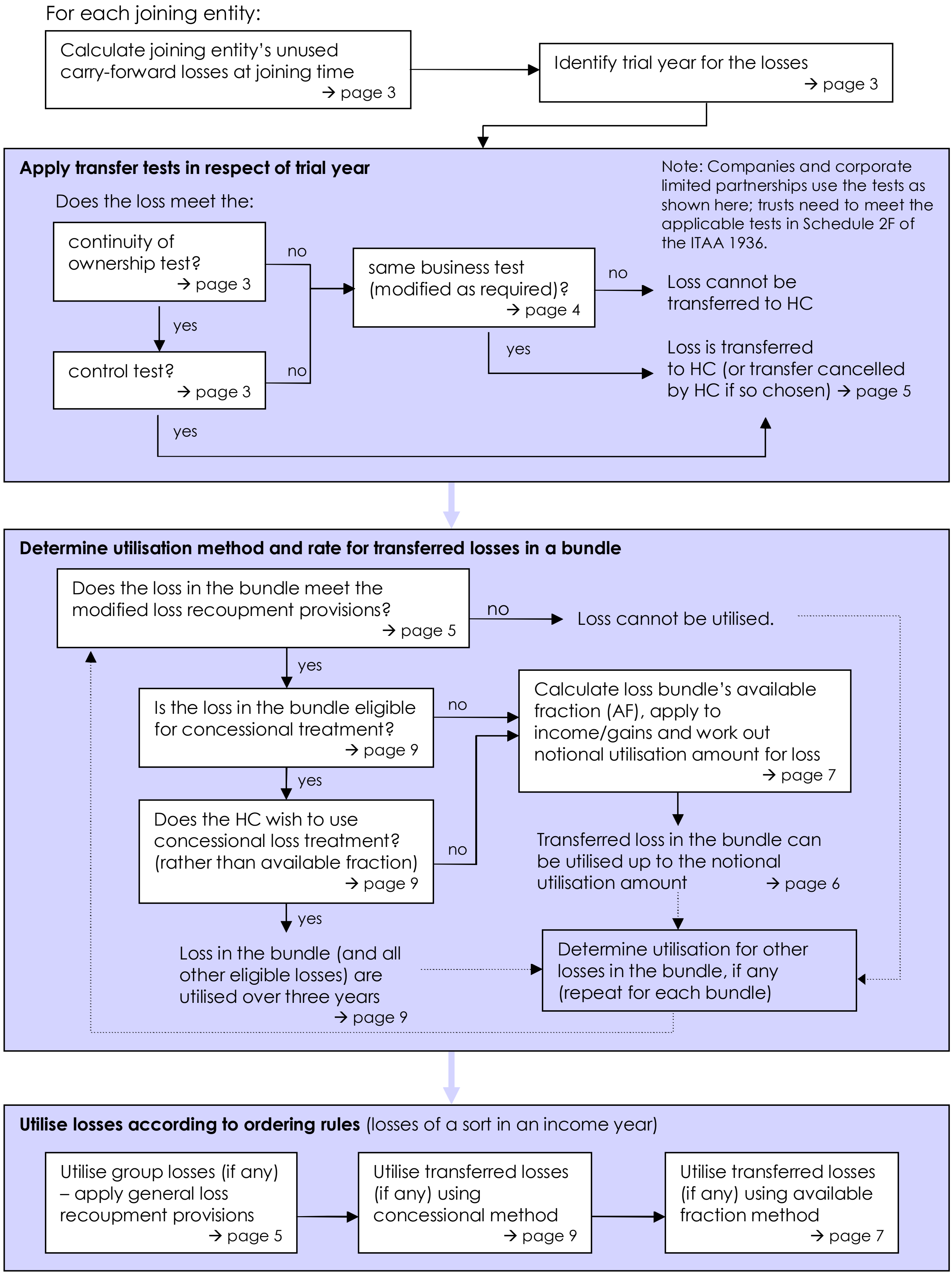
Transferring losses to the consolidated group

When an entity becomes a member of a consolidated group (whether as head company or as a subsidiary), its unused carry-forward losses are transferred to the head company if the losses satisfy modified versions of the usual tests for deducting and applying them (referred to as the 'general loss provisions', which are outside the consolidation rules).

Broadly, the tests are applied as though the 12 months prior to the joining time were the loss claim year (known as the trial year).

The loss is transferred to the head company of the group if the joining entity could have utilised the loss in the trial year assuming it had sufficient income or gains of the relevant type.

Figure 1: Treatment of losses – overview



The trial year

The trial year is the notional loss claim year for transfer testing purposes. It serves two purposes. First, the trial year ensures that the ownership test period ends just after the joining time, which means that ownership changes that occur as part of either forming or joining a consolidated group are counted in determining whether the loss can be transferred. Second, if required to apply the same business test to the joining entity, the trial year ensures that its business is tested for a minimum 12-month period.

While generally the trial year encompasses a 12-month period, in certain circumstances it may actually be shorter. → 'Glossary', A2

Process for transferring losses to the head company

There are generally three steps to be followed by a joining entity seeking to transfer losses to the head company of a consolidated group:

Step 1: the entity works out its taxable income or loss for the period up to the time it joins the group → worked examples C3-3-110, C3-3-120

Step 2: the entity identifies the amount of its unused carry-forward losses as at the joining time → worked examples C3-3-110, C3-3-120

Step 3: the entity then determines whether those losses satisfy the modified tests for using them in the context of the trial year

→ worked examples C3-3-210, C3-3-220, C3-3-230, C3-3-240, C3-3-245, C3-3-246, C3-3-250, C3-3-260, C3-3-270

Thus, where the entity joins the group as a subsidiary member it is required to consider the general loss provisions in the course of establishing its income tax liability (if any) to the point of consolidation, and to then consider them again as transfer tests (modified as required) in the context of the trial year.

The tests generally require the joining entity:

- to have maintained a majority of the same ownership and control for the period between incurring the loss and just after the joining time (the continuity of ownership and control tests), or
- in certain cases, to have carried on the same business for at least the 12 months before the joining time (the same business test).

The continuity of ownership and control tests

→ worked examples C3-3-210, C3-3-220

For companies

The continuity of ownership test would be satisfied if the same majority ownership of the joining entity was maintained from the start of the income year in which the loss was made until just after consolidation. Thus, the trial year captures ownership changes resulting from the choice to consolidate joining entities. The continuity of ownership test requires that the same owners, owning the same shares, satisfy the test for the whole of the period.

The control test is failed if a person starts to control the entity's voting power, during the period in which the continuity of ownership test is applied, for the purposes of gaining a benefit or advantage in relation to the application of the Tax Act.

If the continuity of ownership and control tests are satisfied, the joining entity's losses are transferred to the head company. If either of the tests is not satisfied, the same business test would need to be satisfied before the joining entity's losses could be transferred at consolidation.

Corporate limited partnerships that are treated as companies because of section 94J of the ITAA 1936 also apply these tests, though they are not required to test maintenance of voting power.

For trusts

Where the joining entity is a fixed trust it needs to meet the 50% stake test. This applies in a broadly similar manner to the company continuity of ownership test, though trusts are not required to examine voting power. A non-fixed trust must pass a control test. A non-fixed trust may also be required to pass the 50% stake test or the pattern of distributions test, or both.

→ 'Glossary', A2

The same business test

→ worked examples C3-3-230, C3-3-240,C3-3-245, C3-3-246, C3-3-250

Where the ownership or control tests are failed but the joining entity meets the same business test, the loss is transferred to the head company.

The general company same business test compares the time just before the test time with the income year in which the loss is claimed to determine if the same business was conducted in both periods. The test time is generally when the ownership (or control) test was first failed. However, when applying the same business test as a loss transfer test, the periods examined for comparison may be different to those ordinarily used for recoupment purposes.

Same business test: modifying the periods during which it applies

Modifying the existing same business test rules for transfer testing is required because of the possibility that some or all of the test periods overlap or coincide.

Table 1 shows how the same business test applies for companies joining a consolidated group. Consideration must be given to the different rules as they apply to listed public companies and their 100% subsidiaries.

Table 1: Same business transfer tests for companies

No	In these circumstances:	Test the joining entity's business at these points:
1	The loss was made by the joining entity for an income year starting after 30 June 1999	• just before the end of the income year in which the loss was made • the income year that included the test time (the test time is generally when the ownership or control tests were first failed) • the trial year
2	The loss was made by the joining entity for an income year starting before 1 July 1999	• just before the test time (the test time is generally when the ownership or control tests were first failed) • the trial year

In applying the same business test as a transfer test, it is assumed that the business carried on by the joining entity at and just after the joining time is the same as the business it carried on just before the joining time. This ensures that the test period effectively ends immediately before the joining time.

Where a loss is transferred as a result of satisfying the same business test, in order for it to be transferred again an additional test must be satisfied.

→ worked example C3-3-250

Joining entity losses become losses of the head company

A joining entity's eligible losses are transferred to the head company at the joining time. The head company is then treated as having made the loss itself in the income year of the transfer.

The head company is then the only entity capable of utilising the loss. Losses that have been transferred can be deducted, applied or taken into account (subject to limitations) for all income years of the head company following consolidation, until the losses are either exhausted or rendered non-utilisable.

If the joining entity ceases to be a member of the consolidated group, all losses remain with the head company of the consolidated group. Cessation of membership of the consolidated group can occur through liquidation or sale of the joining entity.

Using losses in the consolidated group

A head company is required to work out its taxable income under section 4-5 of the ITAA 1997 as if each of the other entities in the consolidated group were part of the head company. In the process of working out the head company's taxable income it is entitled to shelter its income through the utilisation of its carry-forward losses (subject to the limits imposed). Broadly speaking, these losses can either be:

- losses generated by the consolidated group (group losses), and/or
- transferred losses that were generated by an entity before it became a member of the group.

Before utilising a group loss or a transferred loss, the head company is required to apply the general loss recoupment provisions. This necessitates the head company passing the continuity of ownership and control tests or the same business test. For transferred losses, these recoupment tests are modified for the purposes of determining whether the company has maintained the same ownership. The two modifications are outlined in Subdivision 707-B.

First, the loss year is modified so that it starts from when the loss was transferred to the head company. This ensures that things that happened to the head company before the transfer time are not taken into account in applying the continuity of ownership test. However, this is subject to the second modification.

The second modification is that in determining whether the head company can use a loss transferred to it from a company as a result of passing the continuity of ownership and control tests, pre-consolidation changes in ownership of the loss company are recognised. → Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 7

When determining the amount of losses utilised in an income year, group losses are effectively utilised before transferred losses of the same sort. Similarly, any losses claimed on a concessional basis in an income year are effectively claimed prior to any utilisation of other transferred losses of the same sort. In some circumstances, group tax losses and tax losses claimed on a concessional basis can be deducted after other transferred tax losses in an income year. The main reason this can occur is the optional use of prior year tax losses.

Transferred losses are bundled. At first instance, a bundle of losses consists of all the losses that are transferred to the head company for the first time by the entity that actually made them. A bundle of losses may consist of only one loss. Losses within the bundle are categorised by sort (such as a film loss or a net capital loss). An available fraction is calculated for each bundle.

All losses in the bundle are treated as having been made by the head company in the same income year.

Determining the amount of a transferred loss that can be utilised for an income year

The amount of a transferred loss that can be utilised by the head company from a particular joining entity is calculated by reference to an available fraction. Generally, each bundle has an available fraction calculated on the basis of the loss entity's modified market value as a fraction of the adjusted market value of the consolidated group.

There is a limit on the amount of losses of each sort within a bundle of losses that can be utilised by the head company. Broadly, the limit is set by multiplying the head company's income or gains of that type by the available fraction for the bundle of transferred losses.

In situations where losses are transferred to the head company part-way through the head company's income year, a rule operates to apportion the limit to which losses can be deducted against income. The apportionment rule ensures that the head company does not obtain 'full-year access' to losses that it has owned for only part of its income year.

The apportionment rule also ensures that the head company's use of its own prior year losses (transferred to itself on consolidation) are unrestricted in respect of income broadly attributable to the pre-consolidation period.

Note

Utilisation of transferred tax losses in the year of transfer and section 36-17

A transferred loss is taken to have been made by the head company for the income year in which the transfer occurs → subsection 707-140(1). However, according to subsection 707-140(2), the head company is not prevented from utilising a transferred loss for the income year in which the transfer occurs. This overrides the general rule that an entity may only deduct or apply losses from earlier income years.

Section 36-17 allows corporate tax entities to choose the amount of prior year tax losses they wish to deduct in a later year of income, subject to certain restrictions. As a result of the effect of subsection 707-140(2), the head company can apply the choice in section 36-17 to a transferred tax loss for the income year in which the transfer occurs.

Note

Foreign loss quarantining no longer required

The foreign loss quarantining rules have been repealed, allowing foreign losses to be offset against domestic assessable income (or assessable foreign income of a different class). Transitional rules in Subdivision 770-A of the *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A) provide for the conversion of past foreign losses to a tax loss with a limit on utilisation in the four year transitional period. These rules are modified for consolidated groups by Subdivision 770-B of the IT(TP)A. These changes apply from the income year beginning on or after 1 July 2008. → 'Amount of transferred losses that can be utilised – foreign loss component of a tax loss', C3-4-560

Calculating the available fraction

The available fraction is a representation of the market value of the loss entity as a proportion of the market value of the consolidated group (including the loss entity). The market values are determined as at the joining time.

The calculation of the available fraction is as follows:

$$\frac{\text{Modified market value of the loss entity}}{\text{Adjusted market value of the consolidated group}}$$

The modified market value of the loss entity is its market value assuming:

- the loss entity has no losses and the balance of its franking account is nil
- the subsidiary members of the group at the joining time are separate entities and not divisions or parts of the head company at the joining time
- the entity's market value does *not* include an amount attributable to a membership interest in a member of the group that is a corporate tax entity or an entity that transferred losses to the head company, and

- a trust (other than a corporate tax entity or a trust with losses) contributes to the joining entity's market value only to the extent attributable to fixed entitlements at the joining time to income or capital of the trust that is not attributable to a membership interest in another member of the group that is a corporate tax entity or a trust with losses.

→ worked example C3-4-110

The adjusted market value of the consolidated group at the joining time is its market value ignoring all losses and assuming that its franking account balance is nil.

An increase in the value of the loss entity is excluded from the entity's modified market value if the increase results from either of these events:

- an injection of capital into the loss entity, its associate or, if the loss entity is a trust, an associate of the trustee → worked example C3-4-120; Taxation Ruling TR 2004/9, or
- a non-arm's length transaction that involved the loss entity, its associate or, if the loss entity is a trust, an associate of the trustee.

These rules prevent a loss entity from inflating its market value before it joins a consolidated group in order to obtain a higher available fraction. They apply to those events described above that occur in the four years before the loss entity joins the group – however, they do not apply to events that occurred before 9 December 2000 → 'Determining the reduction amount – subsection 707-325(3)', C3-6.

Note

Options during the transitional period (1 July 2002 to 30 June 2004)

- An available fraction calculation for a loss bundle may not be necessary if the head company chooses the concessional method for utilisation and all losses in the bundle can be utilised under this method.

  → 'Utilising transferred losses over three years', page 9
- Subject to certain conditions, the available fraction for a bundle of transferred losses may be increased by allowing the head company to add to the loss company's modified market value all or part of the modified market value of another group company.

  → 'Increasing the available fraction (value donor concession)', page 10
- An administrative provision applies during the transitional period under which, if certain conditions are met, market valuations may not be required where the available fraction can be assumed to be 1.000.

  → 'Market valuation transitional option', page 11

Adjustments to available fractions

The available fraction for a bundle of losses must be adjusted if certain events occur. For example, if a new loss member joins the group (and hence a new bundle of losses is transferred), each pre-existing available fraction needs to be recalculated to reflect the new consolidated group structure → worked example C3-4-330. The head company may choose to cancel all the loss transfers in respect of the incoming bundle, thereby avoiding the requirement to adjust each pre-existing available fraction in the group.

Note

Time limit for cancelling the transfer of a loss

The choice to cancel the transfer of a loss cannot be revoked after 31 December 2005. Revocation of the choice before 1 January 2006 is only allowed under certain circumstances. → section 707-145, IT(TP)A 1997

The available fraction for each bundle needs to be adjusted if there is an injection of capital or a non-arm's length transaction that results in an increase in the market value of the group. → worked example C3-4-340

There will also be a requirement to adjust the available fraction when a bundle is transferred for a second or subsequent time. This occurs when another consolidated group acquires the head company of an existing group, and the existing group has transferred losses. → worked example C3-4-310

If the sum of the available fractions in the group exceeds 1, the available fractions need to be adjusted so that their sum is capped at 1.

→ worked example C3-4-350

Concessional treatment in deducting transferred losses

There are concessional measures that may apply to a head company in deducting or utilising transferred losses.

Utilising transferred losses over three years

A head company can choose that certain transferred losses be utilised over three years. These are losses (including foreign losses) that are transferred from a company, as a result of passing the continuity of ownership and control tests, and were actually incurred in an income year ending on or before 21 September 1999. The loss company must join the group during the transitional period – that is, between 1 July 2002 and 30 June 2004 – at the time the group consolidates. This choice must be made by the head company for all eligible losses in a particular bundle by the later of:

- the end of 31 December 2005, and
- the day it lodges its income tax return for the income year in which it first utilises any of its transferred losses.

This choice is irrevocable after 31 December 2005.

→ subsections 707-350(5) & (6), IT(TP)A 1997; worked examples C3-4-520, C3-4-525, C3-4-530

Example

Comparing concessional method and available fraction method

A head company has a bundle consisting of a net capital loss of $600, which it can choose to claim on a concessional basis of one-third per annum. The bundle has an available fraction of 0.250 and the head company derived a capital gain of $1,000 for the year. The head company could claim:

under the concessional method:

Capital gain	$1,000
Less: $600 x 1/3 =	$200
Net capital gain	$800

under the available fraction method:

Capital gain	$1,000
Less: $1000 x .250	$250
Net capital gain	$750

In this case, the head company would be able to utilise more of the loss using the available fraction method.

However, if the capital gain for the year were $500 instead of $1,000, the head company would be able to utilise more of the loss using the concessional method: $200 as opposed to $125 ($500 x 0.250). If the concessional method is chosen, the head company must utilise all of the eligible losses in the bundle on this basis in subsequent income years.

Increasing the available fraction (value donor concession)

The available fraction for a bundle of losses transferred by a loss entity may be increased when a head company chooses to consolidate during the transitional period – that is, between 1 July 2002 and 30 June 2004 – and the loss entity joins the consolidated group at the time that consolidated group comes into existence. Subject to certain conditions, if the loss entity had losses that could have been grouped under the loss transfer provisions available prior to 1 July 2003 (that is, in Division 170 of the ITAA 1997), the bundle of losses transferred by that loss entity will be eligible for a higher available fraction. This concession only applies where the relevant loss entities are companies.

Broadly, this is achieved by allowing the head company to add to the loss company's modified market value all or part of the modified market value of another group company (referred to as the value donor) to which the loss company could have transferred losses under the group loss transfer rules available prior to 1 July 2003. The value donor must also join the consolidated group when it first comes into existence.

The head company may also treat one or more of the value donor's losses as if it was included in the real loss-maker's bundle for the purpose of determining the amount of the losses that can be utilised by the group in any given income year. Broadly, losses can be treated in this way only if they could be transferred from the value donor to the real loss-maker, and to any of the real loss-maker's other value donors, under the group loss transfer rules.

→ worked examples C3-4-210, C3-4-220, C3-4-230, C3-4-240

The value donor concession is available to head companies that consolidated during the transitional period (1 July 2002 to 30 June 2004). The choice to use this concession must be made by the head company by the later of:

- the end of 31 December 2005, and
- the day it lodges its income tax return for the first income year for which it utilises transferred losses using the available fraction method.

The choice cannot be amended or revoked after 31 December 2005.

→ section 707-325 IT(TP)A 1997

Market valuation transitional option

Generally, market valuations of the loss entity (joining subsidiary) and the consolidated group are required to determine the available fraction for losses transferred to the head company. → *Market valuation for tax purposes* (NAT 72508) at **www.ato.gov.au**

However, a transitional option provides that market valuations are not required for this purpose during the transitional period (1 July 2002 to 30 June 2004) where the available fraction can be assumed to be 1.000 irrespective of the actual market values of the group member entities. This will be the case where:

- 100% of the value of all value donors is included in the modified market value of a particular real loss-maker, and
- the value donors plus the real loss-maker consist of the entire consolidated group, whose values are taken into account in determining the adjusted market value of the consolidated group.

This option is provided by the Commissioner of Taxation under the general administrative provision (section 8) of the ITAA 1936. It applies only if all of the following conditions are met:

- All members of the consolidated group – with the exception of bare trusts and partnerships – are companies.
- At least one company has a modified market value greater than nil at the time the group is formed (calculation of the actual amount is not required under the concession).
- All of the companies in the consolidated group are chosen to be a value donor to the particular real loss-maker under section 707-325 of the *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A).
- All value donors and the real loss-maker (all group members) became a consolidated group at the same time and before 1 July 2004.
- The choice is able to be made and is made to add all of the modified market value of all the value donors to the real loss-maker.
- There must be no overall foreign loss transferred to the head company of the group at the time the group is formed.
- The losses in the bundle of the real loss-maker are tax losses or net capital losses whose utilisation is *not* affected by section 707-350 of the IT(TP)A. This section provides a choice to utilise certain losses over three years.

- Each value donor would have been able to transfer each of the real loss-maker's losses in the bundle whose utilisation is *not* affected by section 707-350 of the IT(TP)A to the head company at the initial transfer time, pursuant to the consolidation provisions, assuming that each value donor made each loss for the same income year as the real loss-maker and had not utilised it.
- The real loss-maker would have been able to transfer each of its losses in the bundle to each value donor under the grouping provisions of Division 170 of the ITAA 1997 as they existed prior to the amendments introduced by consolidation legislation[12] for the income year which is generally the trial year as prescribed by section 707-328 of the IT(TP)A. → Taxation Determination TD 2004/89
- All of the losses in the bundle of each value donor must be able to be transferred to the real loss-maker and to all of the other value donors under the conditions outlined in section 707-327 of the IT(TP)A.
- No injection of capital, as described in subsection 707-325(4) of the ITAA 1997, has taken place that would lead to a reduction in the modified market value of any member of the group. Taxation Ruling TR 2004/9 provides the ATO view on the meaning of the expression 'injection of capital'.
- No non-arm's length transaction, as described in subsection 707-325(4) of the ITAA 1997, has taken place that would lead to a reduction in the modified market value of any member of the group.

A group may be able to bring itself within these conditions by cancelling the transfer of certain losses under section 707-145 of the ITAA 1997.

The assumed available fraction of 1.000 continues to apply until the time of an adjustment event, as described in the table in subsection 707-320(2) of the ITAA 1997, that reduces the available fraction below 1.000.

[12] *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002) and *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002).

References

Income Tax Assessment Act 1936:

- schedule 2F
- section 94J
- section 8
- paragraph 160AFD(6)(b); as substituted by *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (No. 83 of 2004), Schedule 2, Part 8

Income Tax Assessment Act 1997:

- section 4-5
- subdivisions 707-A, 707-B and 707-C; as amended by New *Business Tax System (Consolidation) Act (No.1) 2002* (No. 68 of 2002), Schedule 1
- subsection 707-205(1) as amended by *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (No. 83 of 2004), Schedule 2, Part 8
- section 36-17; as amended by *Taxation Laws Amendment Act (No. 5) 2003* (No. 142 of 2003), Schedule 8
- Division 170; as existed prior to the amendments introduced by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002) and *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002)

Income Tax (Transitional Provisions) Act 1997:

- Subdivision 707-C; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 2, and *Tax Laws Amendment (2005 Measures No. 5) Act 2005* (162 of 2005), Schedule 3, Part 2
- Division 701D as inserted by *Taxation Laws Amendment Act No. 1, 2004* (No. 101 of 2004)

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 7

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 2) Bill 2004, paragraphs 2.118 – 2.122

Taxation Ruling TR 2004/9 – Income tax: consolidation: what is meant by ‘injection of capital’ in section 707-325 of the *Income Tax Assessment Act 1997*?

Taxation Determination TD 2004/89 – Income tax: consolidation: for the condition outlined in subsection 707-328(4) of the *Income Tax (Transitional Provisions) Act 1997*, are Subdivisions 170-A and 170-B of the *Income Tax Assessment Act 1997* applied as if they had not been amended, by Schedule 3 to New *Business Tax System (Consolidation) Act (No. 1) 2002*, to only provide for loss transfers involving an Australian branch of a foreign bank?

Revision history

Section C3-1 first published (excluding drafts) 2 December 2002 and updated 28 May 2003. Further revisions are described below.

Date	Amendment	Reason
27.10.03	Additional condition to satisfy use of the market valuation transitional option.	Clarify that in a situation where the modified market values of all the members of the group are nil at the joining time, the transitional option is not available.
5.4.04	Modify description of same business test points.	Reflect changes in *Taxation Laws Amendment Act (No. 5) 2003* (No. 142 of 2003).
	Revise conditions that must be met to use market valuation transitional option.	Exclude bare trusts and partnerships from condition that all group members be companies. Clarify conditions for real loss-makers and value donors. Clarify effect of available fraction adjustment event.
4.6.04	Liquidation or sale of joining entity after consolidation and effect on utilisation of transferred losses.	Clarify that liquidation or sale of joining entity after consolidation has no effect on head company's ability to utilise the transferred losses.
	Choice made by head company to utilise certain transferred losses over three years cannot be revoked after 31 December 2004.	Reflect changes in *Taxation Laws Amendment Act (No.2) 2004.*
14.7.04	Note on recent changes to consolidation rules.	Legislative amendments.
10.12.04	Note on operation of section 36-17 and utilisation of transferred tax losses in the year of transfer, p. 7.	Clarification.
26.10.05	Government announces extension of time for head companies to make or revoke certain elections.	Proposed legislative amendments.
	Updates to reflect recent legislative amendments, taxation rulings and taxation determinations.	
12.9.06	Extension of time for head companies to make or revoke certain elections, pp. 8-10.	Legislative amendments.
	Total income ceiling for same business test, p. 4.	Legislative amendments.
	References to worked examples updated.	
26.6.07	Note on proposed changes to remove the $100 million cap on the same business test, p. 4.	Reflect announcement on 8 May 2007 by Assistant Treasurer in media release no. 48.
30.6.09	Note on repeal of foreign loss quarantining rules, p. 7.	Legislative amendment.

Date	Amendment	Reason
15.4.10	Update to reflect removal of $100 million cap on the same business test with effect from 1July 2005, p 4.	Legislative amendment.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

High-level worked example

Consolidation loss provisions

Description

A joining entity's eligible losses are transferred to the head company at the joining time. The head company is then treated as having made the loss itself in the income year of the transfer. The use of transferred losses is limited by their available fraction – that is, they may be offset against only a fraction of the head company's income and gains. Subject to certain conditions, the available fraction for a bundle of losses[13] transferred by a loss entity may be increased when the head company chooses to consolidate during the transitional period and the loss entity joins the consolidated group at the time that the consolidated group comes into existence.

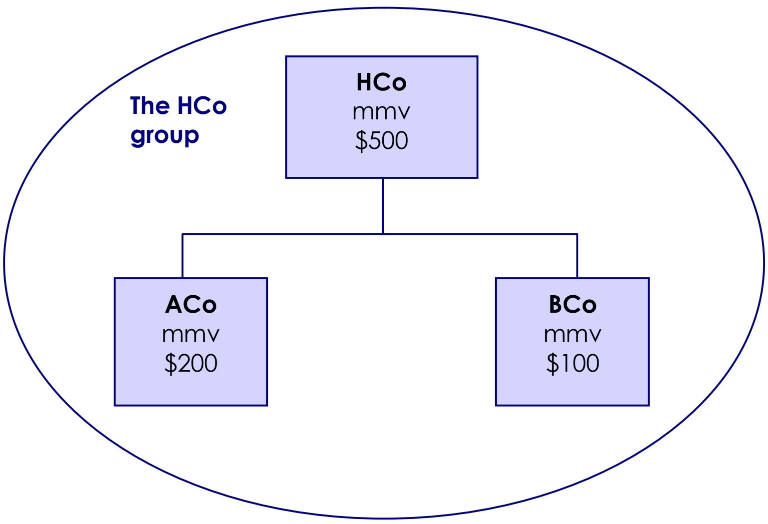
Commentary

Subdivision 707-A sets out the rules for determining whether the joining entity's losses can be transferred to the head company. Subdivision 707-C outlines how much of a transferred loss may be deducted or applied by the head company. The transitional concessions available in relation to losses transferred to a consolidated group are contained in Subdivision 707-C, *Income Tax (Transitional Provisions) Act 1997*.

Example – facts

Assume the following consolidated group structure as at the joining time (1 July 2002).

Figure 1: HCo group structure



ACo has been 90% owned by HCo since incorporation in 1995. The remaining 10% is acquired at the joining time.

BCo was purchased 100% in a takeover by HCo on 27 July 1998.

mmv = modified market value

[13] A bundle of losses consists of all the losses that are transferred to the head company for the first time by the entity that actually made them.

Example – calculation

Loss transfer

How do ACo and BCo determine the amount of any transferable losses?

HCo, ACo and BCo all need to establish their tax position at the joining time (1 July 2002). This enables each entity to determine what unutilised losses they may have available for potential transfer to the head company.

Generally, in order to be transferable, each unutilised loss must have been able to be utilised by the joining entity had it remained outside the consolidated group.

At the joining time, ACo and BCo had the following losses that were eligible for potential transfer to HCo.

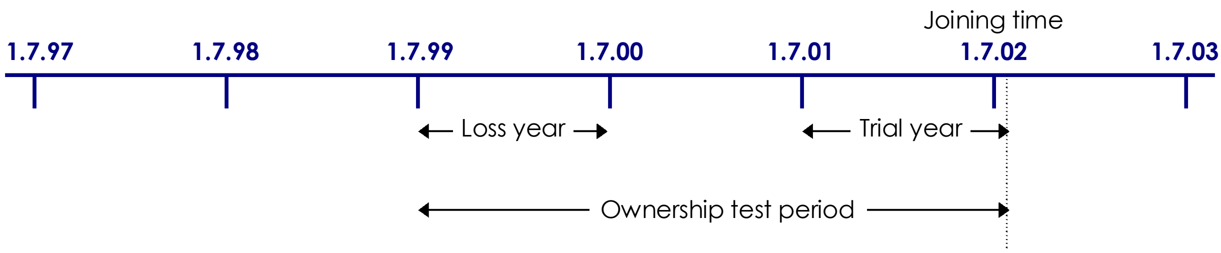
Table 1: Eligible losses of ACo and BCo at joining time

Subsidiary	Loss	Sort	Year incurred
ACo	$250	Net capital loss	2001
	$650	Tax loss	2000
BCo	$350	Net capital loss	1998
	$300	Tax loss	2000

Have the joining entities maintained substantially the same ownership or the same business for the period since the loss was incurred until just after the joining time?

A loss is transferred from ACo or BCo to HCo to the extent that the loss could have been utilised by either ACo or BCo for an income year consisting of the *trial year*.

Figure 2: ACo's 2000 tax loss



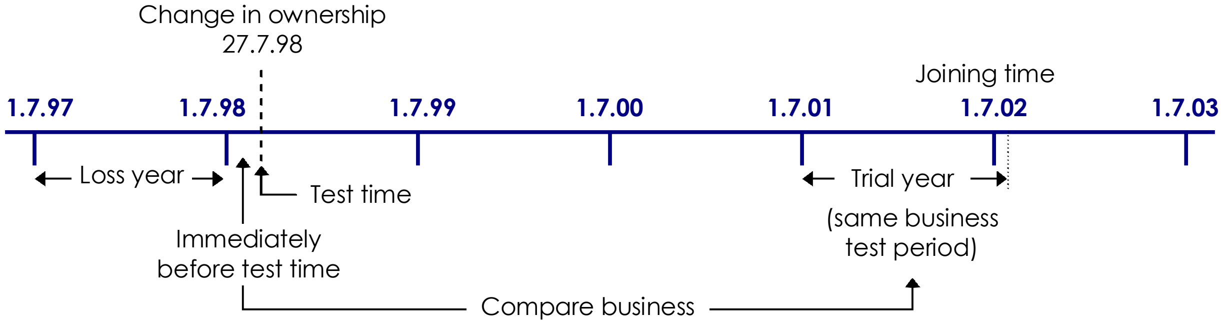
Assume ACo's 2000 tax loss satisfies the continuity of ownership test (COT) and the control test. It follows that ACo's 2001 net capital loss also satisfies these tests. Both losses can therefore be transferred to HCo.

BCo's 1998 net capital loss (pre-1999)

BCo experienced a change in its majority ownership on 27 July 1998. Therefore, the net capital loss that BCo made in the 1998 income year cannot satisfy the COT. BCo will only be able to transfer the loss to HCo if it satisfies a modified same business test (SBT).

As the capital loss was made in an income year beginning prior to 1 July 1999, BCo compares the business conducted immediately before the test time to the SBT period (or trial year[14]) to see if it satisfies the SBT for the loss, as shown in figure 3.

Figure 3: BCo change in ownership on 27.7.98 (test time)



Assume that BCo's 1998 net capital loss satisfies the SBT and can therefore be transferred to HCo.

BCo's 2000 tax loss

Assume that BCo's 2000 tax loss satisfies the COT (as well as the control test) and can therefore be transferred to HCo.

Calculating the available fractions

What are the available fractions for each bundle of losses transferred to HCo in the absence of the value donor concession?

In this example, the calculation of the available fraction is as follows:

$$\frac{\text{Modified market value of the loss company}}{\text{Adjusted market value of the consolidated group}}$$

[14] Although the trial year ends just after the joining time, the SBT period effectively ends immediately before the joining time. This is achieved by assuming that the business carried on by the joining entity at and just after the joining time is the same as the business it carried on just before the joining time.

The adjusted market value of the consolidated group as at the joining time, ignoring any losses and assuming a nil franking account balance, is $800. Thus the available fractions are as follows:

Bundle A: $\dfrac{200}{800} = 0.250$

Bundle B: $\dfrac{100}{800} = 0.125$

HCo chooses to apply the value donor concession

As the HCo group consolidates during the transitional period and BCo has a $300 tax loss that is transferable to HCo under the existing group loss transfer rules contained in Division 170 of the *Income Tax Assessment Act 1997*, a portion of HCo's modified market value can be added to BCo's modified market value for the purposes of working out the available fraction for bundle B. That portion is based on the amount of BCo's losses that are transferable to HCo as a proportion of BCo's total losses. (It should be noted that BCo's 1998 net capital loss of $350 is not transferable to HCo under the group loss transfer rules – it was incurred before BCo became a part of a wholly-owned group with HCo.) Thus the portion of HCo's modified market value that can be added to BCo's modified market value is:

$$\$500 \times 100\% \times \frac{300}{650} = \$231$$

(If losses were also transferred from HCo to the consolidated group, its modified market value would then have to be reduced by the above amount for the purposes of calculating the available fraction for the bundle of losses transferred from HCo.)

As a result of the increase in BCo's modified market value, the available fraction for bundle B is calculated as follows:

$$\frac{(100 + 231)}{800} = 0.414$$

Note

This example is designed to illustrate the operation of the rules. The choices made by HCo here are not purported to represent the best outcome for the group in every case where similar scenarios may exist.

Utilisation of transferred losses

The HCo group's loss bundles are shown in table 2.

Table 2: HCo group loss bundles

Bundle	Loss	Available fraction (AF)	Sort	Basis of transfer	Year incurred*
A	$250	0.250	Net capital loss	COT	2003
	$650	0.250	Tax loss	COT	2003
B†	$350	0.414	Net capital loss	SBT	2003
	$300	0.414	Tax loss	COT	2003

* Losses that have been transferred to HCo are deemed to be made by HCo in the income year in which the transfer occurs.
† BCo's available fraction has been calculated using the value donor concession.

The HCo group has then traded for an income year. Prior to taking into account transferred losses, it determines that it has a capital gain of $500 and other assessable income, net of deductions (assuming no capital gains or assessable foreign or film income) of $1,800 for the 2003 income year. No other losses were incurred by the group during this period.

What is the taxable income position of the HCo group for the 2003 income year?

Assume that HCo has satisfied the COT (as well as the control test) to enable it to utilise its transferred losses for this income year.

Determine limits for utilisation of transferred losses

Step 1: Work out the categories of group income or gains – section 707-310(3)

Table 3: Categories of group income or gains (step 1)

Column 1 income or gains	Gross amount	*Less:* allowable deductions/ reductions	*Less:* group/ concessional losses of that kind	Column 2 income/gains available for bundle
Capital gains	$500	–	–	$500
Other assessable income	$1,800	–	–	$1,800

Step 2: Calculate the fraction of the income/gain that is attributable to each bundle – subsection 707-310(3)

Table 4: Fraction of income/gains attributable to each bundle (step 2)

Column 1 income or gains	Loss bundle	Column 2 income/gains for bundle	*Multiplied by:* AF	AF amount for the bundle
Capital gains	Bundle A	$500	0.250	$125
	Bundle B	$500	0.414	$207
Other assessable income	Bundle A	$1,800	0.250	$450
	Bundle B	$1,800	0.414	$745

Step 3(a) – Work out a notional taxable income for bundle A – subsection 707-310(2)

Table 5: Net capital gain (step 3a)

Capital gains	$	Losses applied	$
Capital gain	125	Transferred net capital loss	125
Total	**125**	**Total**	**125**

The (notional) net capital gain is $0 ($125 – $125).

Table 6: Taxable income (step 3a)

Assessable income	$	Deductions	$
Net capital gain	0	Transferred tax loss	450
Other assessable income	450		
Total	**450**	**Total**	**450**

Transferred losses 'used' in working out notional taxable income for bundle A are:

- transferred net capital loss $125
- transferred tax loss $450

These are the limits for utilisation of these transferred losses when determining the actual taxable income for the group.

Step 3(b) – Work out a notional taxable income for bundle B – subsection 707-310(2)

Table 7: Net capital gain (step 3b)

Capital gains	$	Losses applied	$
Capital gain	207	Transferred net capital loss	207
Total	**207**	**Total**	**207**

The (notional) net capital gain is $0 ($207 – $207).

Table 8: Taxable income (step 3b)

Assessable income	$	Deductions	$
Net capital gain	0	Transferred tax loss	300
Other assessable income	745		
Total	**745**	**Total**	**300**

The (notional) taxable income is $445 ($745 – $300).

Transferred losses 'used' in working out notional taxable income for bundle B are:

- transferred net capital loss $207
- transferred tax loss $300

These are the limits for utilisation of these transferred losses when determining the actual taxable income for the group.

Determine group's actual taxable income

Table 9: Net capital gain

Capital gains	$	Losses applied	$
Capital gain	500	Transferred net capital loss (bundle A)	125
		Transferred net capital loss (bundle B)	207
Total	**500**	**Total**	**332**

The group's net capital gain is $168 ($500 – $332).

Table 10: Taxable income

Assessable income	$	Deductions	$
Net capital gain	168	Transferred tax loss (bundle A)	450
Other assessable income	1,800	Transferred tax loss (bundle B)	300
Total	**1,968**	**Total**	**750**

The group's taxable income is $1,218 ($1,968 – $750).

The loss bundles as at the end of the 2003 income year contain the losses shown in table 11.

Table 11: Losses in loss bundles

Bundle	Loss	Available fraction	Sort	Basis of transfer	Year incurred
A	$125 (i.e. $250 – $125)	0.250	Net capital loss	COT	2003
	$200 (i.e. $650 – $450)	0.250	Tax loss	COT	2003
B	$143 (i.e. $350 – $207)	0.414	Net capital loss	SBT	2003

Note: the whole amount of tax loss of $300 for bundle B is fully utilised.

References

Income Tax Assessment Act 1997, Subdivisions 707-A, 707-C; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Income Tax (Transitional Provisions) Act 1997, Subdivision 707-C; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 2

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapters 6, 8 and 9

Revision history

Section C3-2-110 first published (excluding drafts) 2 December 2002.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Utilising loss in non-membership period – non-membership period is taken to include joining time

Description

This example shows how an entity determines if it can utilise a prior year loss in a non-membership period, where there has been an ownership change at the joining time.

Commentary

An entity that joins a consolidated group transfers any unutilised losses on hand at the joining time to the head company. However, it must first determine whether any of those losses can be utilised in a non-membership period for which it must work out its core purposes.

Subsection 701-30(3A) states that for the purposes of working out an entity's taxable income (if any) for a non-membership period, the entity needs to determine whether it can use a prior year loss in the period assuming that the time just after the end of the non-membership period were in fact the end of that period. This ensures that any ownership changes that occur at the time it becomes a subsidiary member of a consolidated group are relevant in determining if the entity can utilise the loss in the period.

The rule ensures that the continuity of ownership test (COT)[15] applies consistently to the joining entity in determining if it can:

- utilise a loss in a non-membership period that ends just before it joins a consolidated group, and
- transfer a loss to the head company of a consolidated group.

Subsection 701-30(3A) also assumes that the business conducted just after the end of the non-membership period (i.e. at the joining time) is the same as the business conducted just before that time. This ensures that for the purposes of applying the same business test (SBT)[16] as a recoupment test, only the business conducted by the entity as a single entity is considered.

This assumption provides consistency with the application of the SBT as a transfer test under Subdivision 707-A, in that the business conducted by the single entity is not compared with the business conducted by the consolidated group[17], despite the fact that the trial year ends just after the joining time[18].

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[15] Section 165-12

[16] Section 165-13

[17] Subsection 707-120(3) provides that for the purposes of determining if a joining entity conducted the same business throughout the trial year as it carried on at a particular time, it is assumed that the business conducted at and just after the joining time is the same as the business conducted just before the joining time.

[18] Paragraph 707-120(2)(b)

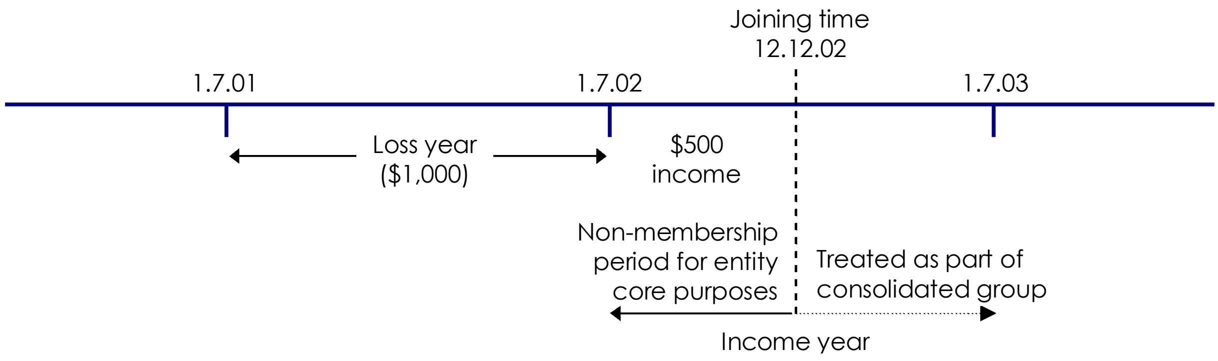
Example

Facts

On 12 December 2002, HCo (the head company of a consolidated group) acquires a 70% interest in LossCo, which results in LossCo becoming a wholly-owned subsidiary of HCo.

LossCo has a tax loss on hand from the income year ended 30 June 2002 of $1,000. LossCo's assessable income for the period 1 July 2002 to 11 December 2002 is $500, before any deduction for prior year losses.

Figure 1: Joining entity (LossCo) timeline



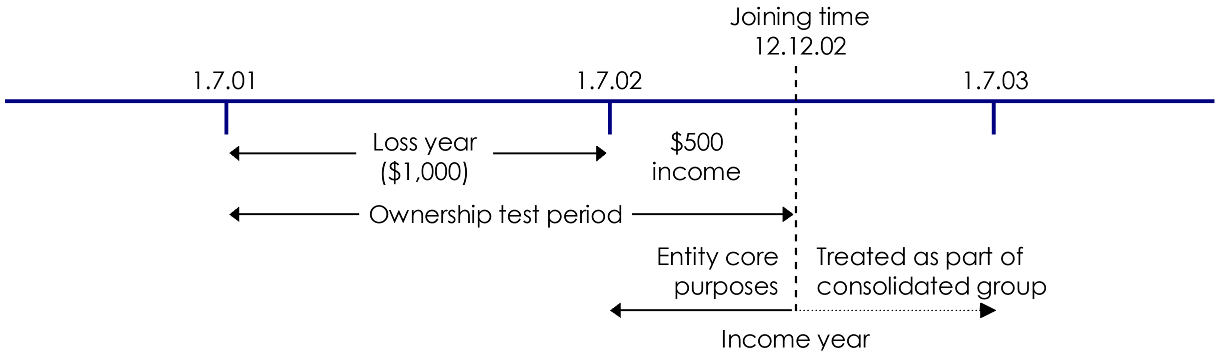
Although the income year of LossCo (the joining entity) is from 1 July 2002 to 30 June 2003, its core purposes are calculated in respect of the non-membership period that ended before the joining time, i.e. from 1 July 2002 to 11 December 2002. → Division 701

To establish the amount of loss on hand at the joining time, LossCo needs to bring to account its loss for the 2002 income year in working out its taxable income for the non-membership period 1 July 2002 to 11 December 2002.

Calculation

Subsection 701-30(3A) provides that for the purposes of determining if LossCo is able to utilise the loss in the non-membership period from 1 July 2002 to 11 December 2002, the non-membership period is taken to include the joining time (i.e. the non-membership period is taken to end on 12 December 2002).

Figure 2: Determining if loss can be utilised in non-membership period



As the non-membership period is taken to end at the joining time, the 70% change in LossCo's ownership on 12 December 2002 is relevant in determining if LossCo is able to utilise the 2002 loss in the non-membership period. LossCo has not maintained majority ownership since the start of the loss year (i.e. 1 July 2001), so it has failed to satisfy the conditions in section 165-12 (i.e. it has failed the COT).

Therefore LossCo is only able to utilise the 2002 year loss in the non-membership period if it can satisfy the SBT when comparing:

- the business conducted during the SBT period, which is 1 July 2002 to 12 December 2002 (assuming the business conducted on 12 December 2002 is the same as the business conducted on 11 December 2002), with
- the business conducted at the time just before the COT was failed (the COT was failed on 12 December 2002, when 70% of LossCo's shares were acquired by HCo).

If LossCo is able to satisfy the SBT in respect of these times it can utilise the loss in the non-membership period. This would result in a taxable income of nil for the period (being $500 – $500). The remainder of the loss ($1,000 – $500) incurred in respect of the 2002 income year would then be tested to determine whether it can be transferred to HCo under Subdivision 707-A.

References

Income Tax Assessment Act 1997:

- section 165-12
- section 165-13
- section 707-115
- paragraph 707-120(2)(b)

Income Tax Assessment Act 1997, subsection 701-30(3A); as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 19

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 6

Revision history

Section C3-3-105 first published 28 May 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Establishing unutilised loss at transfer time – single joining time and prior year loss case

Description

This example shows how an entity establishes what losses are unutilised as at the joining time, assuming a single joining time and a tax loss in the income year prior to joining.

Commentary

An entity that joins a consolidated group transfers any unutilised losses on hand at the joining time to the head company.

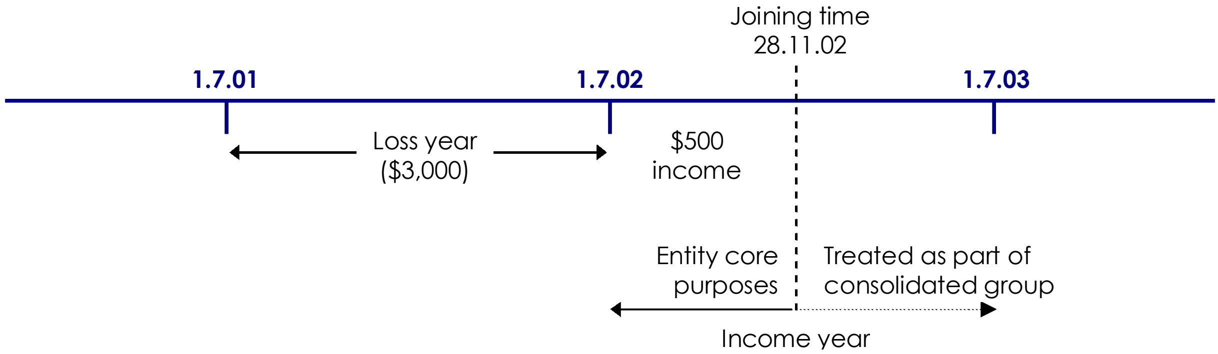
Section 707-115 states that when an entity joins a consolidated group, only a loss made by the entity for an income year ending before the joining time is subject to the transfer provisions of Subdivision 707-A. Subsection 707-115(2) requires that only the unutilised amount of a loss is subject to the subdivision.

Example

Facts

An entity joins a consolidated group on 28 November 2002 with a tax loss of $3,000 on hand from the 2002 income year. The entity's assessable income for the joining year, calculated for the period 1 July 2002 to 27 November 2002, is $500 before the deduction for prior year losses.

Figure 1: Joining entity timeline



Although the income year of the joining entity is 1 July 2002 to 30 June 2003, its core purposes are calculated in respect of the non-membership period that ended before the joining time, that is, 1 July 2002 to 27 November 2002.

→ Division 701

To establish the amount of the loss on hand at the joining time, the entity needs to bring to account its loss for the 2002 income year. This loss is greater than the income for the period 1 July 2002 to 27 November 2002 in the joining year. The unutilised amount of the 2002 loss is subject to the transfer testing process.

Calculation

Step 1: Identify the loss

A tax loss of $3,000 is identified at the joining time. Subsection 701-1(4) lists the sorts of losses that are subject to the subdivision. Paragraph 707-110(2)(a) states how a tax loss is 'utilised'.

Step 2: Income year

As the loss is for the income year that ends on 30 June 2002, it is a loss in respect of an income year that pre-dates the joining time of 28 November 2002.

Therefore, the joining entity's loss of $3,000 satisfies the criteria for application of the loss transfer provisions.

Step 3: Establish the unutilised amount of the loss as at the joining time

In calculating its taxable income for the 2003 income year, the joining entity is able to utilise $500 of the loss (assuming the recoupment tests are satisfied). The joining entity is required to calculate its taxable income in accordance with the core rules in Division 701.

This satisfies the requirement in Paragraph 707-115(2)(b) that only the net amount of the loss is subject to the transfer testing process, as the initial loss is utilised to the extent of $500 'in working out the joining entity's taxable income (if any) for the joining year'.

Thus, the $2,500 remaining of the joining entity's 2002 loss is subject to the transfer testing process of section 707-120.

References

Income Tax Assessment Act 1997 – as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1:

- subsection 701-1(4)
- paragraph 707-110(2)(a)
- section 707-115
- paragraph 707-115(2)(b)
- section 707-120

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 6

Revision history

Section C3-3-110 first published (excluding drafts) 2 December 2002.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Establishing unutilised loss at transfer time – multiple joining times and prior year and current year loss case

Description

An entity may join a consolidated group more than once in an income year. The entity that joins a consolidated group transfers any unutilised losses on hand at each of the respective joining times to the head company of the group joined at that time. As shown in this example, the entity must establish what losses are unutilised at each of these points in time in the joining year.

Commentary

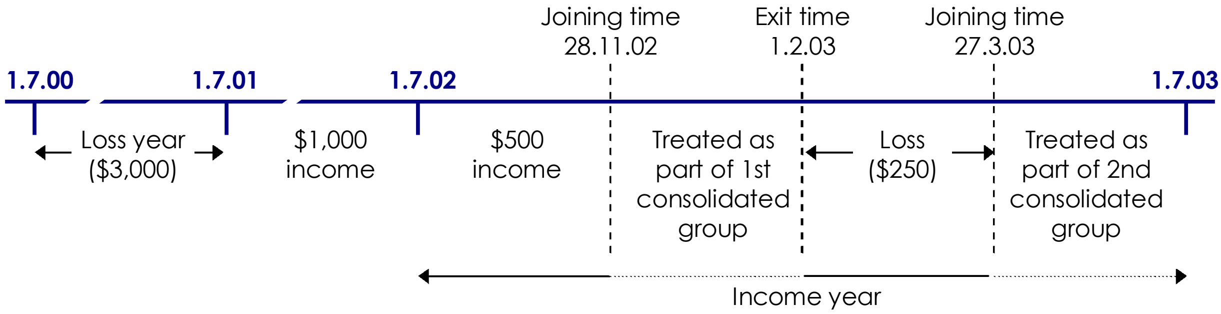
Section 707-115 states that when an entity joins a consolidated group, only a loss made by the entity for an income year ending before the joining time is subject to the transfer provisions (of Subdivision 707-A). Subsection 707-115(2) requires that only the unutilised amount of a loss is subject to the subdivision.

Example

Facts

An entity joins a consolidated group on 28 November 2002, exits from this group on 1 February 2003 and subsequently joins another consolidated group on 27 March 2003. It has a tax loss on hand from the 2001 income year. The loss in the 2001 income (loss) year is $3,000 and the entity utilised $1,000 of this to calculate a nil taxable income for the 2002 income year. The entity's assessable income for the joining year, calculated for the first period of the joining year (1 July 2002 to 27 November 2002), is $500 before the deduction for prior year losses. For the second period in the joining year for which it has entity responsibility, it calculates a tax loss amount of $250.

Figure 1: Joining entity timeline



The income year of the joining entity is 1 July 2002 to 30 June 2003. Its core purposes are calculated in respect of the non-membership periods in the income year (that is, 1 July 2002 to 27 November 2002 and 1 February 2003 to 26 March 2003).

To establish the amount of the loss on hand at the first joining time (28 November 2002), the entity needs to bring to account its loss for the 2001 income year. As the loss is greater than the income in that period 1 July 2002 to 27 November 2002 in the joining year, the unutilised amount of the 2001 loss is subject to the transfer testing process.

In respect of the second joining time, the joining entity needs to establish that the $250 loss for its second non-membership period in the year is an unutilised loss for an income year that ends before the joining time.

Calculation

As there are two loss amounts to consider, each is looked at in order of the respective joining times of the joining entity within the joining year. Note that Division 701 applies to determine how the entity's core purposes are to be met. Each non-membership period identified in the income year is considered as though it were the only period, and as though it was the income year.

In respect of the first joining time:

Step 1: Identify the loss

A tax loss of $3,000 is identified at the first joining time. Subsection 701-1(4) lists the sorts of losses that are subjected to Subdivision 707-A. Paragraph 707-110(2)(a) states how a tax loss is 'utilised'.

Step 2: Income year

In respect of the $3,000 tax loss, the loss was made in the 2001 income year. As 30 June 2001 (the end of the income year) pre-dates the first joining time of 28 November 2002, the loss is for an income year ending before the joining time.

Thus, a loss of $3,000 of the joining entity satisfies the criteria for application of the loss transfer subdivision.

Step 3: Does a modified rule apply?

Not necessary as both steps 1 and 2 satisfied.

Step 4: Establish the unutilised amount of the loss at the joining time

The joining entity has already utilised $1,000 of the 2001 year loss in working out its taxable income for the 2002 income year.

Thus, it has $2,000 unutilised (that is, $3,000 – $1,000) at the beginning of the 2003 income year. In calculating its taxable income for the 2003 income year, the joining entity is able to utilise $500 of the loss (assuming the recoupment tests are satisfied). The joining entity is required, in this case, to calculate its taxable income with reference to Division 701.

This satisfies the requirement in paragraph 707-115(2)(b) that only the net amount of the loss is subject to the transfer testing process. It was utilised to the extent of $500 'in working out the joining entity's taxable income (if any) for the joining year' and $1,000 in respect of an 'earlier income year'.

Outcome

The $1,500 remaining of the joining entity's 2001 loss is subject to the transfer testing process.

In respect of the second joining time:

Step 1: Identify the loss

At the second joining time, a loss amount of $250 is calculated for the period 1 February 2003 to 26 March 2003.

The entity's core purposes (working out taxable income, income tax liability, losses – if any) are governed by Division 701. Only a loss that is calculated for a non-membership period that ends at the end of the income year can be considered a loss of a particular sort for the income year[19].

The non-membership period loss as calculated is not – in the absence of a modified rule – considered a loss of a sort to which Subdivision 707-A applies.

Step 2: Income year

As the income year in which the non-membership period loss is made is the joining year, that is, the 2003 income year, it follows that it is made in an income year that ends after the second joining time – that is, 30 June 2003 follows 27 March 2003.

Accordingly, it is not subject to the subdivision unless a modified rule applies.

Step 3: Does a modified rule apply?

As a non-membership period loss has been identified, subsection 701-30(8) treats it as being a loss for an income year for transfer purposes in relation to the second joining time.

The loss of $250 is now a tax loss (thus satisfying step 1); and it is for an income year that ends before the second joining time (thus satisfying step 2).

Step 4: Establish the unutilised amount of the loss as at the joining time

With respect to subsection 707-115(2), the 2003 loss has not been utilised 'in working out the joining entity's taxable income (if any) for the joining year' to any extent. Thus the full $250 remains unutilised as at the second joining time.

[19] Subsection 701-30(7).

Outcome

The full $250 of the joining entity's 2003 loss is subject to the transfer testing process in section 707-120.

References

Income Tax Assessment Act 1997 – as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1:

- subsection 701-1(4)
- subsection 701-30(7)
- Subdivision 707-A
- paragraph 707-110(2)(a)
- section 707-115
- paragraph 707-115(1)(b),
- subsection 707-115(2)
- section 707-120

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 6

Income Tax Assessment Act 1997, subsection 701-30(8); as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 19

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 6

Revision history

Section C3-3-120 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Transfer testing where no ownership or control failure – single joining time and joining year loss case

Description

This example shows how the relevant recoupment test (modified as required) is applied in a situation where an entity incurs a loss in the year it joins a consolidated group.

Commentary

An entity that joins a consolidated group transfers any unutilised losses on hand at the joining time to the head company. It is necessary to apply the relevant recoupment test (modified as required) to ascertain the basis on which a loss is transferred to a head company.

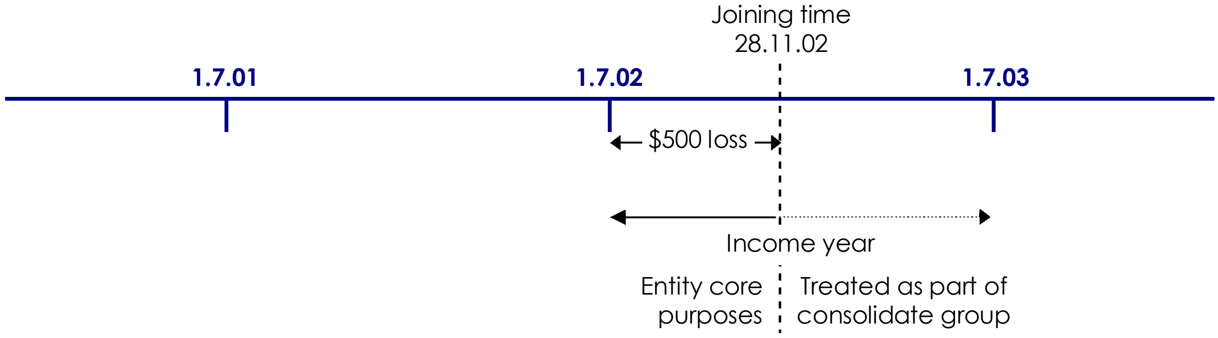
Section 707-120 requires a loss to be tested as if the joining entity was in a position to utilise the loss itself in the context of the trial year and had sufficient income or gains to do so. To the extent that the loss could be so utilised, it is transferred as at the joining time.

Example

Facts

A subsidiary member of a group that consolidates on 28 November 2002 has calculated that it has a loss of $500 for the period 1 July 2002 to 27 November 2002.

Figure 1: Joining entity timeline



Although the income year of the joining entity is 1 July 2002 to 30 June 2003, its core purposes are calculated for the non-membership period that ends before the joining time, that is, 1 July 2002 to 27 November 2002. Refer to Division 701 for the application of the core rules.

Calculation

Step 1: Identify the loss

A loss amount of $500 is identified at the joining time. In working out its core purposes – as required by Division 701 – the joining entity determines that it has in fact incurred a loss for the period 1 July 2002 to 27 November 2002 in the joining year.

The joining entity has a loss as at the joining time.

Step 2: Income year

As the loss is incurred for the 2003 income year (albeit calculated in reference to the non-membership period), the end of the income year (30 June 2003) does not predate the joining time of 28 November 2002. Thus, the joining entity's loss does not satisfy the requirement in paragraph 707-115(1)(b) that it be a loss in respect of an income year that ends before the joining time.

Accordingly, it is not subject to Subdivision 707-A unless a modified rule is applied.

As a loss has been identified in respect of part of an income year, subsection 701-30(8) must be relied on. It provides that a non-membership period loss made by an entity is, for the purpose of Division 707, taken to be a loss made by the entity for an income year that matches the length of the non-membership period. The result is to, in effect, shorten the income year to the period 1 July 2002 to 27 November 2002. The loss is now considered to be a tax loss in respect of an income year that ends before the joining time.

Step 3: Establish the unutilised amount of the loss as at the joining time

Paragraph 707-110(2)(a) states how a tax loss is 'utilised'.

As the tax loss is the net result of calculating its taxable income for the 2003 income year, the joining entity has the full $500 of the loss on hand as at the joining time.

Thus, the full $500 tax loss of the joining entity made in the 2003 income year is subject to the transfer testing process.

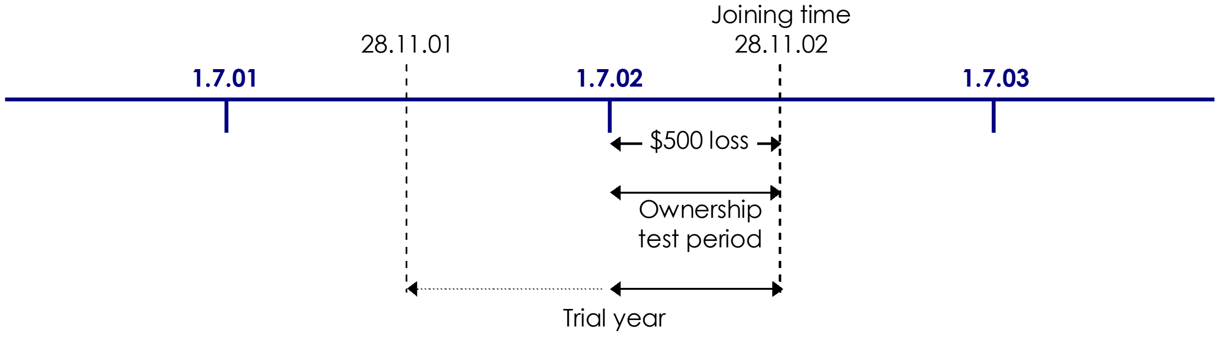
Step 4: Apply the ownership and control transfer tests

Sections 165-12 and 165-15 require the company to test for same owners and same control respectively throughout the ownership test period: from the start of the loss year to the end of the income year. In this case:

- the loss year is 1 July 2002 to 27 November 2002, and
- the income year is represented by the trial year 28 November 2001 to just after 28 November 2002.

Even though the trial year begins before the loss year, testing applies only to the period commencing with the start of the loss year to just after the joining time. In this case, testing for an ownership or control failure within the ownership test period is in respect of the period 1 July 2002 to just after 28 November 2002.

Figure 2: Test period



Outcome

If the testing process concludes that there is no ownership or control failure over the relevant test period, the loss is transferred to the head company.

If the test is not met, the alternative same business test will be necessary to work out whether it will be transferred at all.

If it cannot be transferred, its utilisation will be restricted in accordance with section 707-150 – that is, it cannot be used by any entity for the 2003 and later income years.

References

Income Tax Assessment Act 1997, sections 165-12, 165-15

Income Tax Assessment Act 1997 – as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1:

- Division 701
- paragraph 707-110(2)(a)
- sections 707-115, 707-120, 707-150

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 6

Income Tax Assessment Act 1997, subsection 701-30(8); as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 19

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 6

Revision history

Section C3-3-210 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Transfer testing where ownership or control failed – single joining time and pre-1 July 1999 year loss case

Description

This example shows how the relevant recoupment test (modified as required) is applied in a situation where an entity fails the ownership test prior to joining a consolidated group and incurs a loss prior to 1 July 1999.

Commentary

An entity that joins a consolidated group transfers any unutilised losses on hand at the joining time to the head company. It is necessary to apply the relevant recoupment test (modified as required) to ascertain the basis on which a loss is transferred to a head company.

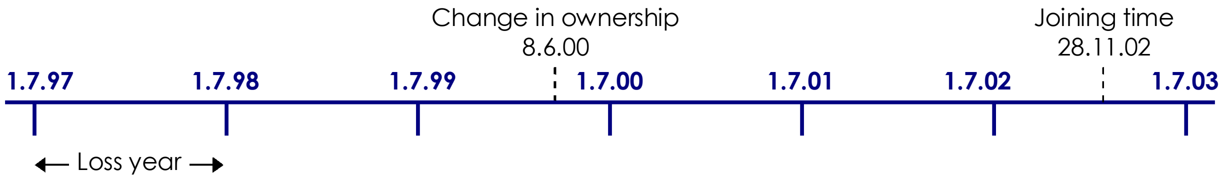
Section 707-120 requires a loss to be tested as if the joining entity was in a position to utilise the loss itself in the context of the trial year and had sufficient income or gains to do so. To the extent that the loss could be so utilised, it is transferred as at the joining time.

Example

Facts

A subsidiary member of a group that consolidates on 28 November 2002 has worked out that it has an unutilised 1998 tax loss of $1,500 as at the joining time. There was an ownership failure on 8 June 2000.

Figure 1: Joining entity timeline



Calculation

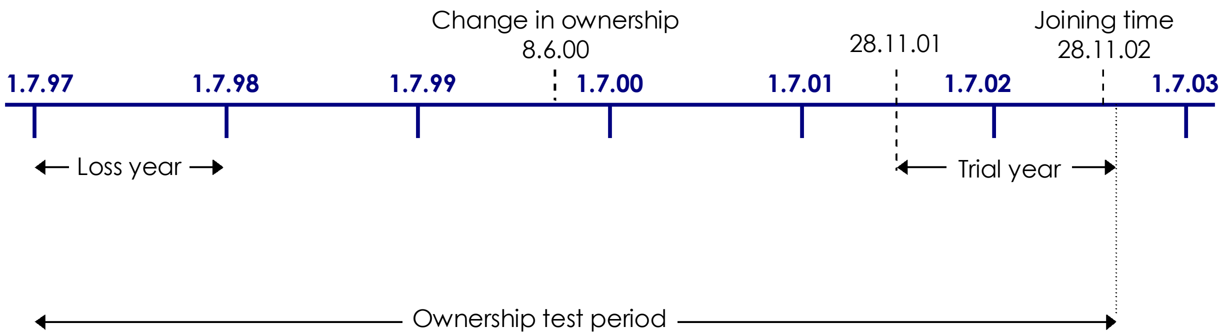
Step 1: Apply the ownership and control transfer tests

Sections 165-12 and 165-15 require the company to test for same owners and same control respectively throughout the ownership test period: from the start of the loss year to the end of the income year. In this case:

- the loss year is the 1998 income year, and
- the income year is represented by the trial year: 28 November 2001 to just after 28 November 2002.

In this case there has been an ownership failure within the ownership test period 1 July 1997 to just after 28 November 2002.

Figure 2: Ownership test period

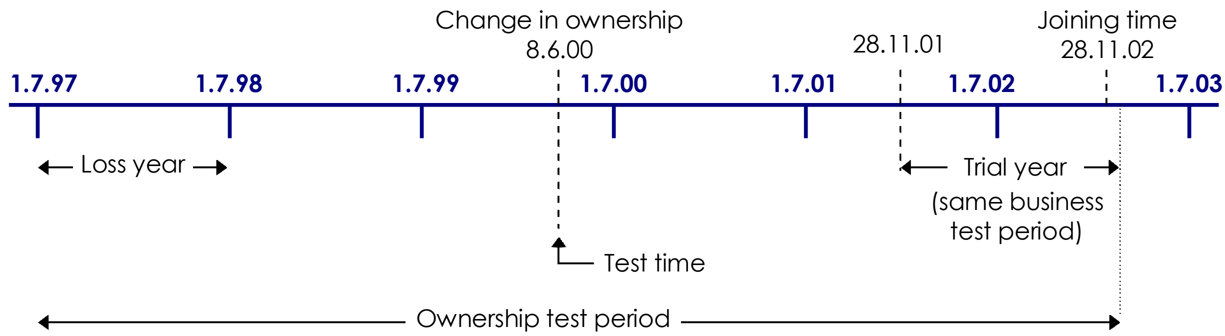


Section 165-10 provides an alternative qualifying test that requires the company to meet the conditions about carrying on the same business.

Step 2: Identify same business test points

Under section 165-13, the company must satisfy the same business test (section 165-210) for the income year (the *same business test period*). That test must be applied to the business that the company carried on immediately before the test time, which in this example is 8 June 2000, when the ownership test is failed. As the trial year is the later income year for transfer testing purposes, it is the same business test period.

Figure 3: Same business test points



Outcome

If the testing process concludes that the same business test was met in respect of these relevant times, the loss is transferred to the head company.

As the loss transfer occurred because the entity from which the loss was transferred carried on during a particular period the same business as it carried on at a particular time, the loss is 'tagged' as a loss that will always be subject to the additional test if transferred again. → section 707-135

If it cannot be transferred, its utilisation will be restricted in accordance with section 707-150 – that is, it cannot be used by any entity for the 2003 and later income years.

References

Income Tax Assessment Act 1997, sections 165-12, 165-15, 165-210

Income Tax Assessment Act 1997 – as amended by:

- *New Business Tax System (Consolidation) Act (No.1) 2002* (No. 68 of 2002), Schedule 1:
  - paragraph 707-110(2)(a)
  - section 707-115
  - subsection 707-120(3)
  - paragraph 707-120(1)(b)
  - sections 707-135, 707-150
- *Taxation Laws Amendment Act (No. 5) 2003* (No. 142 of 2003):
  - sections 165-10, 165-13

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 6

Revision history

Section C3-3-220 first published (excluding drafts) 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
5.4.04	Modify description of same business test points.	Reflect changes in *Taxation Laws Amendment Act (No. 5) 2003* (No. 142 of 2003).

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Transfer testing with modified same business test – where ownership or control failed before trial year but after loss year

Description

This example shows how the modified same business test applies where the ownership or control tests are failed before the trial year but after the loss year.

Commentary

If a joining entity makes a loss for an income year starting after 30 June 1999 and subsection 165-13(2) or 166-5(4) or (5) of the *Income Tax Assessment Act 1997* is relevant to working out (under subsection 707-120(1)) whether the loss is transferred from the joining entity to the head company, the modified same business test must be considered. The same business transfer test for losses made in an income year that starts after 30 June 1999 is stricter than the normal same business test.

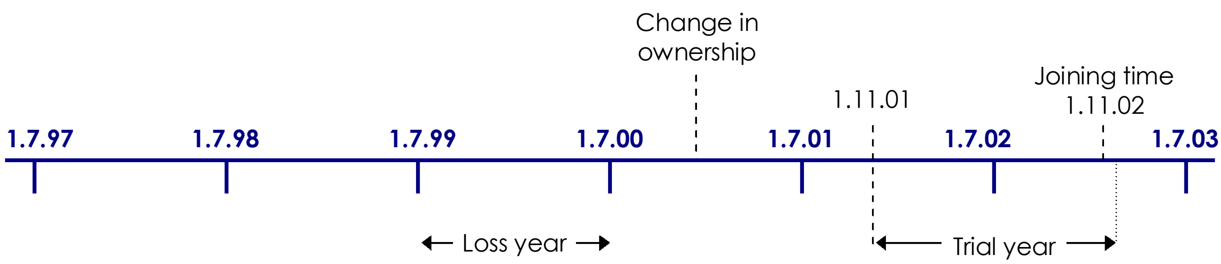
Section 707-125 introduces an additional test point just before the end of the income year in which the loss is made, and tests all of the income year that included the test time that would normally apply for the same business test.

Example

Facts

An entity (a company) joins a consolidated group on 1 November 2002. It had experienced a 90% change in ownership before the trial year but after the loss year.

Figure 1: Joining entity timeline



Calculation

Step 1: Identify the continuity of ownership test failure

In this case there has been an ownership failure within the *ownership test period* 1 July 1999 to just after 1 November 2002. Accordingly, the tax loss would not be deductible to the joining entity under this test in the trial year. Section 165-10 provides an alternative qualifying test that requires the company to meet the conditions about carrying on the same business.

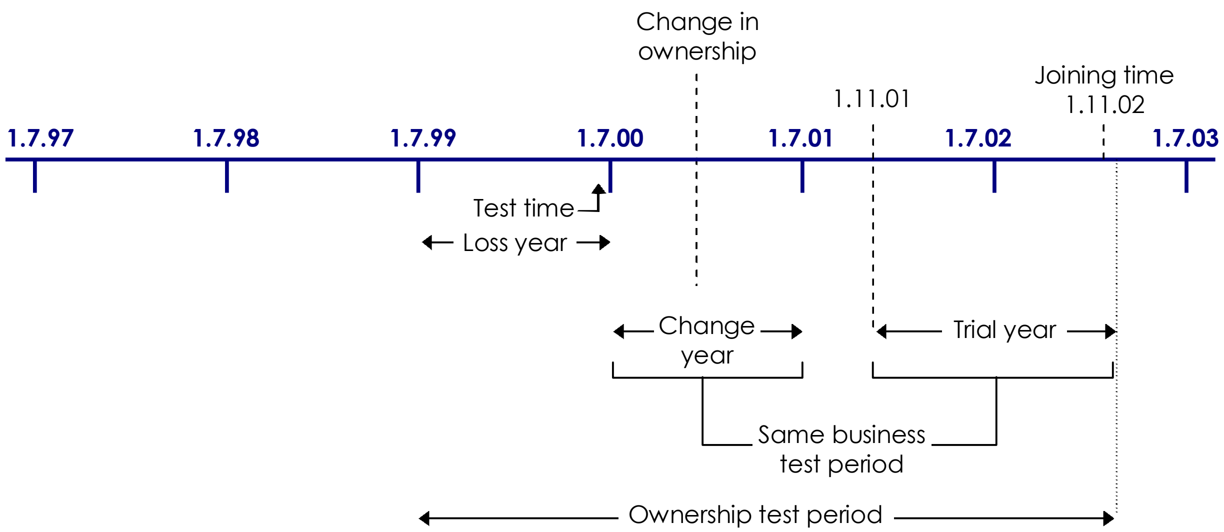
Step 2: Identify the modified same business test points

The company is required to apply the modification to the same business test as stipulated in section 707-125 to work out whether the loss is transferred on the basis that the entity is required to satisfy the same business test for:

- the same business test period, consisting of:
  - the trial year, and
  - the income year that included the test time that would normally apply for the same business test (the *change year*), if that income year started before the trial year, and
- the *test time,* being the time just before the end of the income year for which the loss was made by the company.

As shown in figure 2, the *change year* is the income year in which the ownership test is failed. As the change year starts before the start of the trial year, the *same business test period* consists of the periods 1 July 2000 to 30 June 2001 and 1 November 2001 to just after 1 November 2002.

Figure 2: Modified same business test points



Step 4: Apply the same business test

The joining entity now applies the section 165-210 same business test in respect of the identified test times to work out whether the loss is transferred.

Outcome

If the testing process concludes that the same business test was met at the relevant test times, the loss is transferred to the head company.

If the test is not met, the loss is not transferred to the head company and its utilisation will be restricted in accordance with section 707-150 – that is, it cannot be used by any entity for the 2003 and later income years.

References

Income Tax Assessment Act 1997:

- section 165-12
- subsections 166-5(4), 166-5(5)
- section 165-210

Income Tax Assessment Act 1997 – as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1:
  - subsections 707-120(1), 707-120(3)
  - sections 707-125, 707-150
- *Taxation Laws Amendment Act (No. 5) 2003* (No. 142 of 2003):
  - section 165-10
  - subsection 165-13(2)
  - section 707-125

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 6

Revision history

Section C3-3-230 first published (excluding drafts) 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
5.4.04	Modify description of same business test points.	Reflect changes in *Taxation Laws Amendment Act (No. 5) 2003* (No. 142 of 2003).

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Transfer testing with modified same business test – where ownership or control failure in trial year but after loss year

Description

This example shows how the modified same business test applies where the ownership or control tests are failed in the trial year but after the loss year.

Commentary

If a joining entity has made a loss for an income year starting after 30 June 1999 and subsection 165-13(2) or 166-5(4) or (5) is relevant to working out – under subsection 707-120(1) – whether the loss is transferred from the joining entity, the entity must consider the modified same business test. The same business transfer test for losses made in an income year that starts after 30 June 1999 is stricter than the normal same business test.

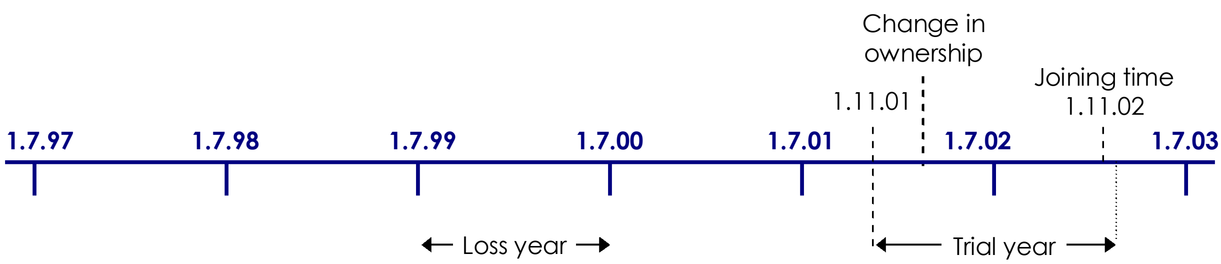
Section 707-125 introduces an additional test point just before the end of the income year in which the loss is made, and tests all of the income year that included the test time that would normally apply for the same business test.

Example

Facts

An entity (a company) joins a consolidated group on 1 November 2002. It had experienced a 90% change in ownership before the joining year but after the loss year.

Figure 1: Joining entity timeline



Calculation

Step 1: Identify the ownership or control failure

In this case there has been an ownership failure within the *ownership test period* 1 July 1999 to just after 1 November 2002. Accordingly, the tax loss would not be utilisable to the joining entity under this test in the trial year. Section 165-10 provides an alternative qualifying test that requires the company to meet the conditions about carrying on the same business.

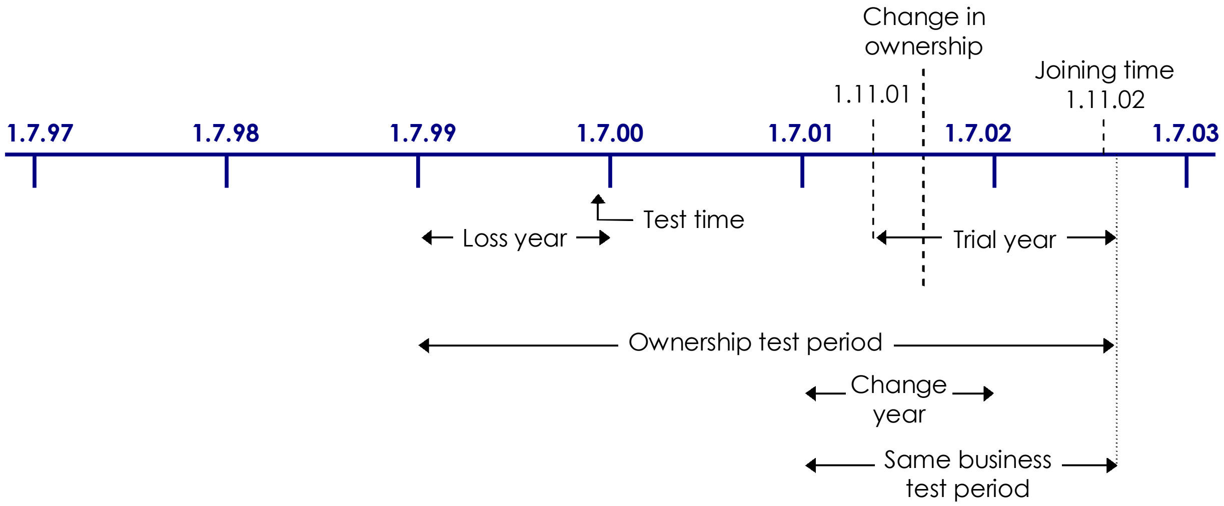
Step 2: Identify the modified same business test points

The company is required to apply the modification to the same business test as stipulated in section 707-125 to work out whether the loss is transferred on the basis that the entity is required to satisfy the same business test for:

- the same business test period consisting of:
  - the trial year, and
  - the income year that included the test time that would normally apply for the same business test (the *change year*), if that income year started before the trial year, and
- the test time, being the time just before the end of the income year for which the loss was made by the company.

As shown in figure 2, the *change year* is the income year in which the ownership test is failed. As the change year starts before the start of the trial year and ends within the trial year period, the *same business test period* consists of the single, continuous period 1 July 2001 to just after 1 November 2002.

Figure 2: Modified same business test points



Step 3: Apply the same business test

The joining entity now applies the section 165-210 same business test in respect of the identified test times to work out whether the loss is transferred.

Outcome

If the testing process concludes that the same business test was met at the relevant test times, the loss is transferred to the head company.

If the test is not met, the loss is transferred to the head company and its utilisation will be restricted in accordance with section 707-150 – that is, it cannot be used by any entity for the 2003 and later income years.

References

Income Tax Assessment Act 1997:

- section 165-12
- subsections 166-5(4), 166-5(5)
- section 165-210

Income Tax Assessment Act 1997 – as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1:
  - subsections 707-120(1), 707-120(3)
  - section 707-125
  - subsection 707-135(2)
  - section 707-150
- *Taxation Laws Amendment Act (No. 5) 2003* (No. 142 of 2003):
  - subsection 165-13(2)
  - section 707-125

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 6

Revision history

Section C3-3-240 first published (excluding drafts) 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
5.4.04	Modify description of same business test points.	Reflect changes in *Taxation Laws Amendment Act (No. 5) 2003* (No. 142 of 2003).
12.5.04	Modify description of same business test points.	Correct an error in previous amendment.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Transfer testing with modified same business test – where head company transfers losses to itself

Description

This example shows how the modified same business test applies where the head company transfers losses to itself.

Commentary

On formation of a consolidated group, losses made in prior income years by the head company in its capacity as a single entity are transferred to itself in its capacity as the head company of the group.[20]

If a joining entity makes a loss for an income year starting after 30 June 1999 and subsection 165-13(2) or 166-5(4) or (5) of the *Income Tax Assessment Act 1997* is relevant to working out (under subsection 707-120(1)) whether the loss is transferred from the joining entity to the head company (even if they are the same entity), the modified same business test must be considered. The modified same business test for losses is stricter than the normal same business test.

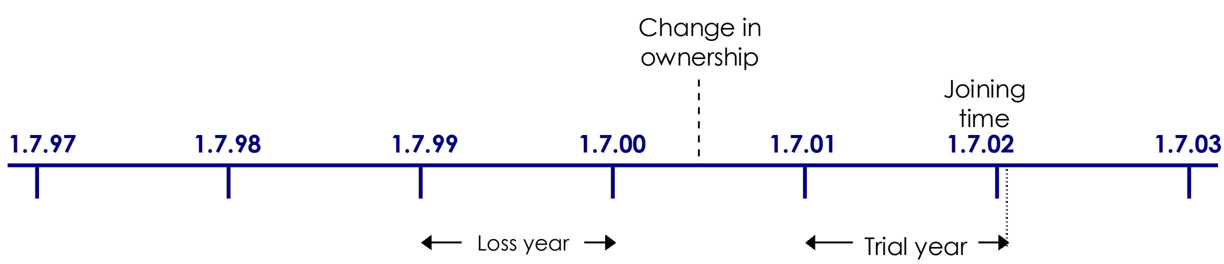
Section 707-125 introduces an additional test point just before the end of the income year in which the loss is made, and tests all of the income year that included the test time that would normally apply for the same business test.

Example

Facts

A head company (HC) forms a consolidated group on 1 July 2002. At the joining time HC has an unutilised tax loss of $1,500 from the 2000 income year. It had experienced a 90% change in ownership before the trial year but after the loss year. HC also incurs a tax loss in the year of transfer (the 2003 income year), and is required to transfer the tax loss to itself at the joining time.

Figure 1: Joining entity timeline



[20] Subsection 707-120(1).

Calculation

Step 1: Apply the continuity of ownership or control test

In this case an ownership failure is identified within the ownership test period 1 July 1999 to just after 1 July 2002. Accordingly, HC would be unable to claim a deduction for the loss under this test in respect of the trial year. Section 165-10 provides an alternative qualifying test that requires HC to meet the conditions about carrying on the same business.

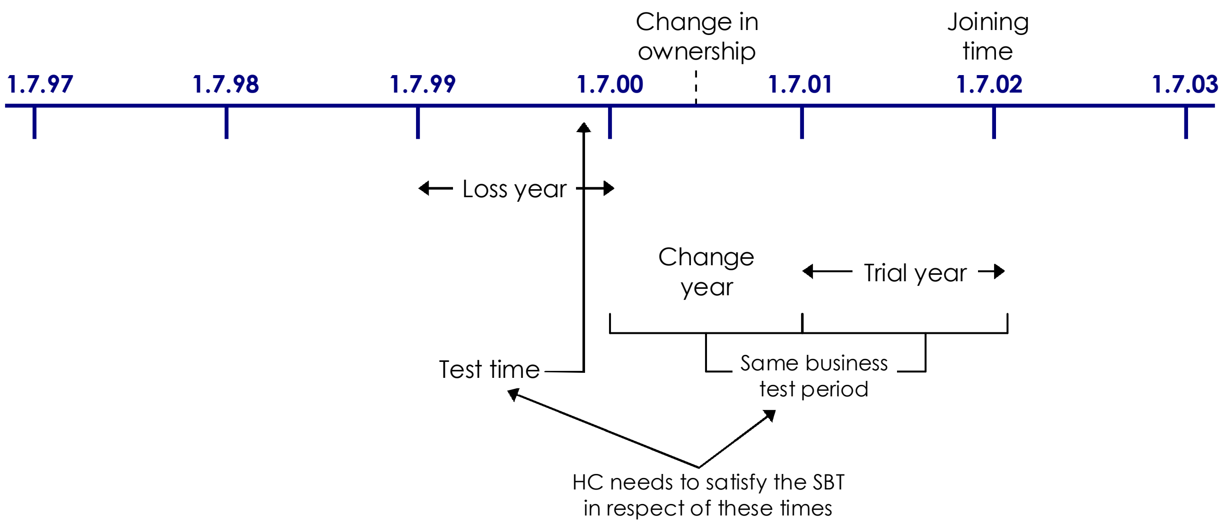
Step 2: Apply the modified same business test

As section 165-13 is relevant to working out the transfer of the loss to HC, HC is required to apply the modified same business test as stipulated in section 707-125. The modified same business test requires HC to satisfy the same business test for:

- the same business test period, consisting of:
  - the trial year, and
  - the income year that included the test time that would normally apply for the same business test (the *change year*), if that income year started before the trial year, and
- the test time, being the time just before the end of the income year for which the loss was made by HC.

As shown in figure 2, the *change year* is the income year in which the ownership test is failed. As the change year starts before the start of the trial year, the *same business test period* consists of a continuous period – 1 July 2000 to just after 1 July 2002.[21]

Figure 2: Modified same business test points



[21] Note that in accordance with subsection 707-120(3) the same business test period effectively ends immediately before the joining time (1 July 2002). This is achieved by assuming that the business carried on by the joining entity at and just after the joining time is the same as the business it carried on immediately before the joining time.

Step 3: Apply the same business test

The joining entity now applies the section 165-210 same business test in respect of the identified test times to work out whether the loss is transferred.

Outcome

If the testing process concludes that the same business test is met at the relevant test times, the loss is transferred to the head company (from itself in this instance).

If the test is not met, the loss is not transferred to the head company and its utilisation is restricted in accordance with section 707-150 – that is, it cannot be used by any entity for the 2003 and later income years.

The loss made by the head company for the 2003 income year does not need to be transfer tested at the joining time as it is not a loss in respect of an income year that ends before the joining time. This loss is treated as a 'group' loss of the head company.

References

Income Tax Assessment Act 1997:

- section 165-12
- subsections 166-5(4), 166-5(5)
- section 165-210

Income Tax Assessment Act 1997 – as amended by:

- New Business Tax System (Consolidation) Act (No. 1) 2002 (No. 68 of 2002), Schedule 1:
  - subsections 707-120(1), 707-120(3)
  - section 707-125
  - section 707-150
- *Taxation Laws Amendment Act (No. 5) 2003* (No. 142 of 2003):
  - sections 165-10, 165-13
  - section 707-125

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 6

Revision history

Section C3-3-245 first published 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
5.4.04	Modify description of same business test points.	Reflect changes in *Taxation Laws Amendment Act (No. 5) 2003* (No. 142 of 2003).
12.5.04	Modify description of same business test points.	Correct an error in previous amendment.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Transfer testing with modified same business test – acquisition of another consolidated group

Description

This example shows how the modified same business test (SBT) applies where the continuity of ownership test (COT) is failed as a result of the head company of a consolidated group being acquired by another consolidated group.

Commentary

If a head company of a consolidated group joins another consolidated group, all unutilised carry-forward losses owned by the former head company are tested to determine whether they transfer to the head company of the acquiring group.

Where a consolidated group acquires another consolidated group outright (i.e. a 100% takeover), the COT for transfer testing purposes may be failed on the acquisition date. In this situation, unutilised carry-forward losses are transferred only if an SBT is satisfied. As all the losses being transfer tested are made in an income year starting after 30 June 1999[22], section 707-125 applies (the 'modified same business test').

Section 707-125 introduces an additional test point just before the end of the income year in which the loss is made by the joining company, and tests all of the income year that included the test time that would normally apply for the SBT.

Example

Facts

A consolidatable group, Small Group, consolidates on 1 July 2003. A loss is transferred from subsidiary member BCo to head company SmallHC when Small Group consolidates. The transfer occurs because the SBT is satisfied.

On 26 February 2004 another consolidated group, Big Group, acquires Small Group. This results in a COT failure for SmallHC.

This sequence of events is shown in figures 1–3.

[22] Losses transferred to a head company are deemed by subsection 707-140(1) to be made for the income year in which the transfer occurs. As the consolidation regime began on 1 July 2002, all losses transferred to a head company are losses made in an income year that starts after 30 June 1999.

Figure 1: Small Group consolidates

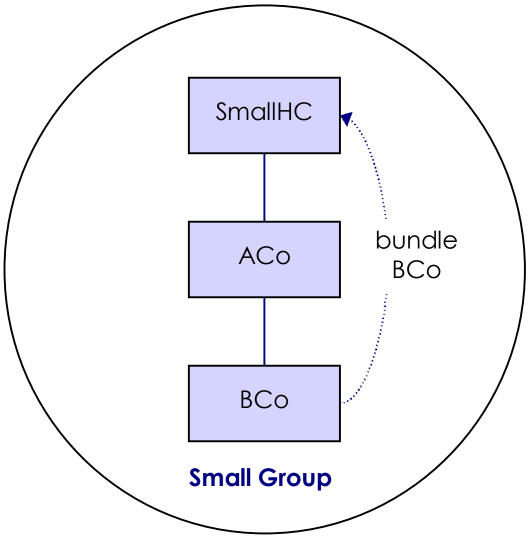


Figure 2: Big Group acquires Small Group

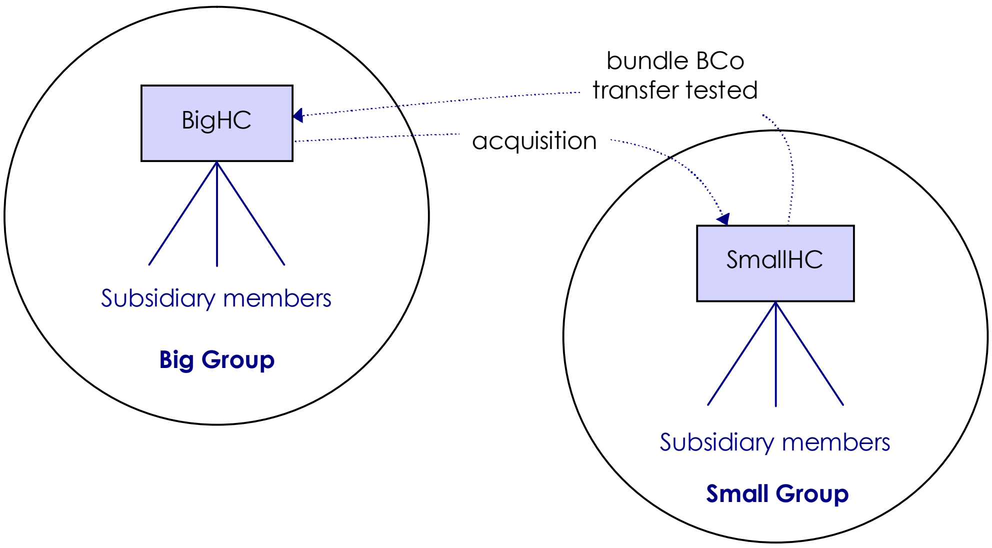
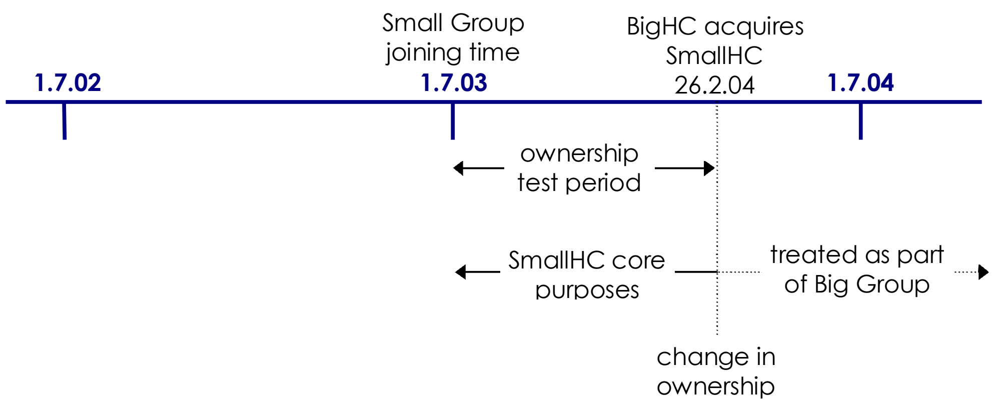


Figure 3: Joining entity (SmallHC) timeline



Calculation

Step 1: Establish the unutilised carry-forward loss in bundle BCo at 26.2.04

To establish the amount of the loss in bundle BCo on hand at the joining time, SmallHC must bring to account any utilisation of the loss in working out its taxable income for the non-membership period 1 July 2003 to 25 February 2004[23].

Subsection 701-30(3A) provides that, for the purposes of determining if SmallHC can utilise the loss in the non-membership period, the period is taken to include the joining time (i.e. the non-membership period is taken to end on 26 February 2004). → 'Utilising loss in non-membership period – non-membership period is taken to include joining time', C3-3-105

SmallHC has not maintained majority ownership from 1 July 2003, the start of the loss year. It has therefore failed the COT.

SmallHC is able to utilise the transferred loss in the non-membership period only if it can satisfy the SBT. As SmallHC is determining whether it can utilise a loss the SBT that must be satisfied is the standard test outlined in section 165-13[24].

Assume that SmallHC satisfies the SBT and that part of the loss is utilised by SmallHC in the non-membership period.

Step 2: Determine whether the loss in bundle BCo is transferred to BigHC

The unutilised portion of the loss in bundle BCo is the loss available for potential transfer to BigHC → section 707-115. It is this loss that is subject to the transfer testing process in section 707-120[25]. The trial year for transfer testing is 26 February 2003 to 26 February 2004.

Step 2(a): Identify the ownership or control failure

The ownership test period for transfer testing is 1 July 2003 (the start of the loss year[26]) to 26 February 2004 (the end of the trial year).

In this example there has been a COT failure on 26 February 2004. Accordingly, the loss cannot be utilised by SmallHC in the trial year unless the modified SBT in section 707-125 is satisfied.

→ For a discussion of the transfer testing process see 'Treatment of losses', C3-1.

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[23] Subsection 707-140(2) ensures SmallHC is not prevented from utilising the transferred loss in bundle BCo in the year of transfer.

[24] For the purpose of applying the SBT in regard to a non-membership period, subsection 701-30(3A) assumes that the business conducted just after the end of the non-membership period is the same as the business conducted just before that time. Therefore, only the business of Small Group is considered.

[25] Note that the loss is a loss made in the non-membership period as it was taken to be made by SmallHC in the year of transfer.

[26] Subsection 707-205(2) deems the loss year to start at the time of transfer.

Step 2(b): Identify the modified SBT points

To work out whether the loss is transferred to BigHC, SmallHC is required to satisfy the SBT for:

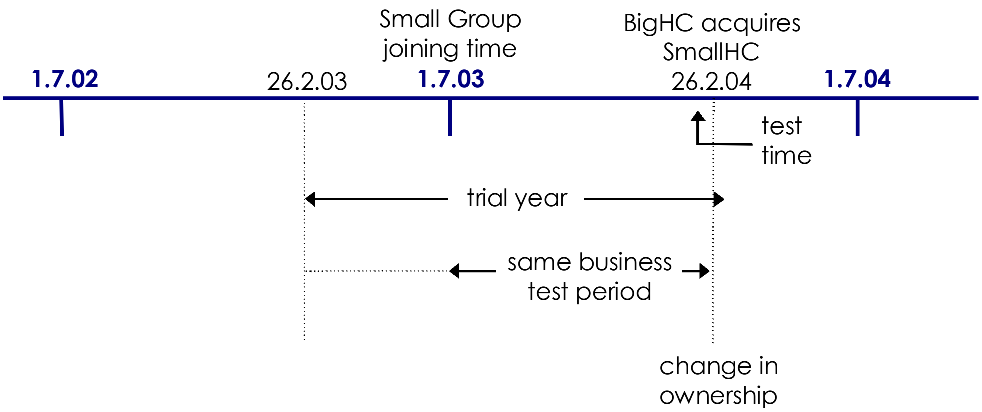
- the SBT period consisting of:
  - the trial year, and
  - the income year that included the test time that would normally apply for the SBT[27] (the 'change year'), if that income year started before the trial year, and
- the test time, being the time just before the end of the income year for which the loss was made by the company.

The change year does not begin before the trial year and therefore the SBT period consists only of the trial year.

The SBT period would normally consist of the single, continuous period 26 February 2003 to just after 26 February 2004[28]. This test would be unlikely to be satisfied, given the business of SmallHC as a head company would be compared to the business of SmallHC as a single entity. For this reason, section 707-400 ensures that the SBT period starts at the time SmallHC became a head company (1 July 2003).

The test time is just before the end of the non-membership period.

Figure 4: Modified SBT points



[27] Section 165-13.

[28] Subsection 707-120(3) assumes that the entity carried on the same business just after the joining time as it was carrying on just before that time. This effectively shortens the SBT period to end just before the joining time.

Step 3: Apply the SBT

SmallHC now applies the section 165-210 SBT in respect of the identified test times to determine whether the loss in bundle BCo transfers to BigHC[29].

Subsequent utilisation of the transferred loss by BigHC

If the testing process concludes that the SBT is met at the relevant times, the loss transfers to the head company. As the loss in bundle BCo is being transferred for a second time, the available fraction that applies for that bundle must be adjusted, in accordance with item 1 in the table in subsection 707-320(2). The adjustment recognises that the available fraction should reflect the new income generating structure of Big Group. → 'Adjusting available fraction – previously transferred losses are transferred again', C3-4-310

The loss transfers to BigHC on 26 February 2004, which is part-way through its 2004 income year. Utilisation of the loss in bundle BCo for the 2004 income year must therefore be apportioned in accordance with section 707-335. Apportionment recognises that the loss has only been 'owned' by BigHC for part of the income year. → 'Apportioning the use of transferred losses', C3-4-610

References

Income Tax Assessment Act 1997:

- sections 165-12, 165-13, 165-210
- subsection 701-30(3A)
- sections 707-115, 707-120, 707-125, 707-140, 707-150
- subsections 707-205(2), 707-320(2)
- sections 707-335, 707-400

Revision history

Section C3-3-246 first published 10 December 2004.

Further revisions are described below.

Date	Amendment	Reason
27.1.05	Add figure 1 and amend text to clarify example.	Clarification.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

[29] If the test is not met, the loss is not transferred and, pursuant to section 707-150, the loss cannot be subsequently utilised by any entity for income years ending after 26 February 2004.

Worked example

Additional test for second or subsequent transfer of a loss previously transferred because the SBT was passed

Description

If, by a previous operation of Subdivision 707-A, a loss had been transferred to a joining entity because the entity from which the loss was previously transferred met the same business test, the loss *will not* be transferred from the joining entity to the head company unless it satisfies an additional test. This example shows how the additional test applies.

Commentary

Section 707-135 introduces an additional test that must be satisfied in order to transfer a loss. Essentially, the joining entity must satisfy the same business test (section 165-210) for the trial year (the same business test period) and the time (the test time) just before the end of the income year in which the loss was transferred to the joining entity.

Example

Facts

A consolidatable group acquires 100% of the equity in a joining entity (a company) on 1 August 2002. A pre-1 July 1999 tax loss of the joining entity is transferred on the basis of satisfying the same business test at the joining time of 1 November 2002 when the group consolidates.

Subsequently – on 1 February 2005 – the head company of the consolidated group becomes a subsidiary member of another consolidated group. The second head company requires only a 5% acquisition to obtain 100% ownership of the first head company. None of the loss has been utilised by the first head company.

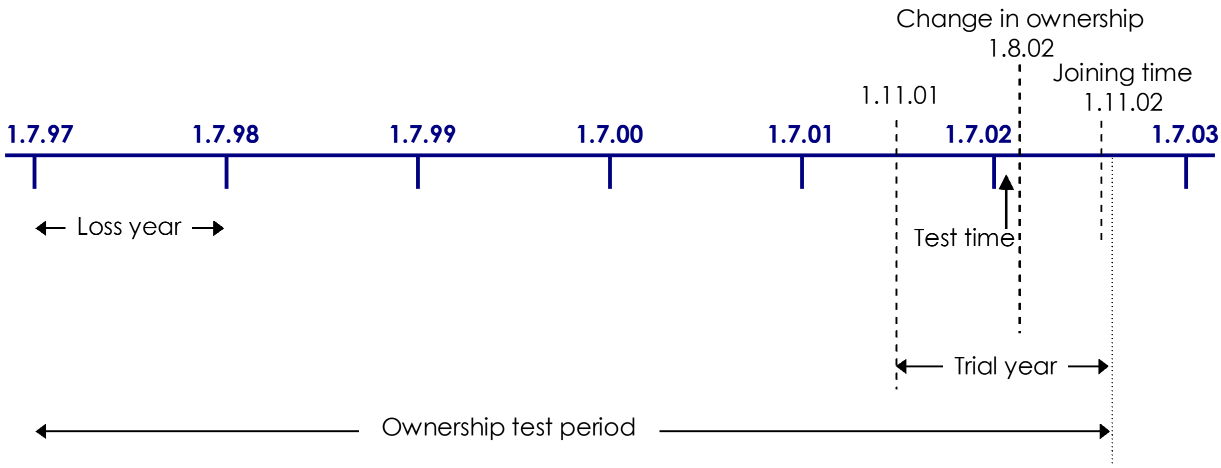
Calculation

Step 1: First head company trial year testing – same business test as a transfer test

The first step is to show how the loss was transfer tested at the first joining time (that is, 1 November 2002) as a result of the ownership failure (under section 165-12) emanating from the acquisition of the joining entity on 1 August 2002.

The recoupment test of section 165-13 was relied on for transfer testing. As the loss tested is a pre-1 July 1999 loss, the modified same business test in section 707-125 did not apply.

Figure 1: Initial same business transfer test (pre-1 July 1999 loss)



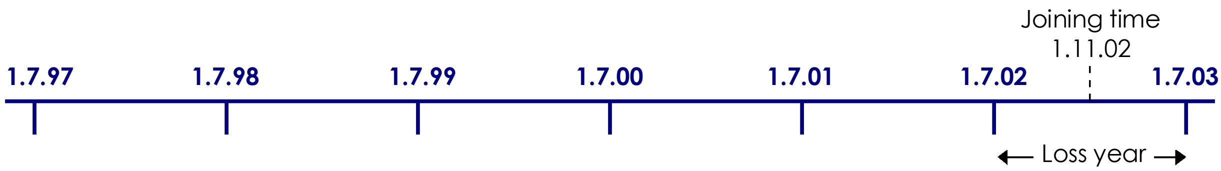
As the loss transfer occurred 'because the entity from which the loss was transferred carried on during a particular period the same business as it carried on at a particular time' (→ subsection 707-135(2)) the loss is 'tagged' as a loss that will always be subject to the additional test if transferred again.

Step 2: Effect of transfer for first head company

The effect of the transfer of the loss from the joining entity to the head company is to treat the loss, for the purposes of income years ending after the transfer, as if the head company had made the loss for the income year in which the transfer occurs. → subsection 707-140(1)

Thus, as shown in the illustration below, the head company is treated as having made the loss for the 2003 income year and is not prevented from utilising it in that year. → section 707-140(2)

Figure 2: Loss of head company



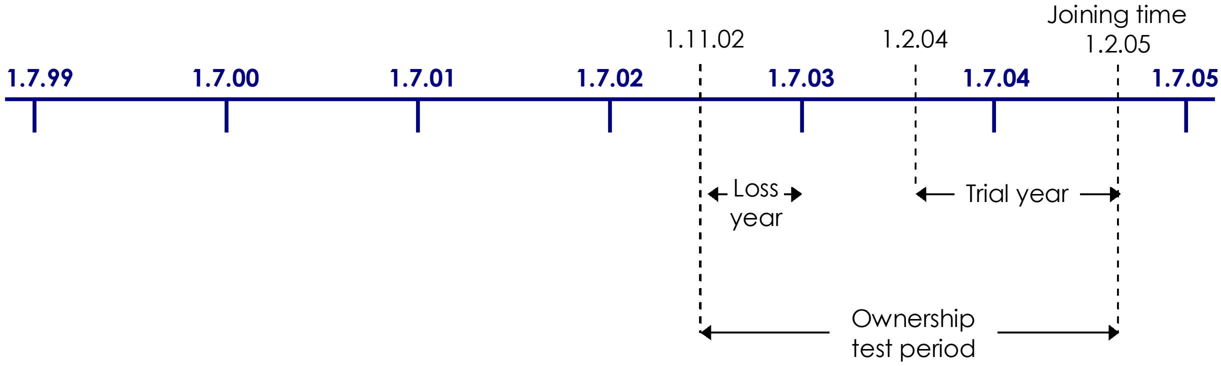
The loss is now designated a loss in respect of the 2003 income year of the head company. The loss is able to be utilised by the head company for the 2003 and subsequent income years on a section 165-12 basis of recoupment, unless there is an ownership or control failure that then forces it to test on a section 165-13 basis.

Step 3: Second head company trial year testing – ownership and control transfer tests

However, on 1 February 2005 the head company itself becomes a subsidiary member of a consolidated group through its parent (the second head company) acquiring the outstanding 5% equity to give 100% ownership. The loss on hand in the first head company is now subject to the transfer testing process in section 707-120.

As shown in figure 3, the loss would appear to satisfy the ownership and control transfer test; that is, there is no failure in the ownership test period from the beginning of the loss year through to the joining time (note the effect of section 707-205 to bring the start of the loss year in line with the transfer time). Normally, this would be sufficient for the loss to be transferred to the second head company (for example, if the loss were instead a group loss rather than a transferred loss of the first head company).

Figure 3: Subsequent transfer test

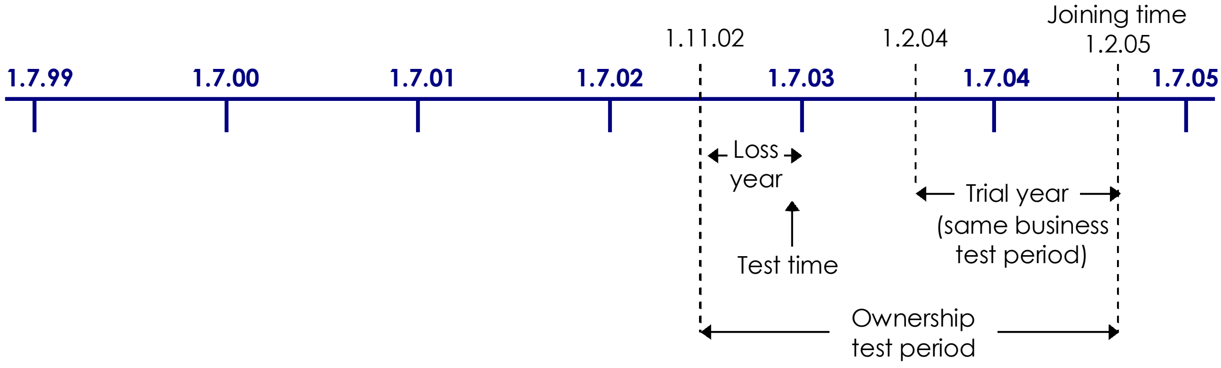


Step 4: Second head company trial year testing – additional transfer test

However, as the loss was previously transferred to the first head company because the original loss-maker carried on during a particular period the same business as it carried on at a particular time, the additional transfer test must be applied. If the loss could not be transferred because the usual tests applied under section 707-120 were failed, there would be no reason to apply the additional test: the additional test, by itself, cannot facilitate the transfer of a loss.

The additional test would apply as shown in figure 4.

Figure 4: Additional transfer test



Thus, not only does a section 707-120 transfer test need to be satisfied; so also does the section 707-135 test. The first head company needs to meet the same business test in respect of the testing points – that is, the trial year and the test time (being just before the end of the loss year).

Outcome

On the basis that the same business test was met in respect of these relevant times, the loss is transferred to the second head company.

If it cannot be transferred, its utilisation will be restricted in accordance with section 707-150 – that is, it cannot be used by any entity for the 2005 and later income years.

References

Income Tax Assessment Act 1997 sections 165-210, 165-12

Income Tax Assessment Act 1997 – as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1:
  - subsections 707-120(1), 707-120(3)
  - sections 707-125, 707-135
  - subsections 707-135(2), 707-140(1), 707-140(2)
  - sections 707-150, 707-205
- *Taxation Laws Amendment Act (No. 5) 2003* (No. 142 of 2003):
  - sections 165-13, 707-125

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 6

Revision history

Section C3-3-250 first published (excluding drafts) 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
5.4.04	‘Continuity period’ removed from figure 1.	Reflect changes in *Taxation Laws Amendment Act (No. 5) 2003* (No. 142 of 2003).

Proposed changes to consolidation

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- **http://assistant.treasurer.gov.au** (Assistant Treasurer’s press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Transfer testing where Subdivision 165-CC applies to a net capital loss that is unutilised at the joining time

Description

This example shows how Subdivision 165-CC applies to a net capital loss that remains unutilised at the joining time and is to be tested to determine whether it can be transferred to the head company under Subdivision 707-A.

Commentary

When transferring losses under Subdivision 707-A, in certain circumstances section 707-120 requires that Subdivision 165-CC be considered. Three key elements are necessary for Subdivision 165-CC to apply:

1 The company has a 'changeover time' after the 'commencement time'

The company's commencement time is 1 pm ACT time on 11 November 1999 – or, if the company came into existence after that time, the time when it came into existence.[1]

A changeover time occurs, broadly, where there is a change in the company's ownership or control.[2] In determining whether there has been a change of ownership (or control), the reference time is the later of the commencement time (11 November 1999) and the time immediately after the latest changeover time.[3]

2 The company has an unrealised net loss (at the changeover time)

The unrealised net loss at changeover time is calculated in accordance with the rules set out in sections 165-115E and 165-115F. In essence, an unrealised net loss is the excess of unrealised losses on assets of the company at the changeover time over any unrealised gains on assets.

In calculating the unrealised gains and losses on assets, the assets are deemed to be disposed of for market value at the changeover time. Gains and losses on revenue assets, including trading stock, are included in the calculation of the unrealised net loss. Gains and losses on pre-CGT assets are also included.

3 There is a subsequent realisation of a (capital/revenue) loss on assets held at the changeover time

If there is a subsequent realisation of a loss on an asset held at the changeover time, then to the extent of the residual unrealised net loss

[1] Subsection 165-115A(2)

[2] Section 165-115C and section 165-115D

[3] Subsection 165-115A(2A)

(RUNL)[4] in respect of the company, the same business test (SBT) must be satisfied for the company to be able to utilise the loss.

The legislation deems the realised capital loss, deduction or trading stock loss to be a loss (a net capital loss or tax loss) of the income year immediately preceding the income year in which the changeover time occurred.[5] The company is also deemed to fail the continuity of ownership test (COT) at the changeover time and therefore cannot deduct the loss unless it passes the SBT.[6]

Although the loss or deduction is deemed to be a loss of the income year immediately preceding the income year in which the changeover time occurred, it cannot be utilised before the income year in which the company actually made it.[7]

Example

Facts

On 3 December 2001, HeadCo had a changeover time under Subdivision 165-CC, as a result of a 5% change in its ownership. There had previously been a 47% change in its ownership, which occurred on 15 March 2000, and this was HeadCo's only other ownership change since 1 pm legal time in the ACT on 11 November 1999 (the commencement time). At the changeover time, HeadCo calculated an unrealised net loss of $5 million and the following asset was held:

Asset	Reduced cost base	Changeover time market value
D	$6 million	$1 million

On 4 June 2002, asset D was disposed of for $0.5 million – a capital loss of $5.5 million (i.e $6 million minus $0.5 million). On 1 July 2002, HeadCo and its subsidiaries form a consolidated group, and there is no new changeover time for HeadCo or its subsidiaries at that time.

The capital loss is not able to be utilised in the income year ended 30 June 2002 as there are no capital gains, and it is HeadCo's only unutilised loss at the joining time. HeadCo seeks to transfer its net capital loss(es) under Subdivision 707-A.

Calculation

Application of Subdivision 165-CC

In this case, the $5.5 million loss on the disposal of asset D exceeds the RUNL balance of $5 million, which means the RUNL balance is reduced to $0 at the time of the disposal on 4 June 2002.

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[4] Subsection 165-115BB(2)

[5] Subsections 165-115B(1) and (2) and paragraph 165-115BA(5)(a)

[6] Subsections 165-115B(3) and (4), and subsections 165BA(4) and (5)

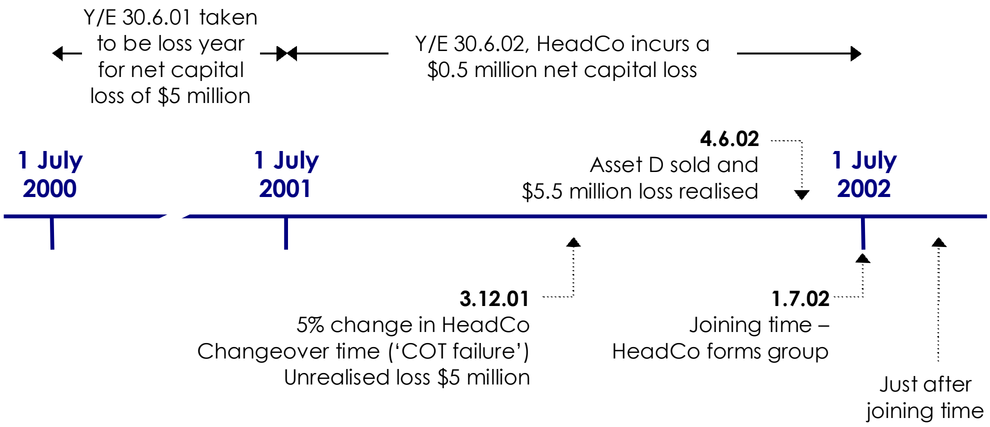
[7] Subsections 165-115B(5) and (6)

Under subsection 165-115B(2), $5 million of the $5.5 million capital loss that HeadCo made on 4 June 2002 is taken to be a net capital loss made in the income year ended 30 June 2001. This leaves the remaining $0.5 million capital loss as being made by HeadCo on 4 June 2002 (i.e when asset D was disposed of).

Under subsection 165-115B(3), HeadCo is taken to have failed the COT in respect of the loss on 3 December 2001. Therefore, for the purposes of applying the SBT in respect of the loss, the continuity period is taken to have ended on 3 December 2001.

In respect of the $0.5 million capital loss made by HeadCo on 4 June 2002, this is available to be offset against any capital gains made in the income year ended 30 June 2002. As there are no capital gains made by HeadCo in the income year ended 30 June 2002, HeadCo has a net capital loss in the income year ended 30 June 2002 of $0.5 million (by applying the method statement in subsection 102-10(1)).

Figure 1: Timeline of events



Application of Subdivision 707-A

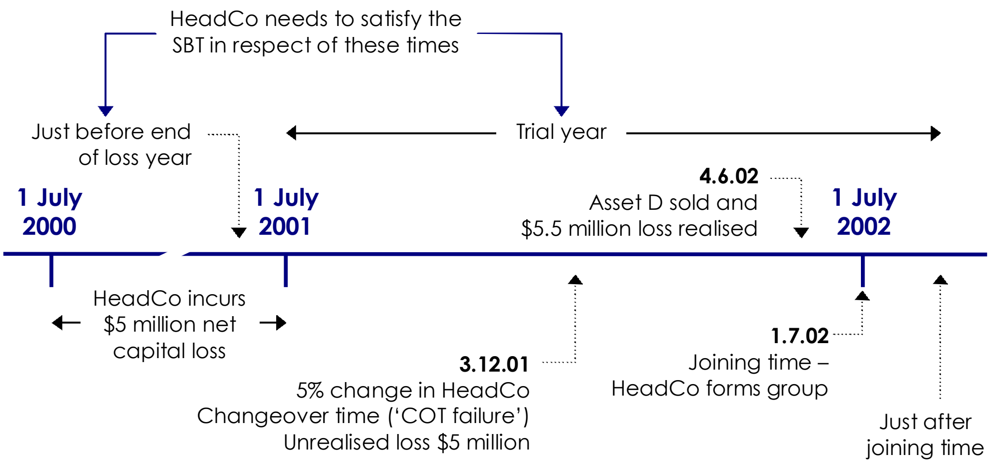
Subsection 707-120(1) provides that a loss is able to be transferred to HeadCo (from itself in this instance) if HeadCo (the joining entity) could have utilised the loss for an income year consisting of the trial year – which in this case is 1 July 2001 to just after 1 July 2002). In this case, the transfer testing process needs to apply to each of the net capital losses incurred by HeadCo.

2001 net capital loss

HeadCo would only be able to utilise the $5 million 2001 net capital loss in the trial year if it satisfied the SBT (as it has been taken to have failed the COT in respect of the loss on 3 December 2001).

The modified SBT in section 707-125 applies as the loss is made by HeadCo in the income year ended 30 June 2001 (i.e. HeadCo incurs the loss in an income year starting after 30 June 1999).

Figure 2: SBT testing times for 2001 net capital loss



Applying the modified SBT in section 707-125, HeadCo will be able to transfer the 2001 net capital loss if it is able to satisfy the SBT in respect of the trial year (i.e. 1 July 2001 to just after 1 July 2002[8]) and just before the end of the income year in which the loss is made (i.e. just before the end of the income year ended 30 June 2001). The income year in which the continuity period ends (i.e. the income year ended 30 June 2002) is not separately examined, as it does not begin before the start of the trial year.

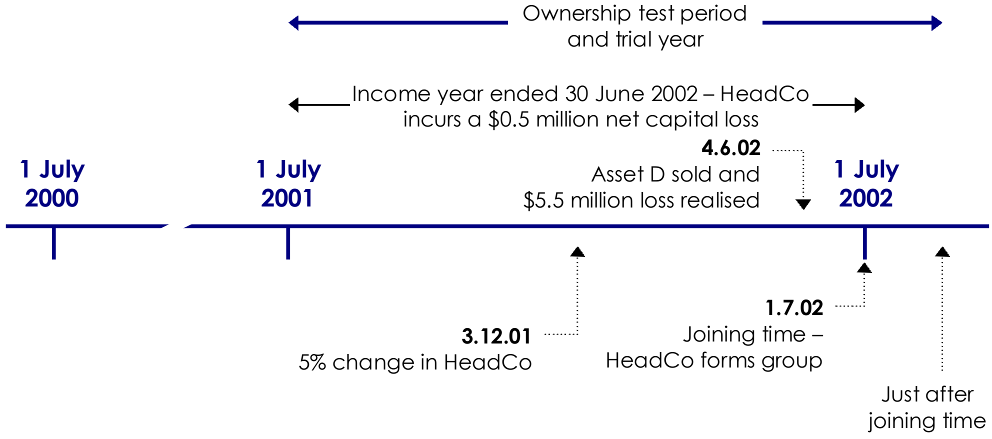
2002 net capital loss

In respect of the $0.5 million net capital loss incurred by HeadCo in the income year ended 30 June 2002, HeadCo has had a 5% change in its ownership from the start of the loss year (i.e. 1 July 2001) to the end of the trial year (i.e. just after the joining time on 1 July 2002).

Therefore HeadCo has maintained majority ownership since the start of the loss year (i.e. it has maintained 95% ownership) and satisfies the COT in respect of the loss. Assuming that the control test has not been failed, the 2002 net capital loss is transferred to HeadCo as a COT transfer as defined by subsection 707-210(1A).

[8] Subsection 707-120(3) provides that the business carried on at and just after the joining time is taken to be the same as the business conducted just before the joining time.

Figure 3: COT testing of 2002 net capital loss



References

Income Tax Assessment Act 1997:

- Division 102:
  - Subsection 102-10(1)
- Subdivision 165-A:
  - Subsections 165-12(2), (3) and (4)
- Subdivision 165-CC:
  - subsection 165-115A(1)(c)(i)
  - subsection 165-115A(2)
  - subsection 165-115A(2A)
  - subsections 165-115B(1), (2), (3), (4), (5) and (6)
  - subsections 165-115BA(4) & (5)
  - subsection 165-115BB(2)
  - section 165-115C
  - section 165-115D
  - section 165-115E
  - section 165-115F

Income Tax Assessment Act 1997 – as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1:

- Subdivision 707-A:
  - subsection 707-120(1) & (3)
  - section 707-125

Income Tax Assessment Act 1997 – as amended by *New Business Tax System (Consolidation and Other Measures) Act (2003* (No. 16 of 2003), Schedule 13:

- subsection 707-210(1A)

Revision history

Section C3-3-260 first published 28 May 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Transfer testing where control or ownership failure and a change in business within the non-membership period

Description

This example shows how a company determines if a loss, or any part of a loss, is transferred to the head company at joining time where there has been a change in ownership accompanied by a change in business within the non-membership period.

Commentary

An entity[30] that joins a consolidated group as a subsidiary member part-way through its income year must determine its income tax position for the period up until the joining time as if that period were an income year → paragraph 701-30(3)(a). This period, which begins at the start of the income year and ends just before the joining time, constitutes a non-membership period → paragraph 701-30(2)(b).

A joining company that experiences a change in ownership and a change in business within such a non-membership period determines its taxable income position under Subdivision 165-B[31]. Subdivision 165-B applies to a company that has not had the same ownership and control during an income year, and has not satisfied the same business test → section 165-35.

Under Subdivision 165-B, the income year is divided into periods → section 165-45. The dividing points between periods are defined by a change in ownership or control.[32] The notional loss or notional taxable income for each period is determined under specific rules for attributing assessable income and deductions to these respective periods.

The joining company's taxable income for the non-membership period in question is then worked out in accordance with section 165-65. Where a taxable income is worked out for one or more notional periods within the non-membership period and there are no other non-membership periods in the income year, this will be the taxable income for the entity in accordance with subsection 701-30(5). Notional losses are not taken into account in working out the taxable income but instead will determine the company's tax loss for the non-membership period, which is calculated in accordance with section 165-70. The tax loss of the joining company is transferred to the head company at the joining time if the transfer tests as described in Subdivision

[30] That was not a member of another consolidated group.

[31] Section 36-25 directs the company to the special rules in Subdivision 165-B.

[32] However, if the same business test is satisfied after the change in ownership or control, it is possible that what would otherwise be two or more successive periods are treated as a single period.

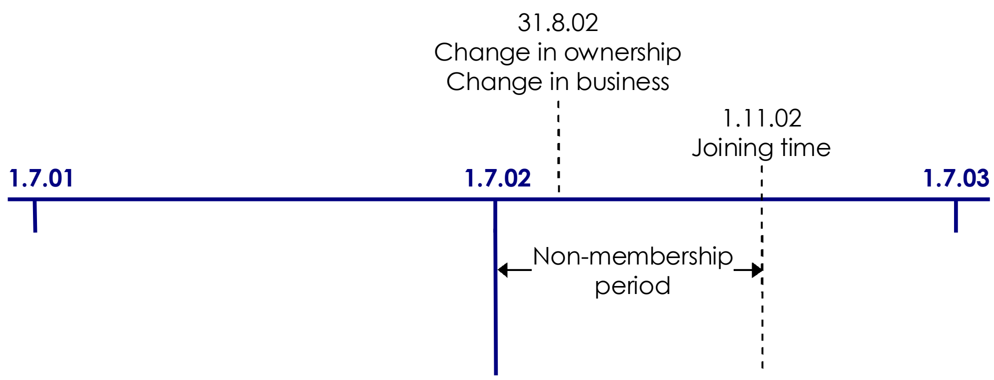
707-A can be satisfied. Given that Subdivision 165-B is relied on by the joining company to work out its taxable income/tax loss position, it follows that the changes in ownership and business may result in none of the tax loss or only part of the tax loss satisfying the transfer tests.

Example

Facts

An entity (a company) joins a consolidated group on 1 November 2002 and remains a subsidiary member of the group for the remainder of the income year. It has a non-membership period from 1 July 2002 to 31 October 2002. The joining entity experiences a change in ownership within the non-membership period which results in a change in the business conducted. The joining entity is able to establish that the change in ownership occurred on 31 August 2002. The joining entity's tax deductions exceed assessable income throughout the non-membership period.

Figure 1: Joining entity timeline

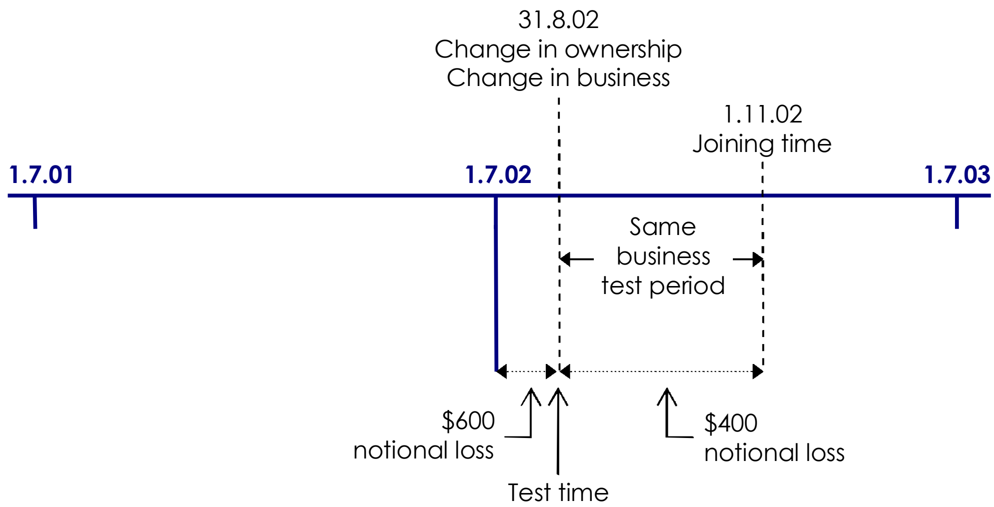


Calculation

Step 1: Determine which losses remain unutilised at the joining time

The entity must work out its net tax position for the non-membership period. It needs to work out its taxable income (if any) for the period, the income tax (if any) payable on that taxable income and its loss (if any). These calculations are to be made as if the start and end of the period were the start and end of an income year → subsection 701-30(3). As a consequence of the ownership change, unless the entity satisfies the same business test for the rest of the non-membership period after the ownership change, Subdivision 165-B will apply to the non-membership period as if it were an income year. As illustrated in figure 2, the entity is required to apply Subdivision 165-B to the non-membership period as if it were an income year.

Figure 2: Calculation of notional losses



Section 165-35 requires the company to apply the same business test to the business that it carried on immediately before the test time (the end of the first period) and the same business test period (the second period in this example). As the same business test is not satisfied, the entity is required to calculate the notional loss or notional taxable income for each period pursuant to section 165-50. The tax loss for the non-membership period is then calculated in accordance with section 165-70.

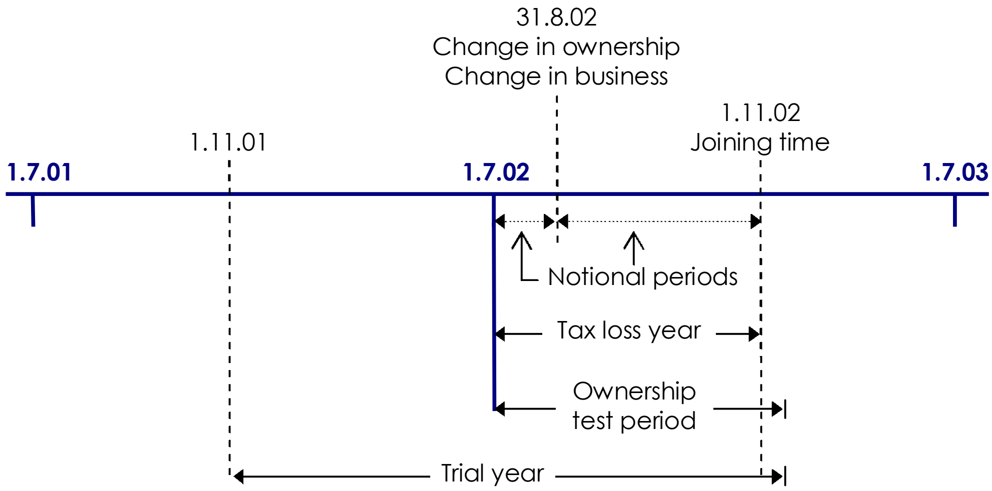
In this example it has been assumed that in the first period there is a notional loss of $600 and in the second period a notional loss of $400. In the absence of any other adjustments, the tax loss for the non-membership period is $1,000, being the sum of the two notional losses that remain unutilised at the joining time. For the purposes of transfer or utilisation, subsection 701-30(8) operates to deem the non-membership period loss of $1,000 as a tax loss for an income year starting on 1 July 2002 and ending on 31 October 2002.

Transfer testing of the loss can now proceed.

Step 2: Apply the continuity of ownership test

In this example there has been an ownership failure within the ownership test period 1 July 2002 to just after 1 November 2002. Accordingly, the tax loss would not be utilisable to the joining entity under this test in the trial year (assuming there is sufficient income). Section 165-10 provides an alternative qualifying test that requires the company to meet the conditions about carrying on the same business.

Figure 3: Continuity of ownership transfer test



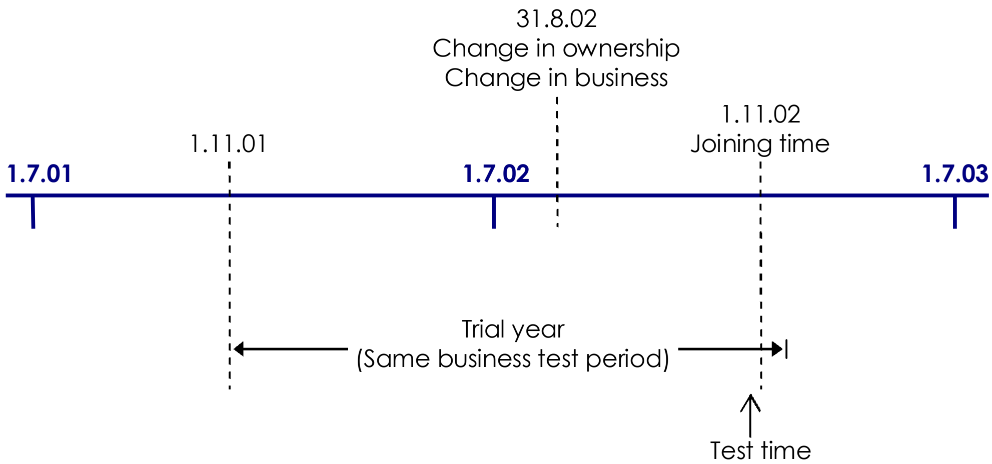
Step 3: Identify the modified same business test points

The company is required to apply the modification to the same business test as stipulated in section 707-125 and work out whether the entity satisfies the same business test for:

- the same business test period, consisting of:
  - the trial year, and
  - the income year that included the test time that would normally apply for the same business test (the 'change year'), if that income year started before the trial year, and
- the test time, being the time just before the end of the income year for which the loss was made by the company.

As shown in figure 4, the same business test period is effectively the trial year, because the change year falls within the trial year period.

Figure 4: Modified same business test points



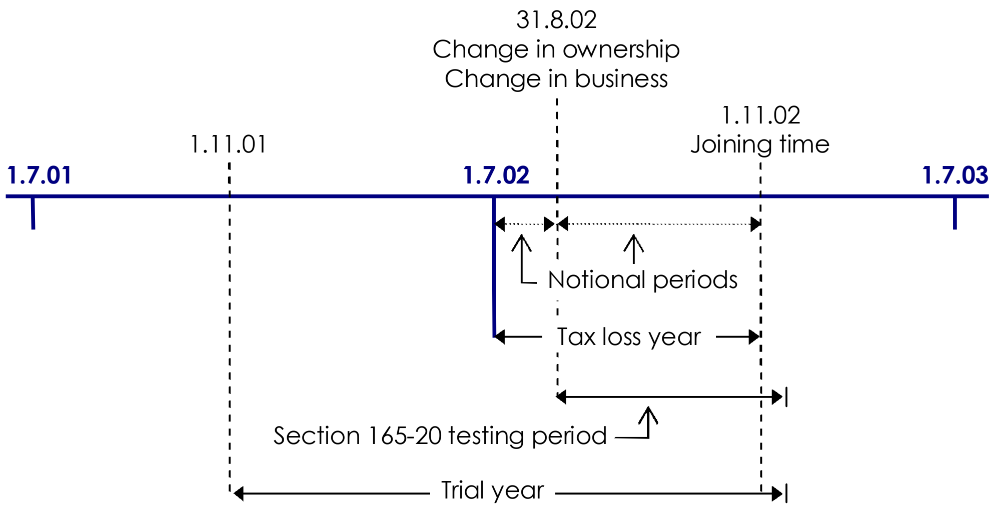
Step 4: Apply the same business test

The joining entity now applies the section 165-210 same business test to the identified same business test period and test time[33] to work out whether the loss is transferred. This test will be satisfied if throughout the same business test period the entity carries on the same business as it carried on at the test time. As noted in figure 4, the entity had a change in business as a result of the change in ownership. Therefore it would similarly fail this qualifying test.

Step 5: Determining whether part of the tax loss can be deducted

As the entity has failed both the continuity of ownership and same business tests, section 165-10 prevents the company from deducting the tax loss. However, section 165-20 may operate to allow a part of the tax loss to be deducted. Under section 165-20, a company can deduct a part of a tax loss that was incurred during a part of the loss year if, assuming that part of the loss year had been treated as the whole of the loss year for the purposes of section 165-10, the company would have been entitled to deduct the tax loss.

Figure 5: Transfer testing applying section 165-20



Conclusion

In this example, the continuity of ownership test will be satisfied for the part of the loss year beginning immediately after the ownership change and ending just before the joining time. Note that subsection 701-30(3A) extends the non-membership period to just after the joining time for the purposes of testing for continuity of ownership. As the notional loss for that particular period is $400, this will be the amount that is utilisable under section 165-20. Therefore, this amount of $400 will be the amount of the tax loss that is transferred to the head company at the joining time under section 707-120. The part of the tax loss that is not transferred is not able to be utilised by any entity for an income year ending after the joining time → section 707-150.

[33] As identified in step 3 by applying the modification in section 707-125.

References

Income Tax Assessment Act 1997:

- section 701-30
- Subdivision 165-B
- Subdivision 165-A
- section 165-210
- section 36-25
- Subdivision 707-A

Revision history

Section C3-3-270 first published 3 November 2004.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Modified market value of a single joining entity

Description

When a loss is transferred from a member of a consolidated group (the real loss-maker) to the head company for the first time, an available fraction may need to be calculated (→ 'Consolidation loss provisions', C3-2-110) for the bundle containing the loss. In order to calculate an available fraction, the modified market value of the entity that transferred the loss must be determined as at the joining time.

This example shows how modified market value is determined for a single joining entity.

Commentary

The modified market value of an entity becoming a member of a consolidated group is its market value, assuming:

- it has no losses and the balance of its franking account is nil
- the subsidiary members of the group at the joining time are separate entities and not parts of the head company, and
- the entity's market value does *not* include an amount attributable (directly or indirectly) to a membership interest in a member of the group that is a corporate tax entity or an entity that transferred losses to the head company.

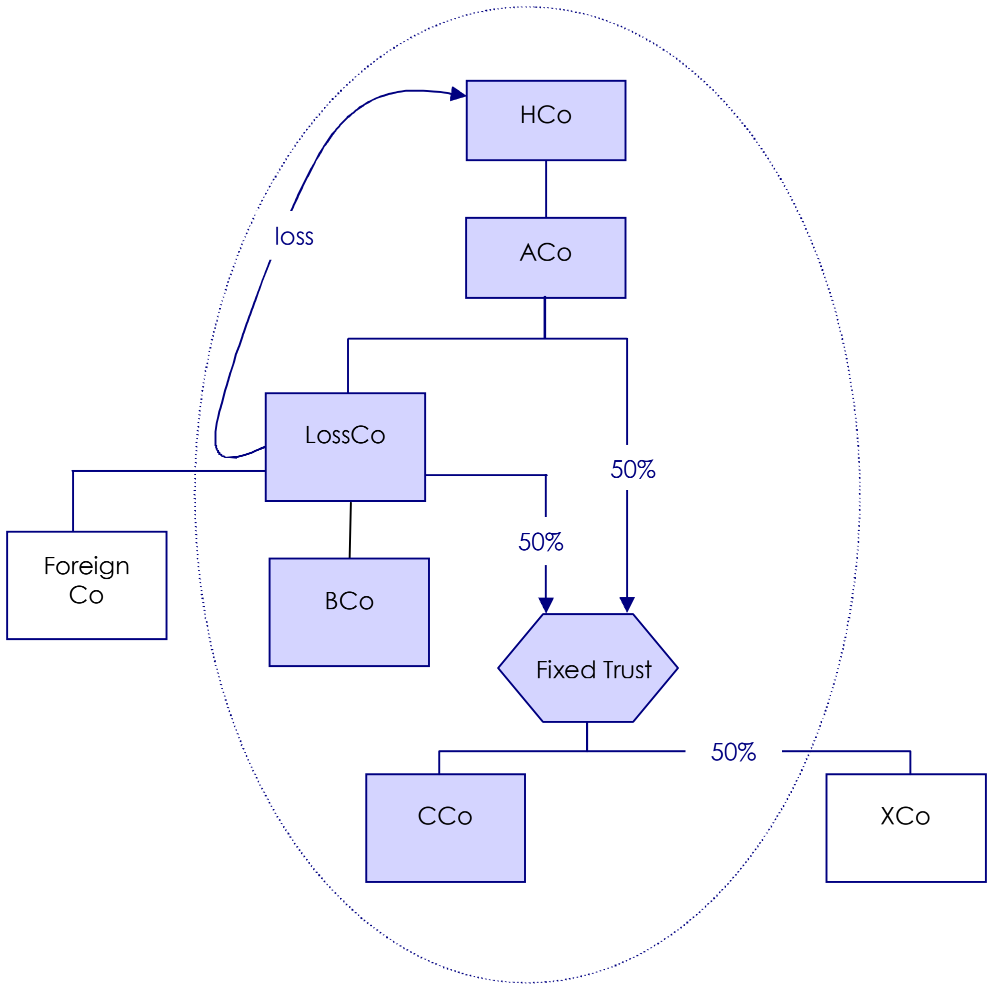
An entity's modified market value may include value contributed by a fixed entitlement in another group member that is a trust. Value taken into account is so much of the trust's value that is not contributed via a membership interest in another member of the group, unless that member is itself a trust in which a fixed entitlement is held. However, an entity's modified market value cannot include the value of a membership interest in a trust that itself transferred losses to the head company or is a corporate unit trust or public trading trust.

Example

Facts

The consolidated group shown in figure 1 formed on 1 July 2002. Subsidiary member LossCo transfers a loss at the joining time to the head company, HCo. LossCo and ACo are beneficiaries of the fixed trust – they each hold a fixed entitlement to 50% of the income and capital of the trust. If the available fraction method of utilisation is going to be used by HCo, the modified market value of LossCo must be determined as at the joining time in order for an available fraction for the bundle to be calculated.

Figure 1: HCo and subsidiary members



Calculation

The modified market value for LossCo is worked out assuming it:

- has no losses
- is a separate entity and not part of the head company
- has no membership interest in other corporate tax entities that are members of the consolidated group (disregard interest in BCo)
- can include the value of the fixed entitlement to the income and capital of Fixed Trust (that is *not* attributable to the trust's membership interest in CCo) that flow to it, and
- can include the membership interest in Foreign Co, as it is not a subsidiary member of the group.

References

Income Tax Assessment Act 1997, section 707-325; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 8

Revision history

Section C3-4-110 first published (excluding drafts) 2 December 2002.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Calculating an available fraction – losses transferred for the first time where there has been a pre-joining injection of capital

Description

The effect of certain pre-consolidation events that have increased a loss entity's market value – such as an injection of capital – are disregarded in calculating an available fraction.

This example shows how to treat an injection of capital into a loss entity prior to consolidation when calculating the entity's modified market value and the available fraction for loss bundles transferred for the first time from that entity.

Note

For more information about:

- loss bundles and calculating the available fraction → 'Treatment of losses', C3-1; 'Consolidation loss provisions', C3-2-110 (high-level worked example)
- working out modified market value → 'Modified market value of a single joining entity', C3-4-110 (worked example)
- working out the reduction amount for modified market value → 'Determining the reduction amount – subsection 707-325(3)', C3-6

Commentary

The utilisation of losses transferred to the head company of a consolidated group is subject to limits determined by reference to an available fraction, which is worked out separately for each loss bundle.

A loss bundle's available fraction is the proportion the joining loss entity's modified market value bears to the market value of the whole group when the bundle of losses is first transferred to a head company (called the 'initial transfer time').

The available fraction is calculated as:

$$\frac{\text{modified market value of the loss entity}}{\text{adjusted market value of the consolidated group}^{34}}$$

Values are worked out as at the initial transfer time. As the calculation of an available fraction for a bundle is a crucial component of the rules for loss utilisation for consolidated groups, special rules are necessary to ensure the

[34] The market value of the consolidated group as at the joining time, ignoring any losses and assuming a nil franking account balance.

integrity of that calculation. These rules are designed to prevent the inflation of an available fraction resulting from certain events occurring prior to consolidation. → subsections 707-325(2) and (4), *Income Tax Assessment Act 1997*.

For example, where a pre-consolidation injection of capital into the loss entity results in an increase in the value of the loss entity, that increase in value is excluded from the entity's modified market value (the numerator in the available fraction calculation). → Taxation Ruling TR 2004/9

The amount excluded is the lesser of:

- the difference between the loss entity's modified market value at the joining time and what would have been its modified market value if the injection had not occurred, and
- the total increase in the entity's market value that occurs immediately after the capital injection.

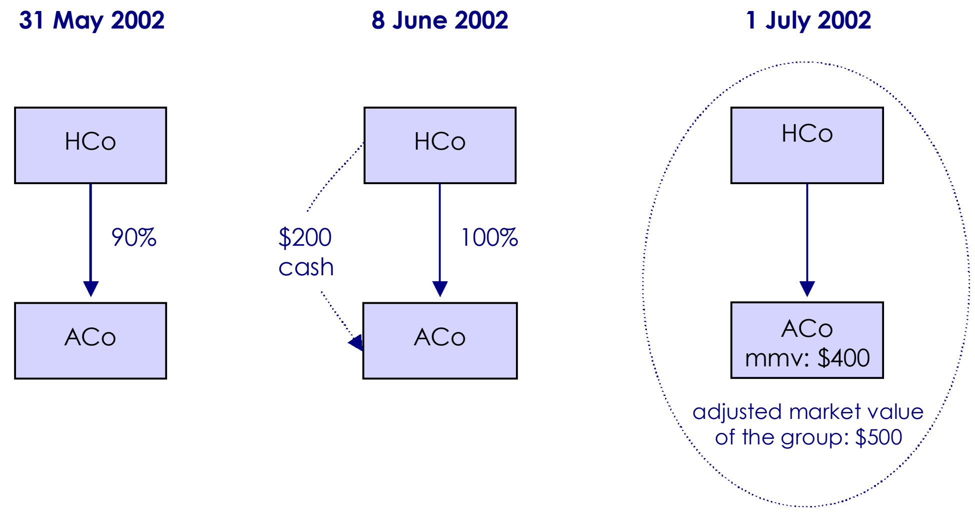
The rules prevent a loss entity from seeking to obtain a higher available fraction by inflating its market value before it joins a consolidated group. They apply to events that occur after 8 December 2000 and in the four years preceding the loss entity joining the group.

Example

Facts

ACo has been 90% owned by HCo since incorporation. On 1 June 2002, HCo acquires the remaining 10% membership interest. Assume that HCo injects an amount of $200 cash into ACo on 8 June 2002. The wholly-owned group then consolidates on 1 July 2002. This sequence of events is represented in figure 1.

Figure 1: Sequence of events



mmv = modified market value

Calculation

In calculating the modified market value of ACo, the anti-inflationary rule works to reduce its market value of $400 by $200, which represents the lesser of:

- $200, which is the difference between the modified market value of ACo at the joining time ($400) and the modified market value of ACo had the capital injection not occurred ($200), and
- $200, which is the increase in ACo's market value immediately after the capital injection.

Therefore, the modified market value of ACo, as adjusted to disregard the increase in market value as a result of the injection of capital, is $200 ($400 – $200).

As a result, the available fraction for ACo's loss bundle would be 0.400 ($200 / $500).

Thus, the injection of capital of $200 has been excluded from the numerator but is still reflected in the market value of the group.

References

Income Tax Assessment Act 1997, Subdivision 707-C; as amended by *New Business Tax System (Consolidation) Act (No.1) 2002* (No. 68 of 2002), Schedule 1

Income Tax (Transitional Provisions) Act 1997, section 707-329; as amended by *New Business Tax System (Consolidation) Act (No.1) 2002* (No. 68 of 2002), Schedule 2

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 8

Taxation Ruling TR 2004/9 Income tax: consolidation: what is meant by 'injection of capital' in section 707-325 of the *Income Tax Assessment Act 1997*?

Revision history

Section C3-4-120 first published 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
26.10.05	References to reduction amount, p. 1 and new taxation ruling.	For clarification.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Adding to modified market value to reflect loss transferability

Description

As shown in this example, a loss entity (the 'real loss-maker'), in calculating its available fraction, may add to its modified market value the modified market value of another company (the 'value donor'). Certain losses from the value donor are also able to be transferred notionally. This enables those losses to be utilised using the available fraction for the real loss-maker.

Note

For more information about:

- loss bundles and calculating the available fraction → 'Treatment of losses', C3-1; 'Consolidation loss provisions', C3-2-110 (high-level worked example)
- working out modified market value → 'Modified market value of a single joining entity', C3-4-110 (worked example)

Commentary

Subdivision 707-C of the *Income Tax (Transitional Provisions) Act 1997* sets out the operation of the value donor concession. In broad terms:

- For a company to be a value donor, it must be a company to which the real loss-maker could have transferred, under the group loss transfer rules in Division 170 of the *Income Tax Assessment Act 1997*, at least one of the losses in its bundle.
- To be eligible for the concession, both the real loss-maker and the value donor must be companies that join the group when it first consolidates, and the group must consolidate during the transitional period (that is, 1 July 2002 to 30 June 2004).

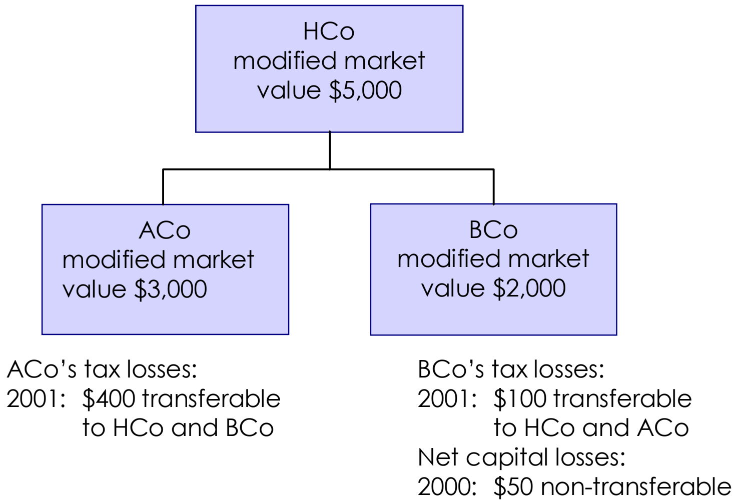
The head company may also treat one or more of the value donor's losses as if it was included in the real loss-maker's bundle for the purpose of determining the amount of the losses that can be utilised by the group in any given income year. Broadly, losses can be treated in this way only if they could be transferred from the value donor to the real loss-maker, and to any of the real loss-maker's other value donors, under the group loss transfer rules.

Example

Facts

A wholly-owned group consists of a head company, HCo, and two subsidiary companies. The group consolidates on 1 July 2002. At that time, the adjusted market value of the group (that is, the market value after ignoring any losses and assuming a nil franking account balance) is $10,000.

Figure 1: HCo and subsidiary members



Calculation

In the absence of the value donor concession, the available fractions for ACo and BCo would be 0.300 and 0.200 respectively. Under the concession, modified market value can be transferred to *either* ACo or BCo or both. A further concession under this subdivision allows losses to be transferred notionally for the purpose of determining their rate of utilisation.

This example will consider two of the options available to HCo under the value donor concession.

Transfer to ACo only (option 1)

ACo's only loss is transferable to HCo under the group loss transfer rules, so ACo can add a chosen percentage of HCo's modified market value when calculating its available fraction. Assume 100% of HCo's value is chosen to be added.

$$100\% \times \$5{,}000 = \$5{,}000$$

ACo's loss is also transferable to BCo, so ACo can add a chosen percentage of BCo's modified market value to its own when calculating its available fraction. Assume 50% of BCo's value is chosen to be added. This would allow some modified market value to remain with BCo to be used in determining an available fraction to allow utilisation of BCo's non-transferable loss.

$$50\% \times \$2{,}000 = \$1{,}000$$

Therefore, ACo's available fraction is now calculated as follows:

$$(\$3{,}000 + \$5{,}000 + \$1{,}000) \div \$10{,}000 = 0.900$$

HCo can treat BCo's transferable loss of $100 as if it was included in ACo's bundle for the purpose of determining how much of the loss can be utilised.

BCo's available fraction for its bundle containing the $50 non-transferable loss is calculated as follows:

$$[\$2{,}000 - (50\% \times \$2{,}000)] \div \$10{,}000 = 0.100$$

Transfer to BCo only (option 2)

BCo has a loss that is transferable to HCo, so BCo can add a portion of HCo's modified market value when calculating its available fraction. That portion is determined by multiplying the chosen percentage of HCo's modified market value by the proportion of BCo's total losses that is transferable to HCo. Assume that 100% of HCo's modified market value is chosen to be added.

$$(100\% \times \$5{,}000) \times (100 \,/\, 150) = \$3{,}333$$

BCo also has a loss that is transferable to ACo, so BCo can add a portion of ACo's modified market value to its own when calculating its available fraction. The portion is calculated as follows (assuming that 100% of ACo's modified market value is chosen to be added):

$$(100\% \times \$3{,}000) \times (100 \,/\, 150) = \$2{,}000$$

HCo can treat ACo's transferable loss of $400 as if it was included in BCo's bundle for the purpose of determining how much of the loss can be utilised.

BCo's available fraction is calculated as follows:

$$(\$2{,}000 + \$3{,}333 + \$2{,}000) \div \$10{,}000 = 0.733$$

All the losses in BCo's bundle, together with ACo's transferable loss, will be utilised with this available fraction.

References

Income Tax Assessment Act 1997, Division 170

Income Tax (Transitional Provisions) Act 1997, Subdivision 707-C; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 2

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 9

Revision history

Section C3-4-210 first published (excluding drafts) 2 December 2002.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Including value donor's losses in real loss-maker's bundle

Description

A loss entity (the 'real loss-maker'), in calculating its available fraction, may add to its modified market value the modified market value of another company (the 'value donor'). Certain losses from the value donor are also able to be transferred notionally to the real loss-maker's bundle. This enables those losses to be utilised using the available fraction for the real loss-maker.

This example shows how to treat a value donor's losses as being included in a real loss-maker's bundle, where the value donor's modified market value is nil.

Note

For more information about:

- loss bundles and calculating the available fraction → 'Treatment of losses', C3-1; 'Consolidation loss provisions', C3-2-110 (high-level worked example)
- working out modified market value → 'Modified market value of a single joining entity', C3-4-110 (worked example)

Commentary

Subdivision 707-C of the *Income Tax (Transitional Provisions) Act 1997* sets out the operation of the value donor concession. In broad terms:

- For a company to be a value donor, it must be a company to which the real loss-maker could have transferred, under the group loss transfer rules in Division 170 of the *Income Tax Assessment Act 1997*, at least one of the losses in its bundle.
- To be eligible for the concession, both the real loss-maker and the value donor must be companies that join the group when it first consolidates, and the group must consolidate during the transitional period (that is, 1 July 2002 to 30 June 2004).

The head company may also treat one or more of the value donor's losses as if it was included in the real loss-maker's bundle for the purpose of determining the amount of the losses that can be utilised by the group in any given income year. Broadly, losses can be treated in this way only if they could be transferred from the value donor to the real loss-maker, and to any of the real loss-maker's other value donors, under the group loss transfer rules.

Example

Facts

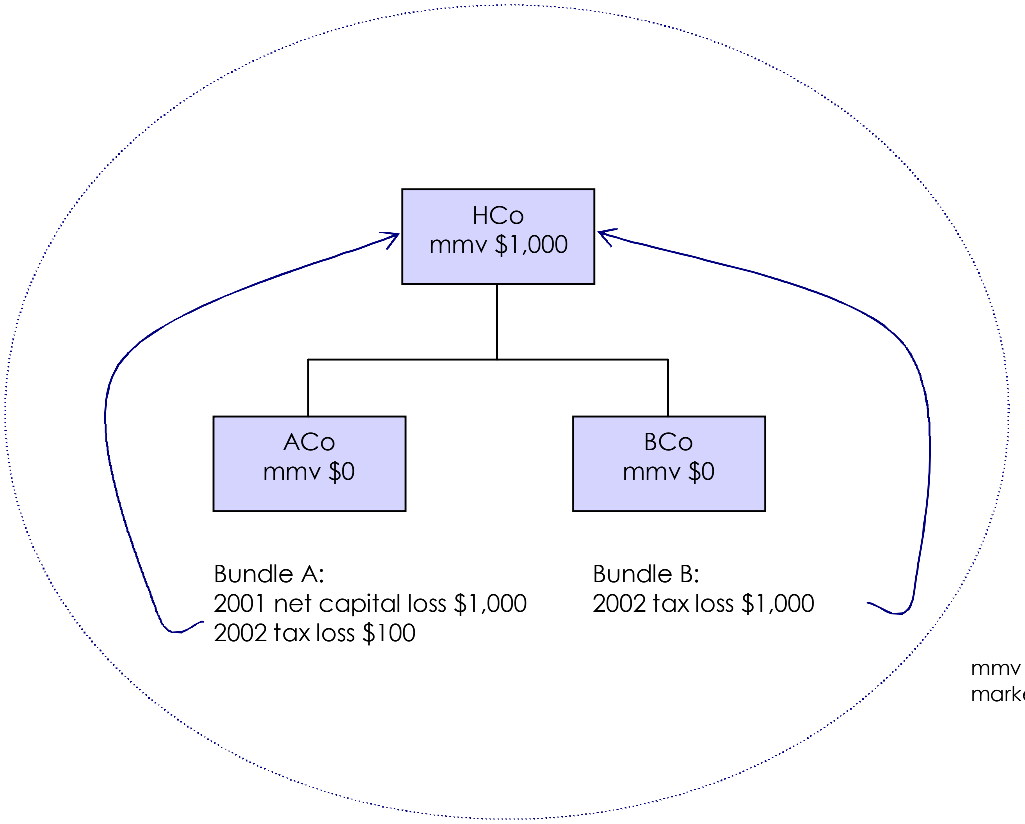
HCo, ACo and BCo have constituted a wholly-owned group for a number of years. There have been no changes in HCo's ownership or control. The group consolidates on 1 July 2002 and ACo's and BCo's losses (as set out in figure 1) are transferred to HCo, the head company of the group, under Subdivision 707-A.

HCo chooses to:

- add to the modified market value of ACo by using an amount of HCo's and BCo's modified market value for the purposes of working out the available fraction for the bundle of losses transferred from ACo, and
- treat the loss transferred from BCo as being included in the bundle of losses transferred from ACo for the purpose of determining its rate of utilisation.

The market value of the consolidated group at the joining time, ignoring losses and assuming a franking account balance of nil, is $1,000.

Figure 1: Transfer of losses at time of consolidation (1 July 2002)



mmv = modified market value

Calculation

Adding to ACo's modified market value an amount of HCo's modified market value

For HCo to be able to add to ACo's modified market value, certain conditions set out in subsections 707-325(1) and (2) must be met:

- The bundle of losses transferred from ACo must contain either a tax loss or a net capital loss and the utilisation of the loss is not affected by section 707-350[35].
- HCo, assuming it had made the loss, could have transferred it to itself under Subdivision 707-A.
- ACo could have transferred the loss to HCo under Subdivision 170-A or 170-B for an income year consisting of the trial year.

Note

Income year and trial year

Throughout this worked example, the income year is treated as consisting of the trial year. However, if the income year in which the loss is made starts after the commencement of the trial year, the income year is a shorter period.

→ subsection 707-328(2)

The amount that is added to ACo's modified market value is worked out in accordance with the formula contained in subsection 707-325(3):

$$\text{HCo's modified market value at initial transfer time} \times \text{Percentage chosen by HCo} \times \frac{\text{Total of ACo's Division 170 losses in bundle}}{\text{Total of ACo's non-foreign losses in bundle}}$$

'Total of ACo's Division 170 losses in bundle' are those losses that meet all of the conditions stated above. Both the 2001 net capital loss of $1,000 and the 2002 tax loss of $100 meet all of the conditions.

'Total of ACo's non-foreign losses in bundle' are those losses that meet the condition contained under the first bullet point. Again, both losses meet the condition.

Substituting the relevant amounts into the above formula and assuming that HCo chooses to use 100% of HCo's modified market value, the amount added to ACo's modified market value is:

$$\$1{,}000 \quad \text{x} \quad 100\% \quad \text{x} \quad \frac{\$1{,}100}{\$1{,}100} = \$1{,}000$$

[35] Section 707-350 of the *Income Tax (Transitional Provisions) Act 1997* provides a concession for the utilisation of certain losses that were originally made by a company for an income year ending on or before 21 September 1999 and transferred to the head company because the continuity of ownership and control tests were satisfied.

Adding to ACo's modified market value an amount of BCo's modified market value

Although BCo's modified market value is nil, certain conditions in section 707-327 must be met for HCo to be able to notionally transfer the loss from BCo's bundle into ACo's bundle. One of these conditions requires that the available fraction for the bundle of losses transferred from ACo has to be worked out under section 707-325 on the basis that an amount of BCo's modified market value is added to ACo's modified market value. The condition will be satisfied even where the amount donated is nil, provided that all the conditions relating to the donation of value are met – in other words, the donation has to be effective.

The relevant conditions, as set out in subsections 707-325(1) and (2) are:

- The bundle of losses transferred from ACo must contain either a tax loss or a net capital loss and the utilisation of the loss is not affected by section 707-350.
- BCo, assuming it had made the loss, could have transferred it to the head company (HCo) under Subdivision 707-A.
- ACo could have transferred the loss to BCo under Subdivision 170-A or 170-B for an income year consisting of the trial year.

All of these conditions are met, which means BCo is able to effectively donate a nil amount of its modified market value for the purposes of working out the available fraction for the bundle of losses transferred from ACo.

Available fraction for bundle of losses transferred from ACo

After taking into account donations of modified market value from HCo and BCo, the bundle of losses transferred from ACo has an available fraction of:

$$\frac{0 + 1{,}000 + 0}{1{,}000} = 1.000$$

Treating the loss transferred from BCo as being included in the bundle of losses transferred from ACo

For HCo to notionally transfer the loss from BCo's bundle into ACo's bundle, certain conditions in section 707-327 must be met:

- An amount of modified market value from BCo is added to the modified market value of ACo. (As discussed above, the amount can be nil.)
- The loss is either a net capital loss or a tax loss and the utilisation of the loss is not affected by section 707-350.
- The loss is transferred under Subdivision 707-A from BCo to HCo at the time when the consolidated group comes into existence.

- If BCo is a real loss-maker under a separate application of section 707-325, the loss must not be a loss that provides the basis for working out the available fraction under that application.[36]
- ACo and any of ACo's other value donors, assuming that they had made the loss, could have transferred the loss to HCo under Subdivision 707-A.
- BCo could have transferred the loss to ACo, and to any of ACo's other value donors, under Subdivision 170-A or 170-B for an income year consisting of the trial year.

All of the above conditions are met in respect of the 2002 tax loss of $1,000 transferred from BCo. The last two conditions are met in relation to both ACo and ACo's other value donor (HCo).

Therefore, the 2002 tax loss of $1,000 will be utilised on the basis of it being included in the bundle of losses transferred from ACo. As stated above, the bundle has an available fraction of 1.000.

References

Income Tax Assessment Act 1997 Subdivisions 170-A, 170-B, 707-A; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Income Tax (Transitional Provisions) Act 1997, Subdivision 707-C, sections 707-325, 707-327, 707-328, 707-350; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 2

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 9

Revision history

Section C3-4-220 first published 2 December 2002.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

[36] In other words, the loss is not covered by paragraphs 707-325(1)(d) and (e) and subsection 707-325(2) in that application of section 707-325.

Worked example

Adding to modified market value to reflect loss transferability – loss made for an income year ending just before the initial transfer time

Description

A loss entity (the 'real loss-maker'), in calculating its available fraction, may add to its modified market value the modified market value of another company (the 'value donor'). Certain losses from the value donor are also able to be transferred notionally to the real loss-maker's bundle. This enables those losses to be utilised using the available fraction for the real loss-maker.

This example shows how the value donor concession operates in circumstances where the loss in question is made in an income year ending just before the initial transfer time.

Note

For more information about:

- loss bundles and calculating the available fraction → 'Treatment of losses', C3-1; 'Consolidation loss provisions', C3-2-110 (high-level worked example)
- working out modified market value → 'Modified market value of a single joining entity', C3-4-110 (worked example)

Commentary

Subdivision 707-C of the *Income Tax (Transitional Provisions) Act 1997* sets out the operation of the value donor concession. In broad terms:

- For a company to be a value donor, it must be a company to which the real loss-maker could have transferred, under the group loss transfer rules in Division 170 of the *Income Tax Assessment Act 1997*, at least one of the losses in its bundle.
- To be eligible for the concession, both the real loss-maker and the value donor must be companies that join the group when it first consolidates, and the group must consolidate during the transitional period (that is, 1 July 2002 to 30 June 2004).

Division 170 generally applies when a company seeks to transfer a loss in a particular income year (i.e. the deduction year for a tax loss or the application year for a capital loss). In determining whether that condition is met in the value donor context, the deduction or application year is replaced under subsection 707-328 of the *Income Tax (Transitional Provisions) Act 1997* with a period that:

- starts at the later of these times:
  - the start of the trial year → subsection 707-120(2), and
  - the start of the loss year, and
- ends just after the time the company joins the group.

Subsection 707-328(6) states that where the loss is made in the income year ending just before the joining time, it is taken to be made in the notional deduction or application year described above. This ensures that subsections 170-35(2) and 170-140(3) apply correctly. They prohibit the transfer of a loss where the loss year and the deduction or application year are the same if the loss was calculated under:

- the current year loss rules (in sections 165-70 or 165-114), or
- the income injection rules (in sections 175-35 or 175-75).

Example

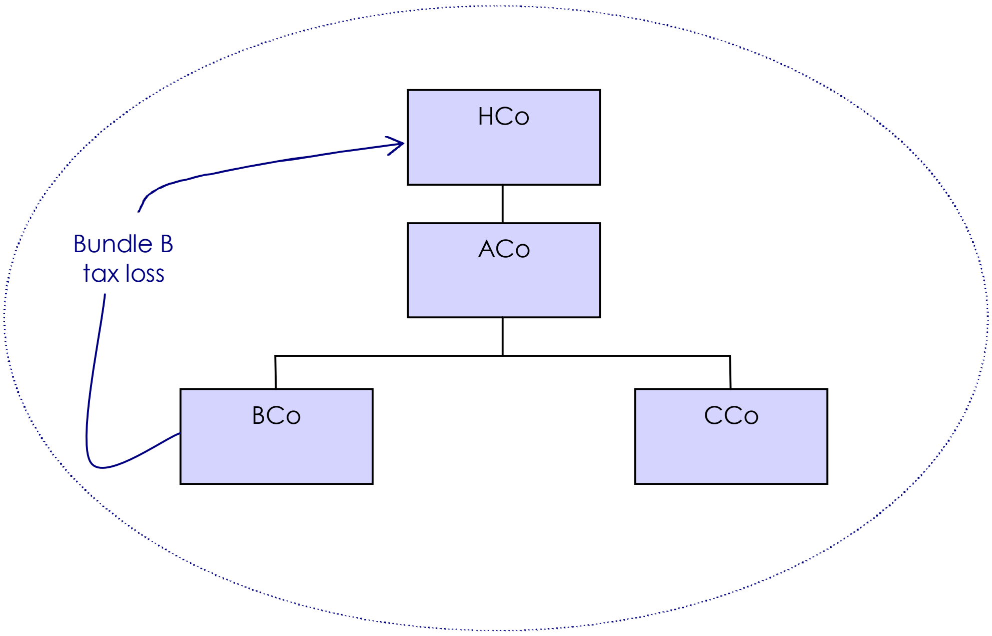
Facts

ACo, BCo and CCo have constituted a wholly-owned group for a number of years. HCo acquires 80% of ACo on 30 September 2002 (it previously held 0%). It acquires the remaining 20% on 21 March 2003. The group chooses to consolidate on that date. BCo begins to carry on a different business during the period 1 October 2002 to 20 March 2003. (There have been no changes in the underlying shareholders of HCo during this time.)

BCo's tax loss for the period 1 July 2002 to 20 March 2003, as calculated under section 165-70, is $1,000. The loss for the period after the change in majority ownership is $500.

The group seeks to transfer all or part of the tax loss to HCo on consolidation and also to apply the value donor concession.

Figure 1: HCo group



Calculation

Amount of loss (if any) that can be transferred to HCo

The tax loss of $1,000 calculated in accordance with section 165-70 cannot be transferred to HCo. BCo would not meet either of the conditions in section 165-10 if its income year consisted of the trial year because it has a change in majority ownership, as well as a change in its business.

However, $500 of the tax loss incurred after the ownership change can be transferred to HCo because section 165-20 would enable BCo to deduct that amount in an income year consisting of the trial year.[37]

Application of value donor concession to loss transferred from BCo

For the value donor concession to apply, BCo must have been capable of transferring the loss to another member of the group under Subdivision 170-A in a notional income year commencing on 1 July 2002 and ending just after 21 March 2003. → subsection 707-328(2)

As the loss is made for an income year ending just before the joining time[38], subsection 707-328(6) deems the loss to be made for an income year commencing on 1 July 2002 and ending just after 21 March 2003 – in other words, the notional loss year and the notional deduction year are the same. Therefore, for the loss to be transferred the condition in subsection 170-35(2) must be met. Subsection 170-35(2) prohibits the transfer of a loss if it is calculated under the current year loss rules in section 165-70, and the loss year and the deduction year are the same.

As the loss here, part of which is transferred to HCo via section 165-20, would be calculated under the current year loss rules for the notional loss year, the condition in subsection 170-35(2) cannot be met. The loss cannot be transferred to another member of the group. As the loss is the only loss in the bundle transferred from BCo, the value donor concession will not apply here.

References

Income Tax Assessment Act 1997, sections 165-10, 165-20, 165-70

Income Tax Assessment Act 1997, Division 701, Subdivision 707-A; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Income Tax (Transitional Provisions) Act 1997, Subdivision 707-C; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 2

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapters 2, 6 and 9

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[37] Section 165-20 allows the deduction if, assuming that the part of the loss year after the disqualifying ownership change was treated as the whole of the loss year, section 165-10 would not prevent BCo from deducting that part of the loss incurred in that part of the loss year. As there has only been a 20% change in the underlying ownership of BCo since the disqualifying ownership change that took place on 30 September 2002, this condition is satisfied. (It is assumed that the control test in section 165-15 is satisfied.)

[38] Subsection 701-30(8) deems a loss made for a non-membership period described in section 701-30 to be a loss made for an income year consisting of the non-membership period.

Income Tax Assessment Act 1997, subsection 701-30(8); as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 19

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 6

Revision history

Section C3-4-230 first published 2 December 2002 and updated 28 May 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Adding to modified market value to reflect loss transferability – bundle includes foreign loss

Description

As shown in this example, a loss entity (the 'real loss-maker'), in calculating its available fraction, may add to its modified market value the modified market value of another company (the 'value donor'). Certain losses from the value donor are also able to be transferred notionally. This enables those losses to be utilised using the available fraction for the real loss-maker. Foreign losses are not able to be transferred notionally. They must be utilised as though the value donor concession was not applied.

Note

For more information about:

- loss bundles and calculating the available fraction → 'Treatment of losses', C3-1; 'Consolidation loss provisions', C3-2-110 (high-level worked example)
- working out modified market value → 'Modified market value of a single joining entity', C3-4-110 (worked example)

Commentary

Subdivision 707-C of the *Income Tax (Transitional Provisions) Act 1997* sets out the operation of the value donor concession. In broad terms:

- For a company to be a value donor, it must be a company to which the real loss-maker could have transferred, under the group loss transfer rules in Division 170 of the *Income Tax Assessment Act 1997*, at least one of the losses in its bundle.
- To be eligible for the concession, both the real loss-maker and the value donor must be companies that join the group when it first consolidates, and the group must consolidate during the transitional period (that is, 1 July 2002 to 30 June 2004).

The head company may also treat one or more of the value donor's losses as if it was included in the real loss-maker's bundle for the purpose of determining the amount of the losses that can be utilised by the group in any given income year. Broadly, losses can be treated in this way only if they could be transferred from the value donor to the real loss-maker, and to any other value donor to the real loss-maker, under the group loss transfer rules.

Note

This example is designed to illustrate the operation of the value donor concession. The choices made by the head company in this example are not purported to represent the best outcome for the group in every case where similar scenarios exist.

Example

Facts

HCo, ACo and CCo have constituted a wholly-owned group for a number of years. During this period, the group, through ACo, has owned 90% of BCo. ACo acquires the remaining 10% of BCo on 21 March 2001. There have been no changes in HCo's ownership or control. The group consolidates on 1 July 2002 and BCo's and CCo's losses (as set out in figure 1) are transferred to HCo, the head company of the group.

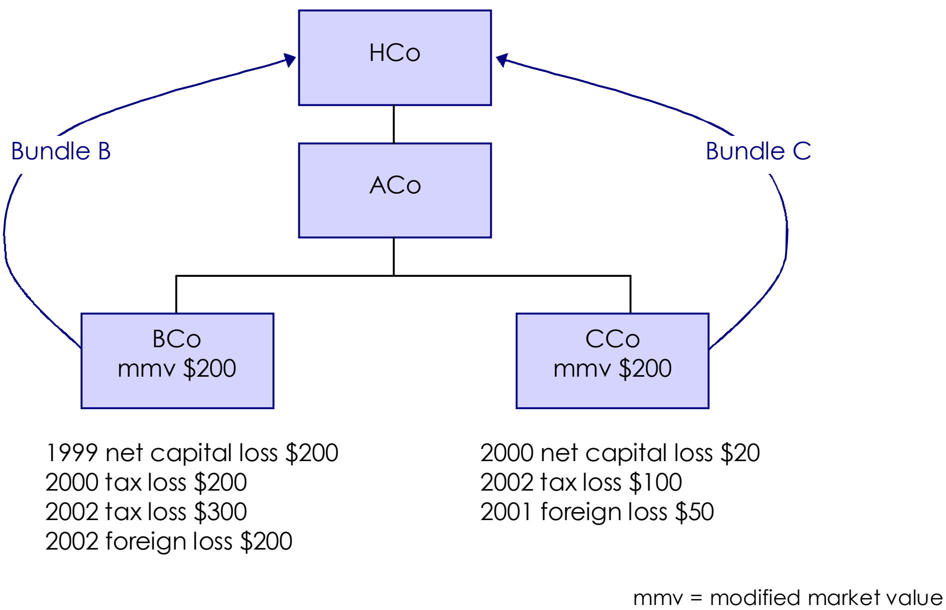
HCo chooses to:

- add to the modified market value of BCo by using an amount of CCo's modified market value for the purposes of working out the available fraction for the bundle of losses transferred from BCo, and
- treat the losses transferred from CCo as being included in the bundle of losses transferred from BCo for the purpose of determining their rate of utilisation.

The market value of the consolidated group at the joining time, ignoring losses and assuming a franking account balance of nil, is $400.

BCo has a 1999 net capital loss of $200, which is transferred to HCo. HCo chooses to utilise the loss over three years under section 707-350[39].

Figure 1: HCo and subsidiary members



[39] Section 707-350 of the *Income Tax (Transitional Provisions) Act 1997* provides a concession for the utilisation of certain company losses that were originally made for an income year ending on or before 21 September 1999 and transferred to the head company because the continuity of ownership and control tests were satisfied.

Calculation

Available fractions for losses transferred from BCo

For HCo to be able to add to BCo's modified market value by using a percentage of CCo's modified market value, certain conditions set out in subsections 707-325(1) and (2) must be met:

- First condition: The bundle of losses transferred from BCo must contain either a net capital loss or a tax loss and the loss is not utilised under section 707-350.
- Second condition: CCo, assuming it had made the loss, could have transferred it to HCo under Subdivision 707-A.
- Third condition: BCo could have transferred the loss to CCo under Subdivision 170-A or 170-B for an income year consisting of the trial year[40].

The amount that is added to BCo's modified market value is worked out in accordance with the formula contained in subsection 707-325(3):

$$\text{CCo's modified market value at initial transfer time} \times \text{Percentage chosen by HCo} \times \frac{\text{Total of BCo's Division 170 losses in bundle}}{\text{Total of BCo's non-foreign losses in bundle}}$$

The 'Total of BCo's Division 170 losses in bundle' are those losses that meet all of the conditions stated above. The 2002 tax loss of $300 is the only loss that meets all of these conditions.

The 1999 net capital loss of $200 and the 2000 tax loss of $200 do not meet the third condition. The losses were incurred before BCo became a part of a wholly-owned group with CCo. The 1999 net capital loss also fails to meet the first condition, because HCo chooses to utilise it over three years under section 707-350.

The 2002 foreign loss of $200 does not meet the first and third conditions (foreign losses cannot be transferred under Division 170).

The 'Total of BCo's non-foreign losses in bundle' means those losses that meet the first condition.

The 2000 tax loss of $200 and the 2002 tax loss of $300 both meets this condition.

Substituting the relevant amounts into the above formula and assuming that HCo chooses to use 100% of CCo's modified market value, the amount added to BCo's modified market value is:

$$\$200 \times 100\% \times \frac{\$300}{\$500} = \$120$$

[40] Generally, here the income year consists of the trial year. However, if the income year in which the loss is made started after the commencement of the trial year, the income year is a shorter period. → subsection 707-328(2)

Tax losses

The tax losses transferred from BCo will be utilised on the basis of the bundle having an available fraction of:

$$\frac{200 + 120}{400} = 0.800$$

Foreign loss

The utilisation of the foreign loss transferred from BCo is limited by the available fraction worked out as if section 707-325 never applied → subsection 707-325(9). Therefore, the foreign loss transferred from BCo will be utilised on the basis of the bundle having an available fraction of:

$$\frac{200}{400} = 0.500$$

Net capital loss

The utilisation of the 1999 net capital loss is not limited by any available fraction because HCo chooses to utilise it over three years under section 707-350.

Available fractions for losses transferred from CCo

The available fraction for the bundle of losses transferred from CCo is affected by subsection 707-325(8). The available fraction has to be worked out on the basis that CCo's modified market value was reduced by the amount worked out under subsection 707-325(3), i.e. the amount that was added to BCo's modified market value. This available fraction will apply to those tax and net capital losses that cannot be notionally transferred into BCo's bundle (see below).

As stated previously, HCo seeks to notionally transfer losses from CCo's bundle into BCo's bundle. Before it can do this, certain conditions contained in section 707-327 must be met:

- First condition: An amount of modified market value from CCo is added to the modified market value of BCo.
- Second condition: The loss is either a net capital loss or a tax loss and is not utilised under section 707-350.
- Third condition: The loss is transferred under Subdivision 707-A from CCo to HCo at the time when the consolidated group comes into existence.

- Fourth condition: If CCo has been a real loss-maker under a separate application of section 707-325, the loss must not be a loss that provides the basis for working out the available fraction under that application[41].
- Fifth condition: BCo, assuming it had made the loss, could have transferred it to HCo under Subdivision 707-A[42].
- Sixth condition: CCo could have transferred the loss to BCo (as well as to any other value donor to BCo) under Subdivision 170-A or 170-B for an income year consisting of the trial year[43].

Only the 2002 tax loss of $100 meets all of the above conditions.

The 2000 net capital loss does not meet the sixth condition. It was incurred before CCo became part of a wholly-owned group with BCo.

The 2001 foreign loss does not meet the second and sixth conditions (foreign losses cannot be transferred under Division 170).

Tax loss

The 2002 tax loss of $100 will be utilised on the basis of it being included in the bundle of losses transferred from BCo. For the purposes of utilising this loss, the bundle will have an available fraction of 0.800 (see above, 'Available fraction for losses transferred from BCo').

Note

Operation of subsection 707-325(3) and section 707-327 of the IT(TP)A

Losses of a value donor that are treated under section 707-327 as being included in the bundle of losses transferred from the real loss-maker are not included in the third element of the formula in subsection 707-325(3).

In accordance with subsection 707-327(4), section 707-327 has effect only for the purposes of the provisions mentioned in that subsection, which do not include section 707-325. Also, in accordance with paragraph 707-327(1)(a), a loss cannot be treated in this way until after section 707-325 has applied.

In this example (page 3), the 2002 tax loss of $100, which is treated as being included in the bundle of losses transferred from BCo, is not taken into account in the third element of the formula contained in 707-325 when working out the amount of CCo's modified market value that is added to BCo's modified market value.

[41] In other words, the loss was not covered by paragraphs 707-325(1)(d) and (e) and subsections 707-325(2) in that application of section 707-325.

[42] This condition would also apply to any other value donors to BCo. In this example there are no other value donors.

[43] Generally, here the income year consists of the trial year. However, if the income year in which the loss is made starts after the commencement of the trial year, the income year is a shorter period. → subsection 707-328(2)

Net capital loss

As stated above, the utilisation of the 2000 net capital loss of $20 is affected by subsection 707-325(8). The available fraction for the bundle of losses transferred from CCo has to be worked out on the basis that CCo's modified market value was reduced by the amount that was added to BCo's modified market value. This amount was $120 (see above, 'Available fractions for losses transferred from BCo').

Therefore, the available fraction for the net capital loss transferred from CCo is:

$$\frac{200 - 120}{400} = 0.200$$

Foreign loss

The utilisation of the foreign loss transferred from CCo is limited by the available fraction worked out as if section 707-325 never applied → subsection 707-325(9). The foreign loss transferred from CCo will be utilised on the basis of the bundle having an available fraction of:

$$\frac{200}{400} = 0.500$$

Table 1: Summary of available fractions

Bundle	Transferred losses	Available fraction
B	$300 tax loss	0.800
	$200 tax loss	0.800
	$100 tax loss (from CCo's bundle)*	0.800
	$200 foreign loss	0.500
	$200 net capital loss**	N/A
C	$20 net capital loss	0.200
	$50 foreign loss	0.500

* This loss remains in CCo's loss bundle. It is treated as being in BCo's loss bundle for the purpose of determining the amount of the loss that can be utilised.

** The utilisation of the $200 net capital loss transferred from BCo is not limited by any available fraction because HCo chooses to utilise it over three years under section 707-350.

References

Income Tax Assessment Act 1997, Division 170

Income Tax Assessment Act 1997, Subdivision 707-A; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Income Tax (Transitional Provisions) Act 1997, Subdivision 707-C; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 2

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 9

Revision history

Section C3-4-240 first published 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
3.11.04	Clarify that foreign losses cannot be transferred notionally.	Clarification.
10.12.04	Note on the operation of subsection 707-325(3) and section 707-327 of the IT(TP)A.	Clarification.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Modified market value is nil where company has negative net assets

Description

When a loss is transferred from an entity (the 'real loss-maker') to the head company of a consolidated group for the first time, an available fraction may need to be calculated for the bundle containing the loss. To calculate an available fraction, the modified market value of the entity that transferred the loss must be determined as at the joining time. Where the value donor concession applies, the modified market value of each value donor must also be determined[44].

This example shows how the available fraction for the real loss-maker is determined where:

- the value donor concession applies, and
- one of the real loss-makers/value donors in the group has a net deficiency of assets (i.e. the value of liabilities exceeds the value of assets).

Commentary

The available fraction is a representation of the market value of the loss entity as a proportion of the market value of the consolidated group (including the loss entity). The market values are determined as at the joining time.

The calculation of the available fraction is as follows:

$$\frac{\text{Modified market value of the loss entity}}{\text{Adjusted market value of the consolidated group}}$$

The modified market value of an entity is its market value based on assumptions contained in subsection 707-325(1) of the *Income Tax Assessment Act 1997* (ITAA 1997). → 'Modified market value of a single joining entity', C3-4-110

The adjusted market value of the consolidated group is its market value ignoring any losses it has and assuming that its franking account balance is nil.

Generally, an increase in the value of the loss entity is excluded from the entity's modified market value if the increase results from either of these events:

- an injection of capital into the loss entity, its associate or, if the loss entity is a trust, an associate of the trustee → 'Calculating an available fraction – losses transferred for the first time where there has been a pre-joining injection of capital', C3-4-120, or
- a non-arm's length transaction that involved the loss entity, its associate or, if the loss entity is a trust, an associate of the trustee.

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[44] Unless the market valuation transitional option applies. → 'Treatment of losses', C3-1

The market value of any operating or trading entity should not, on the face of it, be less than nil. For an operating entity to have less than nil or negative market value implies that it has no prospects whatsoever, either at present, or in the future; the only plausible outcome is that it would cease to conduct business.

For any entity that is a limited liability company, where liabilities exceed the value of assets, the exposure of the holder of the membership interests (shares) is limited to the paid-up share capital. Another 'willing but not anxious' purchaser may be prepared to accept the transfer of shares in a limited liability company without making payment (consideration) in the expectation that the company may become valuable sometime in the future.

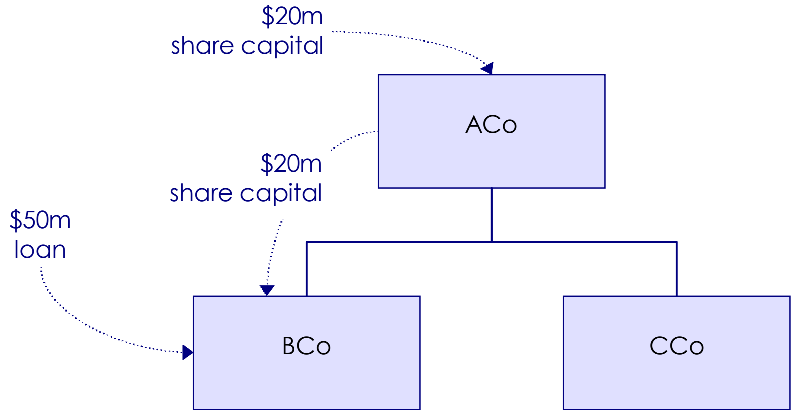
Where these situations are apparent at any point in time, the market value of the membership interest in the entity can be taken to be nil and does not result in a negative market value being assigned to that membership interest.

Example

Facts

ACo, BCo and CCo have constituted a wholly-owned group for a number of years (figure 1). On 21 March 2001, ACo raises an additional $20 million in capital through an external share placement. It uses these funds to subscribe for 20 million new shares in BCo at $1.00 per share. At the same time, BCo borrows $50 million from outside the group. The additional funds are intended for intragroup financing and investment in suitable projects by BCo.

Figure 1: Original group structure and fund flows in March 2001



On 1 July 2003 HCo acquires all the shares in ACo and, as the head company, elects for the group to consolidate on that date.

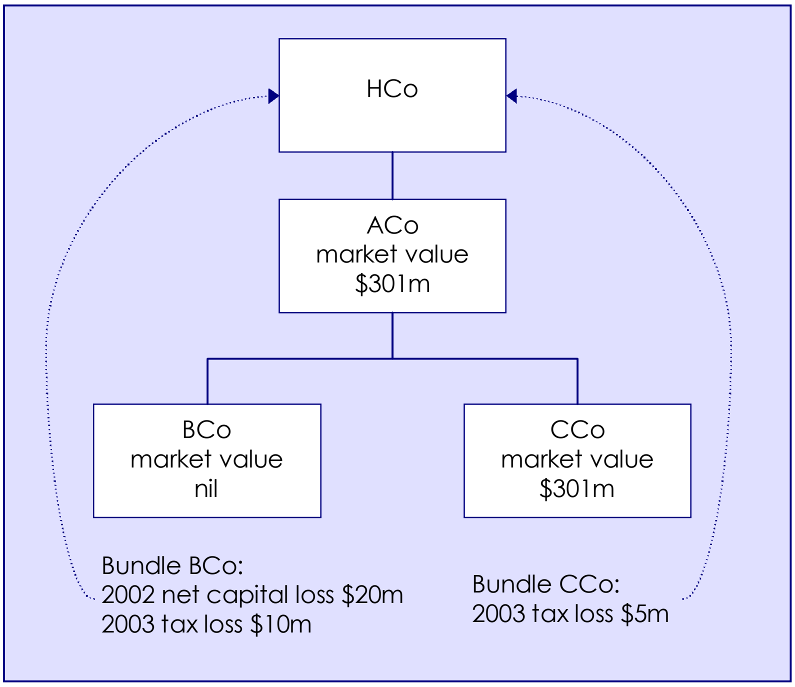
Upon consolidation, BCo's and CCo's losses are transferred to HCo under Subdivision 707-A of the ITAA 1997 (figure 2). (The transfers take place as a result of the same business test having been met → 'Transfer testing with modified same business test – where ownership or control failure in trial year but after loss year', C3-3-240.)

At the joining time the entities have the following market values:

- **CCo: $301 million.** $1 million of CCo's market value is attributable to the 2003 tax loss of $5 million. CCo does not have any franking credits.
- **BCo: nil.** As a result of some poor investment decisions in the preceding two years, BCo has a net deficiency of assets of $40 million at the joining time. However, its market value is nil (as explained in 'Commentary' above).
- **ACo: $301 million.** ACo's only assets consist of its shareholdings in BCo and CCo.

The adjusted market value of the consolidated group – that is, its market value ignoring any losses and assuming a nil franking account balance – is $1,000 million[45].

Figure 2: Consolidated group on 1 July 2003



ACo, BCo and CCo satisfy all the requirements in relation to the value donor concession in Subdivision 707-C of the *Income Tax (Transitional Provisions) Act 1997* (IT(TP) Act 1997). Consequently, HCo elects for any modified market value from ACo and BCo to be donated for the purposes of working out the available fraction for CCo's bundle of losses. It also elects to treat the losses transferred from BCo as if they were included in the bundle of losses transferred from CCo for the purpose of determining their rate of utilisation.

[45] HCo owns other assets in addition to the shares in ACo.

Calculation

Modified market values

It is necessary to determine the modified market value of each loss-maker and value donor in the group as at the joining time:

- CCo's market value is $301 million, $1 million of which is attributable to the 2003 tax loss. One of the assumptions used in determining the modified market value of an entity is that it has no losses. Therefore, CCo's modified market value is $300 million → 'Modified market value of a single joining entity', C3-4-110.
- BCo's market value is nil, despite having a net deficiency of assets of $40 million (as explained in 'Facts' above). BCo's modified market value is also nil. It should be noted that BCo has had capital injected into it after 8 December 2000 and within four years preceding the time it joined the consolidated group. Therefore, the 'anti-inflation' rule may apply → 'Calculating an available fraction – losses transferred for the first time where there has been a pre-joining injection of capital', C3-4-120. However, as BCo's modified market value would be nil ignoring the capital injection, the anti-inflation rule does not apply here (i.e. the capital injection has not resulted in an increase in BCo's modified market value). Therefore, BCo's modified market value remains at nil.
- ACo's market value is $301 million. All of ACo's market value is attributable to its interest in CCo, another corporate member of the consolidated group. Another assumption used in determining the modified market value of an entity is that its market value does not include an amount attributable to a membership interest in another member of the group that is a corporate tax entity. Therefore, ACo's modified market value is nil → 'Modified market value of a single joining entity', C3-4-110.

Again, it should be noted that while ACo has also had capital injected into it in circumstances that could trigger the anti-inflation rule, this rule would not apply, for the same reasons as in BCo's case (i.e. the capital injection has not resulted in an increase in ACo's modified market value).

Value donor concession and available fraction

HCo cannot be a value donor to CCo because CCo would not have been able to transfer its loss to HCo under the group loss transfer rules in Division 170 of the ITAA 1997 → 'Adding to modified market value to reflect loss transferability', C3-4-210.

Both value donors, BCo and ACo, have modified market values of nil. They are able to donate only a nil amount of modified market value to CCo. Therefore, CCo is not able to increase its modified market value for the purpose of calculating its available fraction. However, because all of the relevant conditions in Subdivision 707-C of the IT(TP) Act 1997 are satisfied, HCo is able to treat the losses transferred from BCo as if they are included in the bundle of losses transferred from CCo for the purpose of determining their rate of utilisation → 'Including value donor's losses in real loss-maker's bundle ', C3-4-220.

This bundle will have an available fraction of:

$$\frac{300m + 0 + 0}{1{,}000m} = 0.300$$

References

Income Tax Assessment Act 1997:

- Division 170
- Subdivisions 707-A, 707-C

Income Tax (Transitional Provisions) Act 1997, Subdivision 707-C

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapters 8 and 9

Revision history

Section C3-4-250 first published 3 December 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Donating a value donor's loss where modified market value is added to the value donor (in the capacity of a real loss-maker)

Description

This example illustrates the effect of subsection 707-327(6) of the *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A). This subsection provides that a value donor's loss cannot be taken to be included in a real loss-maker's bundle if that loss provides the basis for working out the amount of modified market value that is added to the value donor (in its capacity as a real loss-maker) under a separate application of section 707-325 of the IT(TP)A.[46]

Note

For more information about:

- the value donor concession in section 707-325 of the IT(TP)A → 'Adding to modified market value to reflect loss transferability', C3-4-210 (worked example)
- notionally 'donating' a loss as provided for by section 707-327 of the IT(TP)A → 'Including value donor's loss in real loss-maker's bundle', C3-4-220 (worked example)

Commentary

Subdivision 707-C of the IT(TP)A sets out the operation of the value donor concession. In broad terms:

- For a company to be a value donor, it must be a company to which the real loss-maker could have transferred, under the group loss transfer rules in Division 170 of the *Income Tax Assessment Act 1997* (ITAA 1997), at least one of the losses in its bundle.
- To be eligible for the concession, both the real loss-maker and the value donor must be companies that join the group when it first consolidates, and the group must consolidate during the transitional period (that is, 1 July 2002 to 30 June 2004).

The head company may also treat one or more of the losses transferred to the head company from the value donor as if it was included in the real loss-maker's bundle for the purpose of determining the amount of the losses that can be utilised by the group in any given income year. Broadly, losses can be treated in this way only if they could be transferred from the value donor to the real loss-maker, and to any of the real loss-maker's other value donors, under the group loss transfer rules.

[46] This is explained in ATO Interpretative Decision ATOID 2005/59.

In some instances, the head company can choose for a company member of the group to be treated as both a value donor and a real loss-maker. In these situations (when considering the company member in its capacity as a value donor), the head company's ability to treat a loss transferred by the company member as if it was included in another bundle of losses can be restricted because of the conditions that need to be satisfied.

Example

Facts

HCo and BCo have constituted a wholly-owned group since 24 May 2001. ACo becomes a member of the wholly-owned group on 18 February 2002. The group consolidates on 1 July 2003 and HCo's and BCo's losses are transferred to HCo (figure 1), the head company of the consolidated group, under Subdivision 707-A of the ITAA 1997.

HCo chooses to:

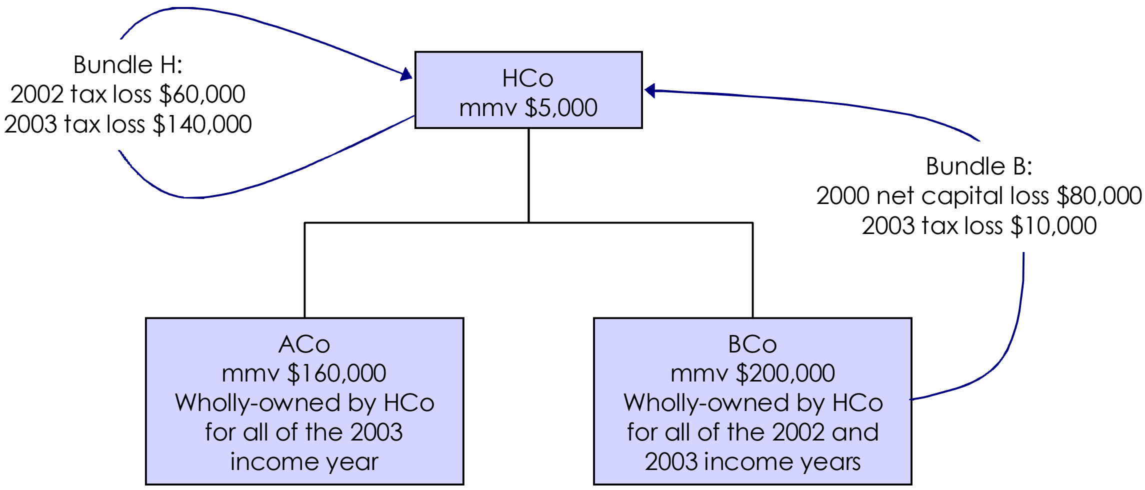
- add to the modified market value of HCo by using an amount of ACo's modified market value, for the purpose of working out the available fraction for the bundle of losses transferred from HCo
- use 100% as the chosen percentage in working out the amount of ACo's modified market value to be added to HCo's modified market value
- add to the modified market value of BCo by using an amount of HCo's modified market value, for the purpose of working out the available fraction for the bundle of losses transferred from BCo
- use 1.08% as the chosen percentage in working out the amount of HCo's modified market value to be added to BCo's modified market value, and
- treat one of the losses transferred from HCo as being included in the bundle of losses transferred from BCo for the purpose of determining its rate of utilisation.

The market value of the consolidated group at the joining time, ignoring losses and assuming a franking account balance of nil, is $365,000.

Note

This example is designed to illustrate the operation of some of the rules in Subdivision 707-C of the IT(TP)A (in particular subsection 707-327(6)). The choices made by HCo here are not purported to represent the best outcome for the group in every case where similar circumstances may exist.

Figure 1: Transfer of losses at time of consolidation (1 July 2003)



Calculation

Adding an amount of ACo's modified market value to HCo's modified market value – HCo in the capacity of a real loss-maker

For ACo to be able to add to HCo's modified market value, certain conditions set out in subsections 707-325(1) and (2) of the IT(TP)A must be met:

- The bundle of losses transferred from HCo must contain a tax loss or net capital loss (in this case the bundle of losses contains only tax losses) and the utilisation of the loss is not affected by section 707-350 of the IT(TP)A.[47]
- ACo, assuming it had made the loss, could have transferred the loss to HCo under Subdivision 707-A of the ITAA 1997.
- HCo could have transferred the loss to ACo under Subdivision 170-A of the ITAA 1997 for an income year consisting of the trial year.

The amount that is added to HCo's modified market value is worked out in accordance with the formula contained in subsection 707-325(3):

$$\text{ACo's modified market value at initial transfer time} \times \text{Percentage chosen by HCo} \times \frac{\text{Total of HCo's Division 170 losses in bundle}}{\text{Total of HCo's non-foreign losses in bundle}}$$

[47] Section 707-350 of the IT(TP)A provides a concession for the utilisation of certain losses that were originally made by a company for an income year ending on or before 21 September 1999 and transferred to the head company because the continuity of ownership and control tests were satisfied.

'Total of HCo's Division 170 losses in bundle' are those losses that meet all of the conditions stated above. The 2003 tax loss meets all of the above conditions.

'Total of HCo's non-foreign losses in bundle' are those losses that meet the condition contained in the first bullet point. Both the 2002 tax loss and the 2003 tax loss meet the condition.

Substituting the relevant amounts into the above formula the amount added to HCo's modified market value is:

$$\$160{,}000 \quad \times \quad 100\% \quad \times \quad \frac{\$140{,}000}{\$200{,}000} \quad = \quad \$112{,}000$$

Adding an amount of HCo's modified market value to BCo's modified market value – HCo in the capacity of a value donor

As with the previous calculation, the conditions set out in subsections 707-325(1) and (2) of the IT(TP)A must be met. For HCo to be able to add to BCo's modified market value, the conditions are:

- The bundle of losses transferred from BCo must contain either a tax loss or a net capital loss and the utilisation of the loss is not affected by section 707-350 of the IT(TP)A.
- HCo, assuming it had made the loss, could have transferred the loss to itself (as head company) under Subdivision 707-A of the ITAA 1997.
- BCo could have transferred the loss to HCo under Subdivision 170-A or 170-B of the ITAA 1997 for an income year consisting of the trial year.

The amount that is added to BCo's modified market value is worked out in accordance with the formula contained in subsection707-325(3):

$$\text{HCo's modified market value at initial transfer time}^{48} \times \text{Percentage chosen by HCo} \times \frac{\text{Total of BCo's Division 170 losses in bundle}}{\text{Total of BCo's non-foreign losses in bundle}}$$

'Total of BCo's Division 170 losses in bundle' are those losses that meet all of the conditions stated above. The 2003 tax loss meets all of the above conditions.

[48] Note that this amount does not include the $112,000 of modified market value that is added to HCo from ACo. This amount is only added for the purposes of working out the available fraction for the bundle of losses transferred from HCo.

'Total of BCo's non-foreign losses in bundle' are those losses that meet the condition contained in the first bullet point. Both the 2000 net capital loss and the 2003 tax loss meet the condition.

Substituting the relevant amounts into the above formula the amount added to BCo's modified market value is:

$$\$5{,}000 \quad \times \quad 1.08\% \quad \times \quad \frac{\$10{,}000}{\$90{,}000} \quad = \quad \$6$$

Available fraction for the bundle of losses transferred from HCo

After taking into account the donation of modified market value from ACo and the donation of modified market value to BCo, the bundle of losses transferred from HCo has an available fraction of:

$$\frac{(5{,}000 - 6) + 112{,}000}{365{,}000} \quad = \quad 0.321$$

Available fraction for the bundle of losses transferred from BCo

After taking into account the donation of modified market value from HCo, the bundle of losses transferred from BCo has an available fraction of:

$$\frac{200{,}000 + 6}{365{,}000} \quad = \quad 0.548$$

Treating the 2002 tax loss transferred from HCo as being included in the bundle of losses transferred from BCo

For HCo to notionally transfer the 2002 tax loss from HCo's bundle into BCo's bundle, certain conditions in section 707-327 of the IT(TP)A must be met:

- An amount of modified market value from HCo is added to the modified market value of BCo (this is the $6 of modified market value that is added to BCo from HCo, in HCo's capacity as a value donor to BCo).
- The loss is either a net capital loss or a tax loss (in this case the loss is a tax loss) and the utilisation of the loss is not affected by section 707-350 of the IT(TP)A.
- The loss is transferred under Subdivision 707-A of the ITAA 1997 from HCo to itself (as the head company of the consolidated group) at the time when the group comes into existence.
- Because HCo is a real loss-maker under a separate application of section 707-325 of the IT(TP)A[49], the loss must not be a loss that provides the basis for working out the available fraction under that application. (HCo's 2002 tax loss did not provide the basis for an amount of ACo's modified

[49] Where ACo is a value donor to HCo in HCo's capacity as a real loss-maker.

market value being added to HCo, in HCo's capacity as a real loss-maker, so therefore this condition is satisfied.)[50]

- BCo and any of BCo's other value donors (if there were any other value donors), assuming that they had made the loss, could have transferred the loss to HCo (as head company) under Subdivision 707-A of the ITAA 1997.
- HCo could have transferred the loss to BCo, and to any of BCo's other value donors (if there were any other value donors), under Subdivision 170-A of the ITAA 1997 for an income year consisting of the trial year.[51]

All of the above conditions are met in respect of the 2002 tax loss of $60,000 that was transferred from HCo. Therefore the 2002 tax loss of $60,000 will be utilised on the basis of it being included in the bundle of losses transferred from BCo. As stated above, the bundle has an available fraction of 0.548.

References

Income Tax Assessment Act 1997; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1:

- Subdivisions 170-A, 170-B, 707-A

Income Tax (Transitional Provisions) Act 1997; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 2:

- Subdivision 707-C
- sections 707-325, 707-327, 707-350

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 9

ATO Interpretative Decision ATOID 2005/59

Revision history

Section C3-4-255 first published 16 December 2005.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

[50] Note that HCo's 2003 tax loss did provide the basis for an amount of ACo's modified market value being added to HCo, so it would not satisfy this condition. Therefore, HCo's 2003 tax loss could not be taken to be included in BCo's bundle because of the operation of subsection 707-327(6) of the IT(TP)A.

[51] Note that if ACo had also been a value donor to BCo, the 2002 tax loss transferred by HCo would not have been able to satisfy this condition because HCo would not have been able to transfer the loss to ACo under Subdivision 170-A of the ITAA 1997 (as HCo and ACo were not members of the same wholly-owned group for the whole of the 2002 income year).

Worked example

Losses transferred from members that are in liquidation can be used as basis for value and loss donation

Description

This example shows that:

- losses incurred by companies in liquidation (liquidation members) when joining a consolidated group on its formation may be transferred to the head company if the requirements in Subdivision 707-A of the *Income Tax Assessment Act 1997* (ITAA 1997) are satisfied
- liquidation members can be value donors and other members can be value donors to them under section 707-325 of the *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A 1997)
- the head company can choose to treat losses transferred from a liquidation member as if they were included in another bundle of losses under section 707-327 of the IT(TP)A 1997.

Note

For more information about:

- the value and loss donor concession → examples C3-4-210 to C3-4-255
- the impact of liquidation on a company's ability to be a member of a consolidated group → 'Impact of liquidation and deregistration', C7-1-220.

Commentary

Transfer of losses incurred by subsidiary company in liquidation

Subdivision 707-A of the ITAA 1997 contains the rules for the transfer of a loss to the head company of a consolidated group. For a loss to be transferred it needs to pass modified versions of the loss recoupment tests. A loss can only be transferred to the extent that it could have been utilised by the joining entity in the trial year. In the context of companies, the relevant recoupment tests are contained in Division 165 of the ITAA 1997 and include the continuity of ownership and control tests, and the same business test as an alternative.

→ 'Treatment of losses', C3-1

Amendments[52] have been made to Division 165 to expressly provide that the appointment of a liquidator or other external administrator to a company does not of itself have an impact on:

- whether the company satisfies the continuity of ownership test, or
- whether shares or interests in shares that it holds can be taken into account in determining whether another company satisfies the continuity of ownership test.

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[52] *Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Act 2005*.

Broadly, the amendments provide that:

- the fact that a company becomes an externally administered body corporate does not prevent an entity from beneficially owning shares in the company or having control of voting power in the company, or having rights to dividends or capital distributions of the company
→ subsection 165-208(1), ITAA 1997
- the fact that a company becomes an externally administered body corporate does not prevent it beneficially owning shares in another company, controlling voting power in another company or having rights to dividends and capital distributions attaching to those shares
→ subsection 165-208(2), ITAA 1997.

The amendments also expressly provide that the appointment of an external administrator to a company does not affect the control of voting power in the company for the purposes of the test in section 165-15 of the ITAA 1997 (or equivalent tests in sections 165-40, 165-115D, 165-115M, and 165-129)
→ section 165-250, ITAA 1997.

The effect of these rules is that there is no impact on the continuity of ownership and control tests for the purpose of transfer testing if the joining entity, or a company interposed between it and an ultimate owner, becomes externally administered.

Value donor provisions and liquidation

Under section 707-325 of the IT(TP)A 1997, a head company may choose to add to the modified market value of a loss entity (the 'real loss-maker') the modified market value of another company (the 'value donor') when calculating the available fraction for the bundle of losses transferred from the real loss-maker. The value donor must be a company to which the real loss-maker could have transferred, under the group loss transfer rules in Subdivisions 170-A and 170-B[53] of the ITAA 1997, at least one of the losses[54] in its bundle.

One of the conditions for transfer under Subdivisions 170-A and 170-B is that both companies (the loss company and the income company) must be members of the same wholly-owned group → sections 170-30 and 170-130, ITAA 1997. Broadly, this means there must be 100% common beneficial ownership of the two companies by another company (holding company) or one company is 100% beneficially owned by the other company (holding company) or its 100% subsidiaries → sections 975-500 and 975-505, ITAA 1997.

This 100% beneficial ownership requirement is not satisfied if a person can or would be able to affect the rights of the holding company in relation to the subsidiary company → section 975-150 and subsections 975-505(2) and (3), ITAA 1997.

[53] On the assumption that neither of those subdivisions had been amended to provide only for transfers involving an Australian branch of a foreign bank (subsection 707-328(4) of the IT(TP)A 1997).

[54] This refers to tax losses and net capital losses.

Section 975-150 of the ITAA 1997 outlines the circumstances in which a person will be in a position to affect the rights of the holding company. The appointment of a liquidator or other external administrator to a holding company will not affect its rights in relation to the subsidiary company for the following reasons:

- Applying paragraph 975-150(1)(a): the liquidator or other external administrator is not a person with a right, power or option to acquire ownership of the company's assets.
- Applying paragraph 975-150(b): the liquidator or other external administrator is not in a position to prevent the holding company from obtaining lawful advantage from the ownership of its shares in the subsidiary.[55] The liquidator or other external administrator will exercise any voting rights as agent of the holding company for the benefit of the company. Equally, any dividends or capital paid by the subsidiary will be received by the liquidator for the holding company's benefit.

For similar reasons, the ability of both the loss company and the income company to satisfy the 100% beneficial ownership requirement will not be affected where a liquidator is appointed to the subsidiary member or an interposed company.[56]

As a result, being in liquidation does not affect the ability of a holding company or its subsidiary to make a loss transfer agreement under Division 170 as the wholly-owned group requirement is not affected. Therefore, a liquidation member can still be a value donor, and other members can be a value donor to it, provided other conditions in section 707-325 of the IT(TP)A 1997 are also satisfied.

Loss donor provisions and liquidation

The head company may treat one or more of the value donor's losses (if any) as being included in the real loss-maker's bundle under section 707-327 of the IT(TP)A 1997. This enables those losses to be utilised using the available fraction for the real loss-maker.

As a liquidation member can be a value donor, its losses can also be donated to another bundle of losses if other conditions in 707-327 of the IT(TP)A 1997 are satisfied. Also, losses can be donated to the bundle of losses of the liquidation member for the same reasons.

[55] See Commissioner of Taxation v Linter Textiles Australia Ltd (In Liquidation) (2005) 220 CLR 592; HCA 20, at paragraphs 55–8.

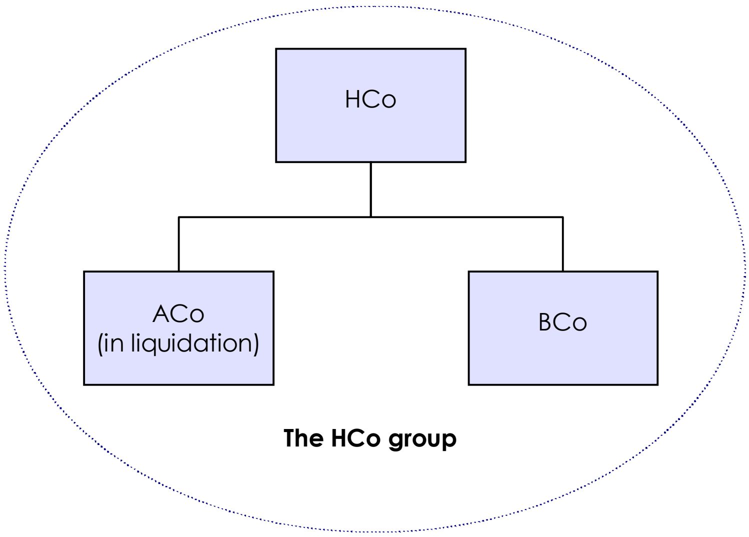
[56] However, the appointment of an administrator to a subsidiary member or an interposed company may, depending on the terms upon which the administrator is appointed, have a bearing on whether the two companies can satisfy the 100% beneficial ownership requirement.

Example

Facts

HCo, ACo and BCo have constituted a wholly-owned group for a number of years. On 12 April 2002, a court orders that ACo be wound up under the Corporations Law. The court appoints a liquidator to the company to administer the winding up of the company. On 1 July 2002, the group consolidates with HCo as the head company and ACo and BCo as subsidiary members (figure 1).

Figure 1: The HCo group structure (1 July 2002)



At the formation time, ACo and BCo have unutilised losses for potential transfer to HCo (table 1).

Table 1: Unutilised losses at formation time

Subsidiary member	Amount ($m)	Sort	Year incurred
ACo	200	Tax loss	2002
	100	Tax loss	2001
BCo	20	Tax loss	2000

Provided these losses are able to be transferred to HCo at consolidation, HCo seeks to use the value and loss donor concessions in sections 707-325 and 707-327 of the IT(TP)A 1997 to maximise their utilisation.[57] Market valuations as at the formation time (the initial transfer time) are set out in table 2.

[57] Note that these losses cannot be utilised using the 1/3 COT concession under section 707-350 of the IT(TP)A 1997 as they were actually made for income years ending after 21 September 1999.

Table 2: Market valuations at initial transfer time

Entity	Modified market value* ($m)
HCo	300
ACo	nil
BCo	200

* In accordance with 707-325 of the ITAA 1997.

Analysis – loss transfer

Transfer tests for ACo's and BCo's tax losses

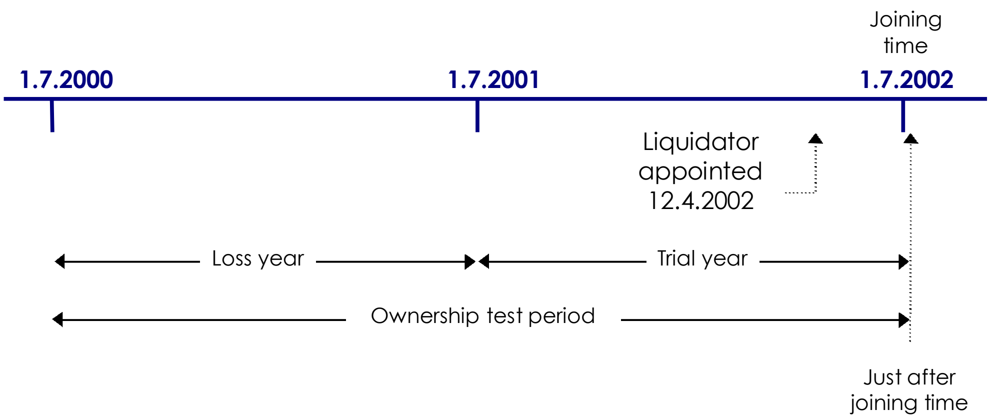
A loss is transferred from ACo or BCo to HCo to the extent that the loss could have been utilised by either ACo or BCo for an income year consisting of the trial year.

Sections 165-12 and 165-15 require the companies to test for same owners and same control respectively throughout the ownership test period (i.e. from the start of the loss year to the end of the income year).

ACo's tax losses

For ACo's 2001 tax loss, the loss year is 1 July 2000 to 30 June 2001 and the income year is represented by the trial year – that is, 1 July 2001 to just after 1 July 2002.

Figure 2: The ownership and control tests

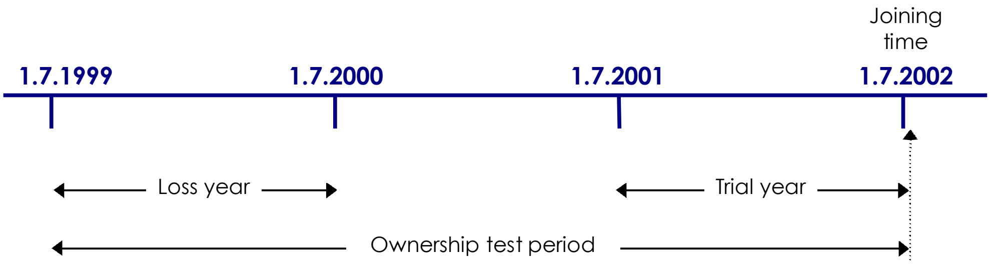


Since there was no ownership or control failure over the ownership test period, ACo's 2001 tax loss can be transferred to HCo. The fact that ACo had a liquidator appointed on 12 April 2002 does not impact on the application of the continuity of ownership test or the control test → subsection 165-208(1) and section 165-250, ITAA 1997. It follows that ACo's 2002 tax loss would also satisfy these tests and can be transferred to HCo.

BCo's 2000 tax loss

For BCo's 2000 tax loss, the loss year is 1 July 1999 to 30 June 2000 and the income year is represented by the trial year – i.e. 1 July 2001 to just after 1 July 2002.

Figure 3: The ownership and control tests



Since there was no ownership or control failure over the ownership test period, BCo's 2000 tax loss can be transferred to HCo.

Analysis – available fraction

Available fraction for losses transferred from ACo

Option 1:

Can HCo choose to donate the tax losses in ACo's bundle to BCo's bundle (assuming HCo was able to add 100% of HCo's modified market value to BCo's modified market value)?

For HCo to donate the tax losses from ACo's bundle into BCo's bundle, so these losses can be utilised using BCo's available fraction, certain conditions contained in section 707-327 of the IT(TP)A 1997 must be met, including:

- an amount of modified market value from ACo is added to the modified market value of BCo under section 707-325 of the IT(TP)A 1997
- ACo could have transferred its tax loss to BCo and HCo under Subdivision 170-A for an income year consisting of the trial year.

For HCo to be able to add an amount of modified market value from ACo to the modified market value of BCo, one of the conditions under section 707-325 of the IT(TP)A 1997 is that BCo could have transferred its tax loss to ACo under Subdivision 170-A for an income year consisting of the trial year. As the appointment of a liquidator on 12 April 2002 does not affect ACo's and BCo's ability to satisfy the condition of being members of the same wholly-owned group during the relevant period, BCo could have transferred its tax losses to ACo assuming other conditions in Subdivision 170-A are also satisfied. As a result, HCo is able to add an amount of modified market value from ACo to the modified market value of BCo.[58]

ACo could have transferred its tax losses to BCo and HCo under Subdivision 170-A for an income year consisting of the trial year for the same reasons.

[58] Assuming other conditions in section 707-325 of the IT(TP)A 1997 are also satisfied. Note that this amount can be nil according to the note in subsection 707-325(3) of the IT(TP)A 1997.

Therefore, HCo can choose to donate the tax losses in ACo's bundle to BCo's bundle and utilise these losses using the available fraction for BCo's bundle.[59]

Option 2:

Alternatively, for the same reasons, HCo is also able to choose to:

- add a percentage of BCo's modified market value and HCo's modified market value to the modified market value of ACo[60]
- donate the tax loss in BCo's bundle to ACo's bundle.[61]

References

Income Tax Assessment Act 1997:

- Subdivision 707-A; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- Subdivisions 170-A & 170-B; as existed prior to the amendments introduced by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002) and *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002)
- Division 165; as amended by *Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Act 2005*
- Division 975

Income Tax (Transitional Provisions) Act 1997, Subdivision 707-C; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 2

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapters 6 and 9

Revision history

Section C3-4-256 first published 12 September 2006.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

[59] Assuming other conditions in section 707-327 of the IT(TP)A 1997 are also satisfied.

[60] Assuming other conditions in section 707-325 of the IT(TP)A 1997 are also satisfied.

[61] Assuming other conditions in section 707-327 of the IT(TP)A 1997 are also satisfied.

Worked example

Group waiver rule – disregarding reductions to modified market value caused by intragroup injections of capital

Description

An integrity rule prevents the inflation of modified market value in respect of an injection of capital between members of a consolidated group. As illustrated in this example, the group waiver rule[62] ignores the effect of this integrity rule.

Note

For more information about:

- the integrity rule → 'Calculating an available fraction – losses transferred for the first time where there has been a pre-joining injection of capital', 'Calculating an available fraction – losses transferred for the first time where there has been a pre-joining injection of capital', C3-4-120
- applying the value donor concession → 'Adding to modified market value to reflect loss transferability', C3-4-210
- the single waiver rule → 'Single waiver rule – disregarding a reduction to modified market value caused by an injection of capital from a value donor', C3-4-270

Commentary

The group waiver rule is only relevant when applying the value donor concession[63].

Broadly, the value donor concession enables the available fraction for a bundle of losses to be increased if the value donor could have received a loss from the real loss-maker under the wholly-owned company group loss transfer rules in Division 170 of the *Income Tax Assessment Act 1997* (ITAA 1997).

The increase to an available fraction provided by the value donor concession can be affected by the integrity rule. The integrity rule operates to reduce the modified market value of the entity (whether a real loss-maker or value donor) whose value was increased as a result of an event. The reduction amount essentially represents the increase in the value of the entity as a consequence of injections of capital[64] or non-arm's length transactions involving the entity in the four years[65] before it joins the consolidated group. → subsections 707-325(2) to (5), ITAA 1997

[62] Section 707-328A, *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A).

[63] The value donor concession is contained in Subdivision 707-C, IT(TP)A.

[64] Taxation Ruling 2004/9 provides the ATO view on the meaning of the expression 'injection of capital'.

[65] The integrity rule does not apply to events that occur before 9 December 2000.

In certain circumstances it is appropriate to 'waive' the consequences of inflationary events occurring within the wholly-owned group. In working out an available fraction for the real loss-maker's bundle of losses, the group waiver rule ignores the effect of the integrity rule in respect of the following events:

- a pre-consolidation injection of capital into a group member by another group member, and
- a non-arm's length transaction involving only group members.

The group waiver rule applies only if all other group members donate their value and losses to the real loss-maker under the value donor concession. The head company must choose to apply the group waiver rule in respect of a single group member that transferred losses to the head company on group formation under Subdivision 707-A of the ITAA 1997. This choice must be made by the later of:

- the end of 31 December 2005, and
- the day it lodges its income tax return for the first income year for which it utilises transferred losses using the available fraction method.

  → subsection 707-328A(4), (IT(TP)A)

The group waiver rule can be applied only if the following conditions are met:

- all members of the group at the formation time are companies
- the choice is made for the value donor concession to apply whereby value is donated to the real loss-maker from every other group member
- the head company chooses to treat any losses transferred to it on formation by the value donors as if they were included in the real loss-maker's bundle, and
- none of the group members have had their modified market value reduced because of an injection of capital or a non-arm's length transaction involving an entity that did not become a member of the group on formation.

If all the conditions are met, all of the group's transferred losses[66] are utilised with reference to the chosen real loss-maker's available fraction. That fraction is worked out on the basis of the real loss-maker's modified market value plus the modified market value of all other group members.

Where the conditions are not met, the single waiver rule, which looks individually at each real loss-maker and value donor relationship within the group, may be able to be applied.

→ section 707-326, IT(TP)A; 'Single waiver rule – disregarding a reduction to modified market value caused by an injection of capital from a value donor', C3-4-270

[66] Excluding overall foreign losses, whose utilisation is not affected by the value donor concession.

Example

Facts

HCo and its subsidiaries ACo and BCo have constituted a wholly-owned group for a number of years. On 1 July 2003, HCo chooses to form a consolidated group.

On formation ACo and BCo transfer tax losses to HCo. HCo and ACo are able to donate value to BCo (the real loss-maker) for the purpose of determining the available fraction for BCo's bundle of losses. ACo's transferred losses meet the conditions for them to be utilised as though they are included in BCo's bundle.

Prior to formation HCo injected capital of $100 into each of ACo and BCo.

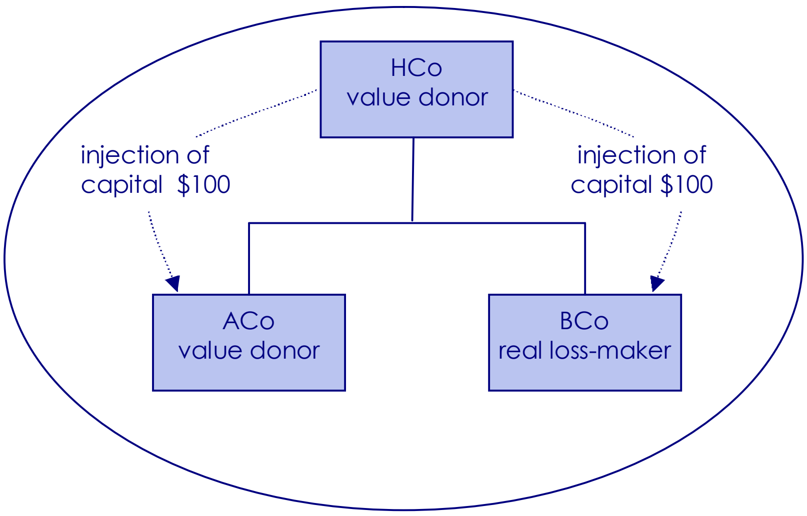
Assume for the purposes of subsection 707-325(3) of the ITAA 1997 that the reduction amount equals the amount of each injection of capital.

HCo, ACo and BCo satisfy all the requirements in relation to the value donor concession.

HCo chooses 100% of the modified market values of HCo and ACo to be donated for the purposes of working out the available fraction for BCo's bundle of losses.

These facts are represented in figure 1.

Figure 1: HCo and subsidiary members



The adjusted market value of the consolidated group at the initial transfer time is $1,200.

Modified market values ascertained as at the joining time are shown in table 1.

Table 1: Modified market values at 1 July 2003

Entity	Modified market value (subsection 707-325(1), ITAA 1997)	'Reduced' modified market value (subsection 707-325(2), ITAA 1997)
HCo	$800	$800*
ACo	$100	nil
BCo	$300	$200

* The integrity rule does not apply in respect of HCo.

Calculation

Applying the value donor concession, ignoring the application of the group waiver rule, the available fraction for BCo's bundle of losses would be:

$$\frac{200 + \text{nil} + 800}{1{,}200} = 0.833$$

Application of the group waiver rule

The group waiver rule can be applied because the only injections are entirely intragroup. This means the modified market values of ACo and BCo are worked out disregarding the effect of subsection 707-325(2) of the ITAA 1997 in respect of the injections of capital from HCo → subsection 707-328A(3), IT(TP)A. The modified market value of ACo can therefore include the $100 of value injected by HCo, and the modified market value of BCo can include the $100 of value injected by HCo.

Applying the value donor concession, including the application of the group waiver rule, the available fraction for BCo's bundle of losses would be:

$$\frac{300 + 100 + 800}{1{,}200} = 1.000$$

References

Income Tax Assessment Act 1997, sections 707-320, 707-325

Income Tax (Transitional Provisions) Act 1997, Subdivision 707-C; as amended by *Tax Laws Amendment (2005 Measures No. 5) Act 2005* (162 of 2005), Schedule 3, Part 2

Revision history

Section C3-4-260 first published 27 January 2005. Further revisions are described below.

Date	Amendment	Reason
12.9.06	Extension of time to revoke election to apply group waiver rule, p. 2.	Legislative amendment.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Single waiver rule – disregarding a reduction to modified market value caused by an injection of capital from a value donor

Description

An integrity rule prevents the inflation of modified market value in respect of an injection of capital from a value donor to a real loss-maker. This example shows how the single waiver rule[67] ignores the effect of this integrity rule.

Note

For more information about:

- the integrity rule → 'Calculating an available fraction – losses transferred for the first time where there has been a pre-joining injection of capital', C3-4-120
- applying the value donor concession → 'Adding to modified market value to reflect loss transferability', C3-4-210
- the group waiver rule → 'Group waiver rule – disregarding reductions to modified market value caused by intragroup injections of capital', C3-4-260

Commentary

The single waiver rule is only relevant when applying the value donor concession.[68]

Broadly, the value donor concession enables the available fraction for a bundle of losses to be increased if the value donor could have received a loss from the real loss-maker under the wholly-owned company group loss transfer rules in Division 170 of the *Income Tax Assessment Act 1997* (ITAA 1997).

The increase to an available fraction provided by the value donor concession can be affected by the integrity rule. The integrity rule operates to reduce the modified market value of an entity. The reduction amount essentially represents the increase in the value of the entity as a consequence of injections of capital[69] or non-arm's length transactions involving the entity in the four years[70] before it joins the consolidated group. → subsections 707-325(2) to (5), ITAA 1997

[67] Section 707-326, *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A).

[68] The value donor concession is contained in Subdivision 707-C, IT(TP)A.

[69] Taxation Ruling 2004/9 provides the ATO view on the meaning of the expression 'injection of capital'.

[70] The integrity rule does not apply to events that occur before 9 December 2000.

In certain circumstances it is appropriate to 'waive' the consequences of certain inflationary events occurring between related entities. The single waiver rule disregards the effect of the integrity rule in respect of injections and transactions involving the real loss-maker and a value donor. It may apply to groups unable to satisfy the conditions of the group waiver rule. → section 707-328A, IT(TP)A

The single waiver rule applies if either of these events occurred before the joining time:

- an injection of capital directly into the real loss-maker by the value donor, or
- a non-arm's length transaction involving only the real loss-maker and the value donor.

Where these conditions are met, the modified market value of the real loss-maker is not adjusted to exclude an increase in value caused by the event.

However, the single waiver rule has no application if the integrity rule has applied to the value donor in respect of events involving the value donor and an entity that is not the real loss-maker → subsection 707-326(5), IT(TP)A. This ensures a value donor cannot be used as a conduit to direct value from another entity to the real loss-maker, thereby avoiding the effect of the integrity rule.

Example

Facts

HCo and its subsidiaries ACo and BCo have constituted a wholly-owned group for a number of years. On 1 July 2003, HCo chooses to form a consolidated group.

BCo (the real loss-maker) transfers a loss at the joining time. HCo and ACo are able to donate value to BCo for the purpose of determining the available fraction for bundle BCo.

An injection of capital of $100 was made by HCo into BCo on 1 December 2002.

An injection of capital[71] of $50, used to acquire trading stock, was made by XCo, an entity outside the consolidated group, into ACo on 1 January 2003.

An injection of capital of $200 was made by ACo into BCo on 1 March 2003.

Assume for the purposes of subsection 707-325(3) of the ITAA 1997 that the reduction amount equals the amount of each injection of capital.

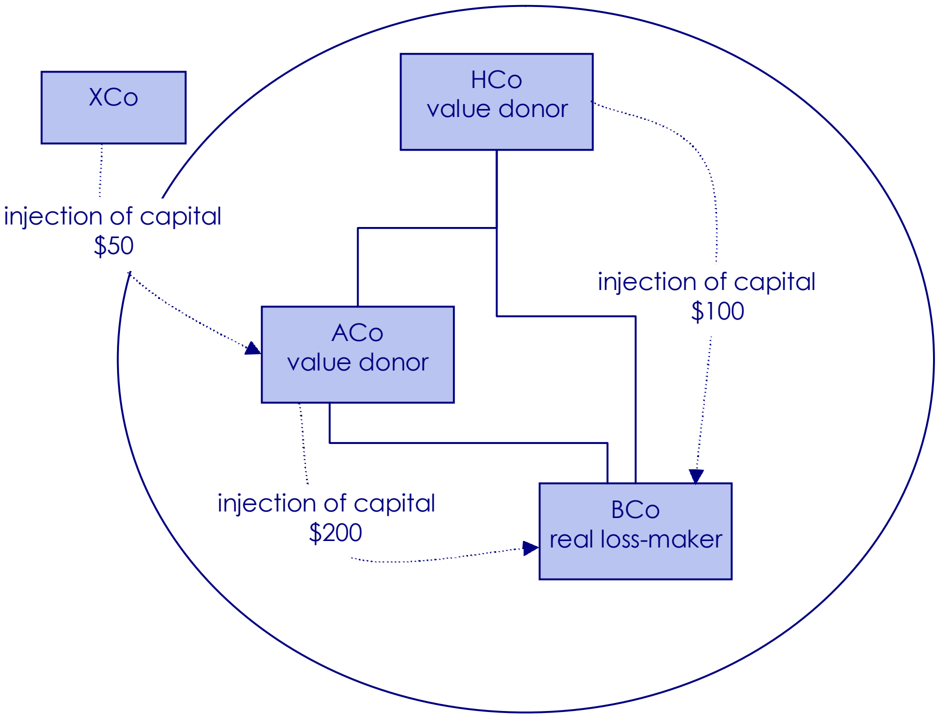
HCo, ACo and BCo satisfy all the requirements in relation to the value donor concession.

[71] A payment for non-share equity.

HCo chooses 100% of the modified market values of HCo and ACo to be donated for the purposes of working out the available fraction for BCo's bundle of losses.

These facts are represented in figure 1.

Figure 1: HCo and subsidiary members



The adjusted market value of the consolidated group at the initial transfer time is $1,650.

Modified market values ascertained as at the joining time are shown in table 1.

Table 1: Modified market values at 1 July 2003

Entity	Modified market value (subsection 707-325(1), ITAA 1997)	'Reduced' modified market value (subsection 707-325(2), ITAA 1997)
HCo	$100	$100*
ACo	$950	$900
BCo	$600	$300**

* The integrity rule does not apply in respect of HCo.

** The reduction amount for the purposes of subsection 707-325(2) of the ITAA 1997 is the collective increase in market value that occurred as a result of the injections.

Calculation

As a result of the injection of capital from XCo the group is unable to meet the conditions for applying the group waiver rule. → 'Group waiver rule – disregarding reductions to modified market value caused by intragroup injections of capital', C3-4-260

Applying the value donor concession, ignoring the application of the single waiver rule, the available fraction for BCo's bundle of losses would be:

$$\frac{300 + 900 + 100}{1{,}650} = 0.788$$

Application of the single waiver rule

The single waiver rule can be applied to the injection of capital from HCo to BCo. BCo's modified market value is worked out disregarding the effect of subsection 707-325(2) of the ITAA 1997 in respect of the injection of capital from HCo → subsection 707-326(2) of the IT(TP)A. The modified market value of BCo can therefore include the $100 of value injected by HCo on 1 December 2002.

The single waiver rule has no application in respect of the injection of capital from ACo because ACo was required to reduce its modified market value to take into account the injection of capital from XCo.

Applying the value donor concession, including the application of the single waiver rule, the available fraction for BCo's bundle of losses would be:

$$\frac{400 + 900 + 100}{1{,}650} = 0.848$$

References

Income Tax Assessment Act 1997:

- sections 707-320, 707-325

Income Tax (Transitional Provisions) Act 1997:

- sections 707-325, 707-326, 707-329

Revision history

Section C3-4-270 first published 27 January 2005.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Adjusting available fraction – previously transferred losses are transferred again

Description

Available fractions are adjusted to ensure they continue to approximate the proportion of the group's income that can be said to be generated by the relevant entity or group that transferred the loss.

This example shows how the available fraction for a loss bundle is adjusted when the loss is transferred for a second or subsequent time.

Note

For more information about:

- loss bundles and calculating the available fraction → 'Treatment of losses', C3-1; 'Consolidation loss provisions', C3-2-110 (high-level worked example)
- working out modified market value → 'Modified market value of a single joining entity', C3-4-110 (worked example)
- market values → 'Market valuation guidelines', C4-1

Commentary

The available fraction for a loss bundle must be adjusted if the losses in it are being transferred for a second or subsequent time. This will generally occur when the head company of a consolidated group (the old group) joins another consolidated group (the new group) and transfers losses to the head company of the new group that had been previously transferred to it.

The available fraction for each bundle of previously transferred losses is adjusted by multiplying it by the factor at item 1 in the table in subsection 707-320(2). The factor is the lesser of one and this fraction:

$$\frac{\text{market value of the old group}}{\text{market value of the new joined group}}$$

The market values[72] of the old and new groups are worked out as at the time the old group joins the new group. The new joined group is the whole group including the old group.

[72] Note that market value is used in the adjustment factor, as opposed to modified market value. Modified market value is used when an available fraction is being calculated for the first time.

Example

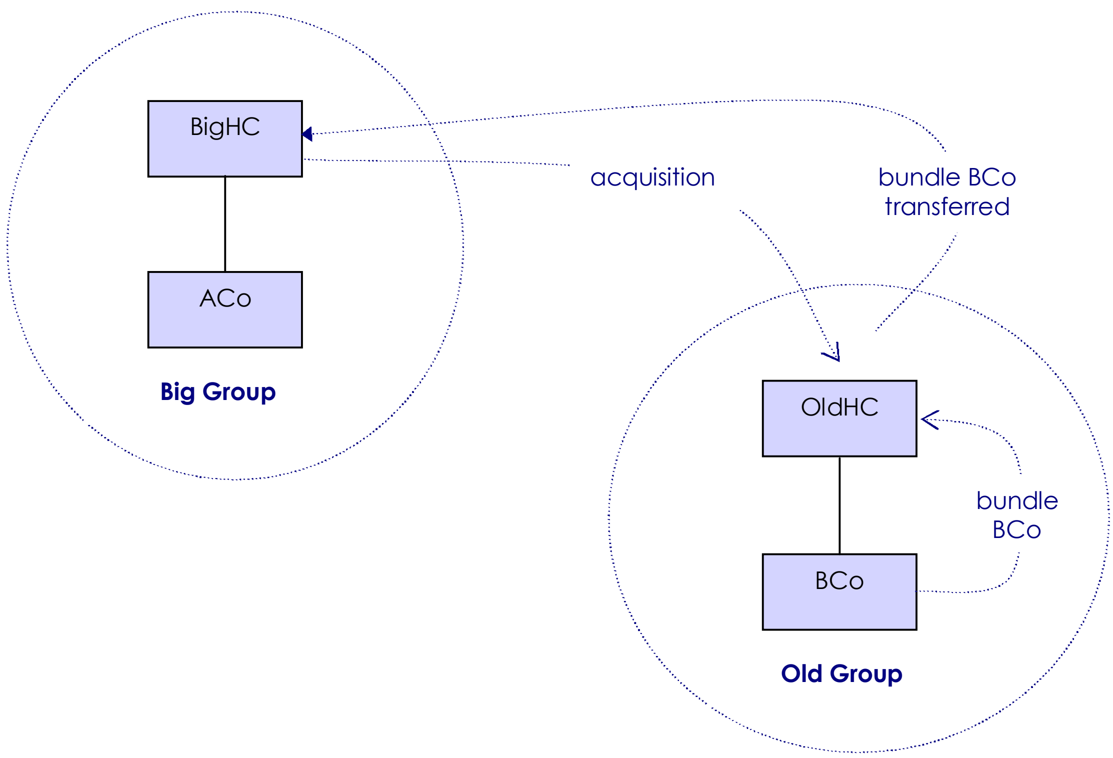
Facts

A consolidatable group, 'Old Group', consolidates on 1 July 2003. A loss is transferred from subsidiary member BCo to OldHC when Old Group consolidates. An available fraction of 0.425 is established for bundle BCo at the initial transfer time.

On 1 July 2004 another consolidated group, 'Big Group', acquires Old Group.

This sequence of events is shown in figure 1. Big Group must adjust the available fraction for the incoming loss bundle.

Figure 1: Big Group acquires Old Group



Market values are ascertained as at the time of the subsequent transfer (1 July 2004) as follows:

- market value of Old Group = $500
- market value of the new joined group (including the market value of Old Group) = $1,500

Calculation

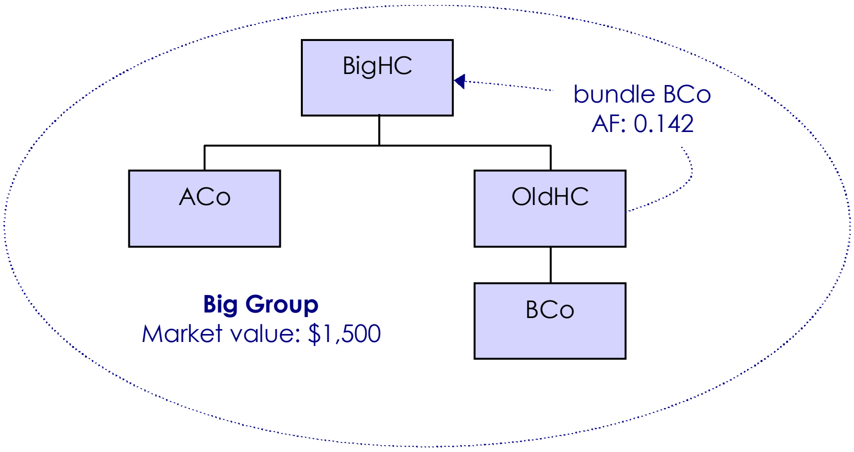
Multiply the available fraction for bundle BCo by the factor:

$$0.425 \quad \times \quad \frac{500}{1{,}500} \quad = \quad 0.142$$

The utilisation of the losses in bundle BCo are subject to limits determined by reference to the available fraction method. Assuming no other adjustment events occur during the income year, the available fraction that applies to bundle BCo for the 2005 income year is 0.142.

The new consolidated structure just after the transfer time is shown in figure 2.

Figure 2: The new joined group



References

Income Tax Assessment Act 1997, subsection 707-320(2), section 707-330; as amended by *New Business Tax System (Consolidation) Act (No.1) 2002* (No. 68 of 2002), Schedule 1

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 8

Revision history

Section C3-4-310 first published 2 December 2002.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Adjusting available fraction – transferred losses and group losses are transferred at the same time

Description

Available fractions are adjusted to ensure they continue to approximate the proportion of the group's income that can be said to be generated by the relevant entity or group that transferred the loss.

This example shows how the available fractions for loss bundles are adjusted when both group losses and previously transferred losses are transferred to another consolidated group.

Note

For more information about:

- loss bundles and calculating the available fraction → 'Treatment of losses', C3-1; 'Consolidation loss provisions', C3-2-110 (high-level worked example)
- working out modified market value → 'Modified market value of a single joining entity', C3-4-110 (worked example)

Commentary

If the head company of a consolidated group (the old group) joins another consolidated group (the new group), unrecouped losses of the old group are transferred to the head company of the new group (if the relevant transfer tests are met). If these transferred losses comprise both previously transferred losses and group losses (i.e. losses generated by the consolidated group), the available fraction for each transferred loss bundle must be adjusted under item 2 in the table in subsection 707-320(2).

The available fraction for each bundle being transferred from the old group is adjusted by multiplying it by the following factor:

$$\frac{\text{the lesser of the available fraction for group losses and 1}}{\text{the total of available fractions for all bundles being transferred}}$$

This factor caps the total of the available fractions for incoming bundles so that their sum does not exceed what would have been the available fraction for the group loss bundle. This adjustment ensures available fractions bear the correct proportion to each other and ensures that any adjustment required under item 3 is applied correctly.

If there are previously transferred losses in the new group, adjustments are also required under item 3 in the table in subsection 707-320(2). In this case, there is essentially a 4-step calculation process[73]:

- Step 1: The available fraction for the bundle of group losses needs to be established. The available fraction for a bundle of losses being transferred for the first time is calculated under subsection 707-320(1).
- Step 2: The available fraction for each of the old group's previously transferred bundles now being transferred to the new group is adjusted under item 1 in the table in subsection 707-320(2).

  → For an example of this adjustment see 'Adjusting available fraction – previously transferred losses are transferred again', C3-4-310
- Step 3: The available fraction for each incoming bundle is adjusted under item 2 in the table in subsection 707-320(2).
- Step 4: The available fraction for each bundle of the previously transferred losses still held by the new group is adjusted under item 3 in the table in subsection 707-320(2). → For an example of this adjustment see 'Adjusting available fraction – another loss entity joins the group', C3-4-330

Example

Facts

A consolidatable group, 'Old Group', consolidates on 1 July 2003. A loss made by subsidiary member BCo is transferred to OldHC, the head company of Old Group, when the group consolidates. An available fraction of 0.875 is established for bundle BCo at the initial transfer time.

Another consolidated group, 'Big Group', consists of head company BigHC and subsidiary member ACo. A loss made by ACo is transferred to BigHC when ACo joins the consolidated group. An available fraction of 0.386 is established for bundle ACo at the initial transfer time.

Big Group acquires Old Group on 1 July 2004.

When OldHC joins Big Group, the loss in bundle BCo and a group loss incurred for the 2004 income year are transferred to BigHC, which then has three loss bundles:

- bundle ACo
- bundle BCo
- bundle OldGroup (containing the group loss originally made by Old Group).

This sequence of events is shown in figure 1. Big Group must establish an available fraction for bundle OldGroup and adjust all available fractions by the relevant item in the adjustment table.

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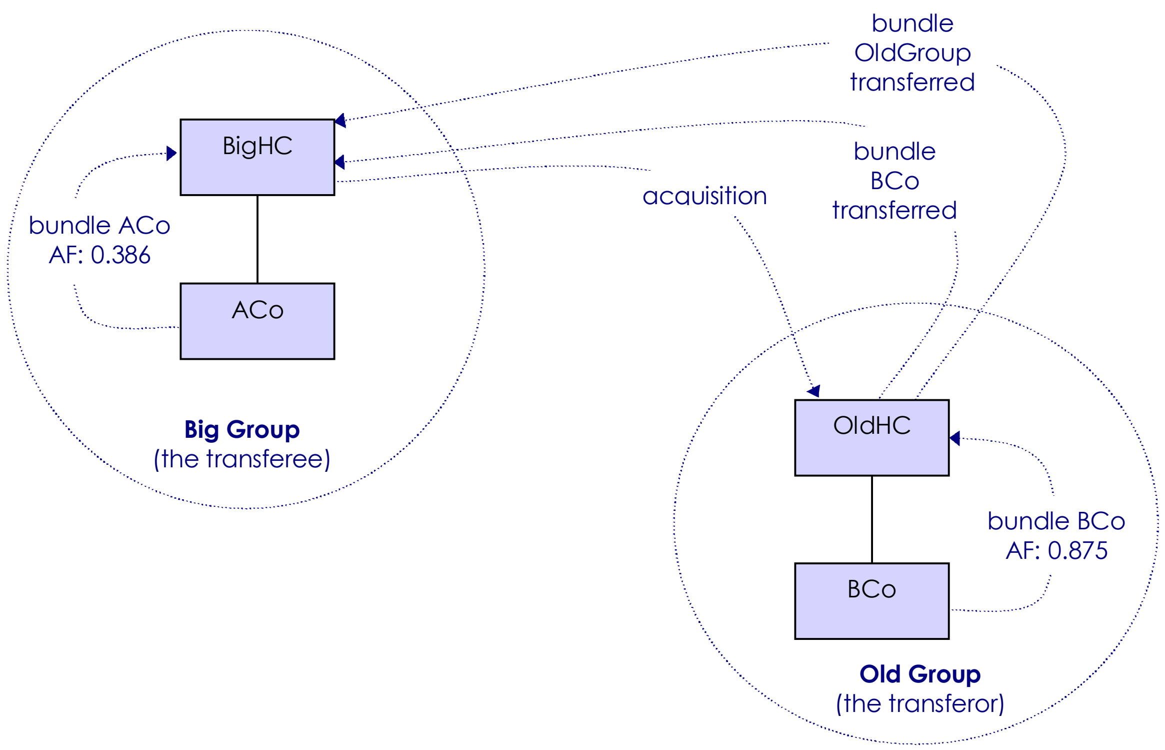
[73] Subsection 707-320(3) ensures that calculations are made in the order they appear in the table. Results of an adjustment made under an earlier item are used in making a calculation under a later item.

Figure 1: Big Group acquires Old Group



Market values are ascertained as at the time of Old Group joining (1 July 2004) as follows:

- market value of Old Group = $500
- market value of the new joined group (including the market value of Old Group) = $1,500

Calculation

Step 1 – Establish the available fraction for bundle OldGroup (assuming the modified market value of the transferor equals the market value of Old Group and the adjusted market value of the transferee equals the market value of the new joined group):

$$\frac{500}{1,500} = 0.333$$

Step 2 – Apply adjustment item 1 to the available fraction for bundle BCo by multiplying it by the relevant factor:

$$0.875 \quad x \quad \frac{500}{1,500} = 0.292$$

The sum of the available fractions for the bundles being transferred is 0.625 (0.333 + 0.292). This figure will be the denominator of the item 2 factor.

Step 3 – Apply adjustment item 2 to the available fractions for bundles OldGroup and BCo by multiplying each by the item 2 factor:

$$\text{OldGroup:} \quad 0.333 \times \frac{0.333}{0.625} = 0.177$$

$$\text{BCo:} \quad 0.292 \times \frac{0.333}{0.625} = 0.156$$

The sum of the available fractions for new bundles that have been transferred is 0.333 (0.177 + 0.156). This corresponds with the available fraction initially calculated for bundle OldGroup. This figure will be inserted into the item 3 factor.

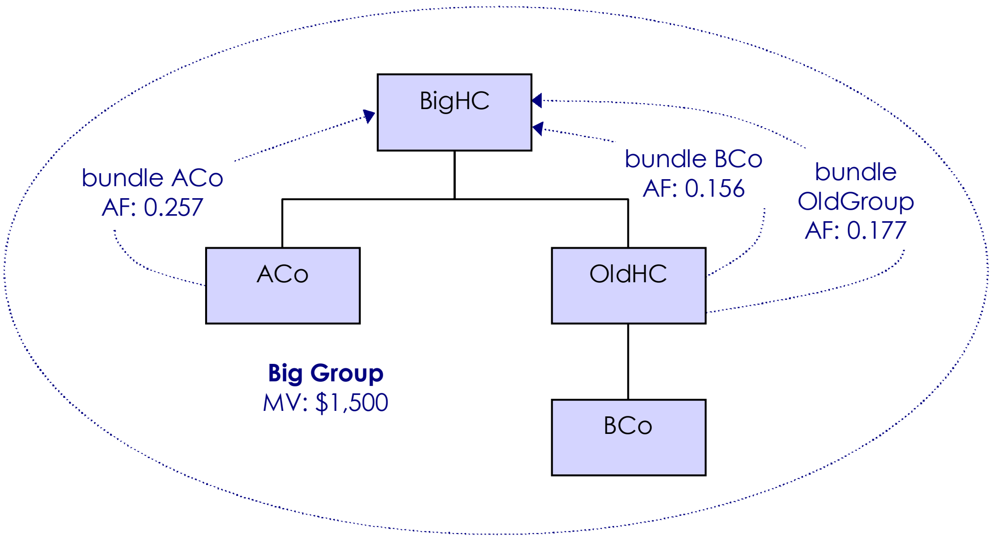
Step 4 – Apply adjustment item 3 to the available fraction for bundle ACo by multiplying it by the item 3 factor:

$$\text{ACo:} \quad 0.386 \times \left[\, 1 - 0.333 \,\right] = 0.257$$

The utilisation of losses in each bundle is subject to limits determined by reference to the available fraction method.

The new consolidated structure just after the transfer time is shown in figure 2.

Figure 2: The new joined group



References

Income Tax Assessment Act 1997, subsections 707-320(1), 707-320(2), 707-320(3); as amended by *New Business Tax System (Consolidation) Act (No.1) 2002* (No. 68 of 2002), Schedule 1

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 8

Revision history

Section C3-4-320 first published 2 December 2002.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Adjusting available fraction – another loss entity joins the group

Description

Available fractions are adjusted to ensure they continue to approximate the proportion of the group's income that can be said to be generated by the relevant entity or group that transferred the loss.

The available fraction for each existing loss bundle in a consolidated group must be adjusted if another loss entity or group joins. This example shows how to:

- adjust the available fraction for an existing loss bundle in the consolidated group, and
- establish an available fraction for the new loss bundle.

Note

For more information about:

- loss bundles and calculating the available fraction → 'Treatment of losses', C3-1; 'Consolidation loss provisions', C3-2-110 (high-level worked example)
- working out modified market value → 'Modified market value of a single joining entity', C3-4-110 (worked example)
- market values → 'Market valuation guidelines', C4-1

Commentary

The adjustment to the available fraction for each existing loss bundle is required at the time losses in an incoming bundle or bundles are transferred to the head company. The head company has the option of cancelling the transfer of each incoming loss to avoid the adjustment[74].

The available fraction for each existing bundle of transferred losses is adjusted by multiplying it by the factor at item 3 in the table in subsection 707-320(2).

The factor is:

$$\left[\ 1 - \text{the total of the available fractions for all the new loss bundles transferred to the head company}\ \right]$$

[74] The effect of cancellation is that the transfer is treated as if it had never occurred. Losses that are cancelled can never be used by any entity after the loss entity joins the group.

Essentially, the adjustment is a 2-step process:

- First, the available fraction for each incoming bundle needs to be established. The available fraction for each incoming bundle is either:
  - calculated for the first time under subsection 707-320(1), or
  - adjusted under item 1 in the table in subsection 707-320(2) if the losses are being transferred for a second or subsequent time

    → 'Adjusting available fraction – previously transferred losses are transferred again', C3-4-310
- Second, the available fraction for each existing bundle in the group is adjusted under item 3 in the table in subsection 707-320(2).

Example

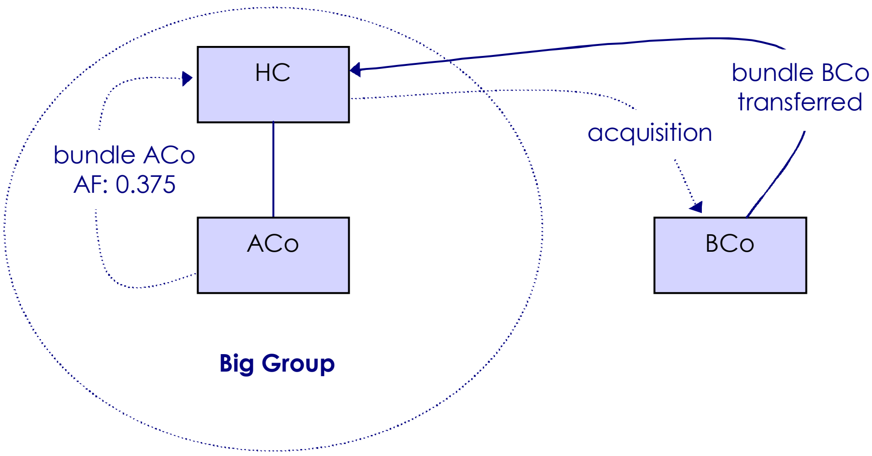
Facts

A consolidated group, 'Big Group', consists of head company HC and subsidiary member ACo. A loss made by ACo is transferred to HC when ACo joins the consolidated group. An available fraction of 0.375 is established for bundle ACo at the initial transfer time.

Big Group acquires another company, BCo, on 1 July 2004. BCo has a loss that is transferred to HC at the joining time.

This sequence of events is shown in figure 1. Big Group must establish an available fraction for the incoming loss bundle (bundle BCo) and adjust the existing available fraction for its bundle of previously transferred losses (bundle ACo).

Figure 1: Big Group acquires BCo



Values are ascertained as at the time of transfer (1 July 2004) as follows:

- modified market value of BCo = $400
- adjusted market value of Big Group = $1,100 (including the market value of BCo)

Calculation

Step 1 – Establish the available fraction for bundle BCo:

$$\frac{400}{1{,}100} = 0.364$$

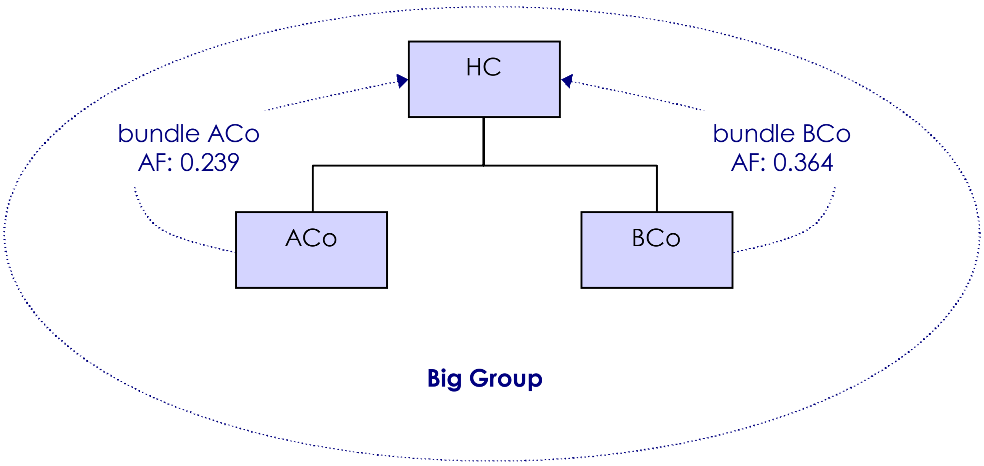
Step 2 – Multiply the available fraction for bundle ACo by the factor:

$$0.375 \times [1 - 0.364] = 0.239$$

The utilisation of losses in both bundles is subject to limits determined by reference to the available fraction method. Assuming no other adjustment events occur during the income year, the available fraction that applies to bundle ACo for the 2005 income year is 0.239 and the available fraction that applies to bundle BCo is 0.364.

The new consolidated structure just after the transfer time is shown in figure 2.

Figure 2: Big Group just after transfer time



References

Income Tax Assessment Act 1997, subsections 707-320(1), 707-320(2); as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 8

Revision history

Section C3-4-330 first published 2 December 2002.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Adjusting the available fraction – post-consolidation events that increase market value of group

Key points

This section explains how an adjustment is made to the existing available fraction for a bundle of losses under item 4 in the table in subsection 707-320(2) of the ITAA 1997. It focuses on how the adjustment applies to an existing consolidated group or MEC group.

Broadly, an adjustment to existing available fractions is required if:

- there is an event as described in subsection 707-325(4), and
- the group's market value increases as a result of the event.

Background

The available fraction is the core component of the rules for the utilisation of transferred losses by consolidated groups. It establishes the limit for the utilisation of transferred losses in a bundle for an income year. The rationale is that the rate of loss usage should be restricted to approximate the rate that would have been available to the entity from which the loss was transferred had it remained a single entity outside the consolidated group.

Available fractions are adjusted to ensure they continue to approximate the proportion of the group's income that can be said to be generated by the relevant loss entity. Adjusting event 4 applies where the group's market value has increased as a result of an injection of capital or a non-arm's length transaction involving entities external to the group. Existing available fractions are multiplied by the factor contained in item 4 in the table in subsection 707-320(2).

Note

For examples of the application of adjusting event 4 see:

- 'Adjusting available fraction – post-consolidation injection of capital into subsidiary member', C3-4-341
- 'Adjusting available fraction – post-consolidation injection of capital where head company issues shares in scrip for scrip merger', C3-4-342.

These worked examples show the procedure for adjusting available fractions. They are not intended to provide guidance on what constitutes an event or how valuations should be undertaken.

When are available fractions adjusted?

Under adjusting event 4, the available fraction for a bundle of losses is adjusted if the market value of the company[75] to which the losses were most recently transferred is increased as a result of either of these events:

- an injection of capital[76] into the group or an associate of the group, or
- a non-arm's length transaction that involves the group or an associate of the group.

Certain injections of capital, as described in subsection 707-325(5), are disregarded. Broadly, they are injections into a listed public company made through a dividend reinvestment scheme and injections under a qualifying employee share acquisition scheme.

Adjustment factor

Under item 4 in the table in subsection 707-320(2), each available fraction is reduced just after the event by multiplying it by the following factor:

$$\frac{\text{Market value of the company just before the event}}{\text{Market value of the company just before the event} + \text{Amount of the increase}}$$

In the case of an existing consolidated group, the reference to an increase in the market value of the company means an increase in the market value of the entire consolidated group, as a result of the operation of the single entity rule.[77]

As this section focuses on the application of adjusting event 4 where the transferee is a head company, the term 'market value of the group' is used hereafter for ease of understanding.

Market value of the group just before the event

In determining the market value of the group just before the event, the Tax Office would expect a taxpayer to be able to clearly demonstrate how this valuation has been calculated, given the particular facts of each case. The Tax Office has published guidelines on undertaking valuations required by consolidation law. → 'Market valuation guidelines', C4-1

Amount of the increase

In determining the amount of the increase in the market value of the group attributable to the event, taxpayers need to ensure that any impact from other transactions or events that occur around the time of the event are not taken into account.

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[75] This will generally be the head company of a consolidated group or MEC group. In a situation where the consolidated group or MEC group has ceased to exist, this will be the former head company of that group.

[76] Taxation Ruling TR 2004/9 provides the Tax Office view on the meaning of the expression 'injection of capital'.

[77] For MEC groups, ATO Interpretative Decision 2004/961 states that references to the 'market value of the company' in item 4 in the table in subsection 707-320(2) are references to the market value of the entire MEC group.

A method of establishing the amount of the increase in market value is to obtain two valuations. The first would be undertaken as at the time just after the event occurs. The second valuation would be undertaken as at that time on the assumption the event did not take place. This second valuation establishes what the market value would have been had the event not occurred. The difference between these two valuations establishes the amount of the increase.

Using this approach, actual and hypothetical market valuations need to be undertaken for each event.

Calculating the reduced available fractions

There are four steps to determining the reduced available fraction for each bundle of losses in a situation where adjusting event 4 applies (table 1).

Table 1: Steps to determining the reduced available fraction

Step	Description	Determination or calculation	Short cut*
1	Market value before event	Determine market value of consolidated group or MEC group just before the event	Yes
2	Amount of the increase	Determine increase in group market value attributable to the injection of capital or non-arm's length transaction	Yes
3	Factor	Divide the step 1 amount by the sum of the step 1 and step 2 amounts	–
4	Adjust available fraction	Multiply the available fraction for the bundle of losses by the step 3 factor. Repeat for each bundle of losses.	–

*Short cut options apply only in certain circumstances.

Item 4 short cut option

There may be substantial costs in obtaining the valuations required to accurately calculate the factor (identified at step 3).

In recognition of these costs, the Commissioner of Taxation has provided a short cut option for adjusting event 4 that removes the need to obtain additional valuations.

All groups other than certain listed public groups

Amount of the increase

This short cut option is only available where the event is a cash injection. In this situation, the Tax Office will accept the actual dollar amount of the cash injected into the group as the amount of the increase (the step 2 amount).

This short cut option is not available where the event is a non-cash injection or a non-arm's length transaction. In these situations there is still a requirement to obtain the necessary valuations.

Certain listed public groups

The following short cut option applies where all the shares in the head company are ordinary shares and listed on the Australian Stock Exchange (ASX).

If this short cut option is chosen, both elements of the short cut must be adopted where applicable.

(1) Market value just before the event

The Tax Office will accept, as the market value of the consolidated group just before the event (the step 1 amount), the amount obtained by multiplying the ASX share price at that time by the number of shares.

This short cut option is provided in recognition that the group's market value just before the event is contained in both the numerator and denominator of the formula for working out the factor at step 3 and because it can provide significant compliance savings.

(2) Amount of the increase

(a) Cash injections

Where the event is a cash injection the Tax Office will accept the actual dollar amount of the cash injected into the group as the amount of the increase (the step 2 amount).

(b) Scrip for scrip mergers or takeovers

Where the event is a scrip for scrip merger or takeover that is effected by way of a court ordered scheme of arrangement, the Tax Office will accept the listed ASX share price at the end of the merger implementation date multiplied by the amount of new shares issued to effect the merger as the amount of the increase. → 'Adjusting available fraction – post-consolidation injection of capital where head company issues shares in scrip for scrip merger', C3-4-342.

Example

Applying the short cut option

The head company of a consolidated group has a bundle of losses. The head company issues additional shares on the share market. The share subscription raises $70 million of additional share capital.

Just prior to this event:

- the available fraction for the bundle of losses was 0.350
- the issued capital of the head company comprised 100 million ordinary shares, all of which were listed on the ASX, and
- the ASX share price was $9.30.

Applying the short cut option:

1. Market value just before the event is $930 million (100 million × $9.30).
2. Amount of the increase is $70 million.
3. The factor is:

$$\frac{930 \text{ million}}{930 \text{ million} + 70 \text{ million}} = 0.93$$

4. Adjusted available fraction for the bundle of losses is determined as follows:

   0.93 × 0.350 = 0.326

The available fraction is therefore reduced from 0.350 to 0.326 just after the event.

Revision history

Section C3-4-340 first published 2 December 2002 as a worked example.

On 6 April 2006 it was withdrawn and replaced by:

- this version of C3-4-340, which explains adjusting event 4
- the related worked examples C3-4-341 and C3-4-342.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Adjusting available fraction – post-consolidation injection of capital into subsidiary member

Description

This example shows the application of adjusting event 4 to an injection of capital into a subsidiary member of a consolidated group. The injection is made by an entity external to the group in exchange for additional membership interests in the subsidiary, resulting in that member entity leaving the group. Item 4 in the table in subsection 707-320(2) of the ITAA 1997 may operate to reduce available fractions for loss bundles held by the consolidated group if the leaving entity remains an associate of the head company. The adjustment required, if any, will depend on the impact of the injection of capital on the market value of the group.

Note

For more information:

- 'Adjusting the available fraction – post-consolidation events that increase market value of group', C3-4-340 (explanation)
- 'Adjusting available fraction – post-consolidation injection of capital where head company issues shares in scrip for scrip merger', C3-4-342 (worked example)
- 'Market valuation guidelines', C4-1

Commentary

The available fraction for a bundle of losses is reduced if the market value of the company[78] to which the losses were most recently transferred is increased as a result of either of these events:

- an injection of capital[79] into the group or an associate of the group, or
- a non-arm's length transaction that involves the group or an associate of the group.→ subsection 707-325(4), ITAA 1997

When applying item 4 in the table in subsection 707-320(2) (adjusting event 4) to an existing consolidated group, each available fraction is reduced just after the event by multiplying it by the following factor:

$$\frac{\text{Market value of the company just before the event}}{\text{Market value of the company just before the event} + \text{Amount of the increase}}$$

[78] This will generally be the head company of a consolidated group or MEC group. In a situation where the consolidated group or MEC group has ceased to exist, this will be the former head company of that group.

[79] Taxation Ruling TR 2004/9 provides the Tax Office view on the meaning of the expression 'injection of capital'.

The reference to an increase in the market value of the company will mean an increase in the market value of the entire consolidated group where the company still meets the definition of a head company in section 703-15. This is as a result of the operation of the single entity rule.[80] As this worked example focuses on adjusting event 4 applying to a head company, the term 'market value of the group' is used hereafter for ease of understanding.

Four-step process to calculate reduced available fractions

There are four steps to determine the reduced available fraction for each bundle of losses in a situation where adjusting event 4 applies:

1. Determine the market value of the consolidated group just before the event.
2. Determine the increase in the market value of the consolidated group attributable to the injection of capital or non-arm's length transaction.
3. Divide the step 1 amount by the sum of the step 1 and step 2 amounts.
4. Multiply the available fraction for the bundle of losses by the step 3 factor. Repeat for each bundle of losses.

Injection into subsidiary

Timing of the event

A reduction to the available fractions of existing loss bundles may be necessary where a subsidiary member of a consolidated group issues additional shares in itself in return for cash consideration from an entity that is not a member of the consolidated group.[81] Such a transaction will result in the member entity leaving the consolidated group.[82] If the leaving entity remains an associate[83] of the head company for the purposes of paragraph 707-325(4)(a), an event for the purposes of adjusting event 4 is taken to have occurred in relation to the group.

The leaving entity will remain a subsidiary member of the group until the injector becomes entitled to be registered as owner of the shares.[84] The event does not occur until the transaction displays all of the characteristics of an injection of capital.[85] For the purposes of this example, it is assumed that the leaving entity leaves the group at the time the event takes place. Therefore the injection of capital is not considered to have been made into the group.

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[80] For a MEC group, ATO Interpretative Decision 2004/961 states that a reference to the 'market value of the company' in item 4 in the table in subsection 707-320(2) is a reference to the market value of the entire MEC group.

[81] Note that consideration may be in the form of property rather than cash (paragraph 11 of TR 2004/9).

[82] As the entity will no longer be a wholly-owned subsidiary of the head company of the group.
→ section 703-15, ITAA 1997

[83] 'Associate' is defined in section 318, ITAA 1936.

[84] Similar to the rule in section 703-33 of the ITAA 1997, which determines when beneficial ownership changes where shares in a company are sold.

[85] Paragraph 12, TR 2004/9.

Impact on market value

A reduction to available fractions is required if there is an increase in the market value of the consolidated group as a result of the event. The market value of the group will increase if the value of its holding in the leaving entity increases.

A method of establishing the amount of the increase in respect of an event is to obtain two valuations. The first would be undertaken as at the time just after the event occurs. The second valuation would be undertaken as at that time on the assumption the event did not occur. This second valuation establishes what the market value would have been had the event not occurred. The difference between these two valuations establishes the amount of the increase.

In arriving at an assessment of the impact of the event on the market value, the Tax Office expects taxpayers to clearly demonstrate, where required, how the valuation has been calculated. Assumptions made in arriving at a valuation should be documented and supportable.

Example

Facts

The HCo Group, a consolidatable group consisting of HeadCo and its wholly-owned subsidiaries ACo and BCo, consolidates on 1 July 2003.

A loss is transferred from BCo to HeadCo at the joining time. The available fraction calculated for the bundle containing the loss (bundle BCo) is 0.800.

On 1 December 2003, XCo, an entity not associated with HeadCo, acquires a 20% membership interest in ACo by subscribing for new shares in the capital of ACo.

ACo remains an associate of HeadCo.

The issue of shares by ACo is considered an event under paragraph 707-325(4)(a) for the purposes of adjusting event 4 in relation to HeadCo.

To illustrate the effect of this share issue on the available fraction for bundle BCo, it is assumed that this injection of capital has a positive impact on the value of ACo. This may, for example, be a result of XCo being in a position to better exploit the assets held by ACo than the HCo Group.

Accordingly, through its holding in ACo, HeadCo's market value also increases. As such, the available fraction for bundle BCo must be reduced under adjusting event 4.

These facts are represented in figures 1 and 2 below.

Figure 1: HCo Group consolidates

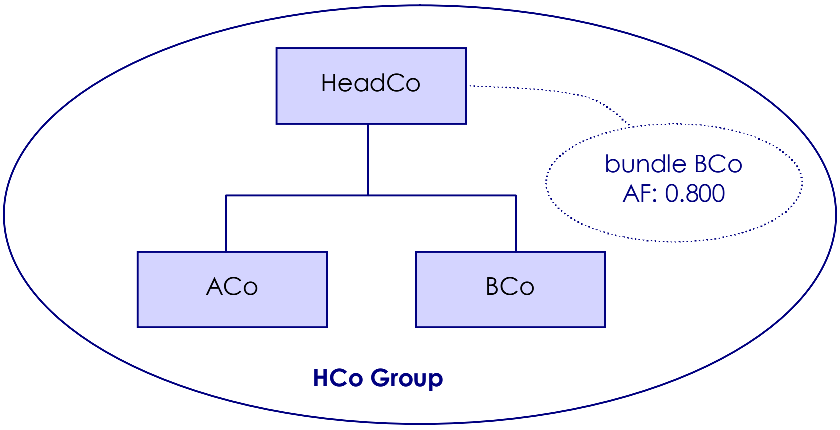
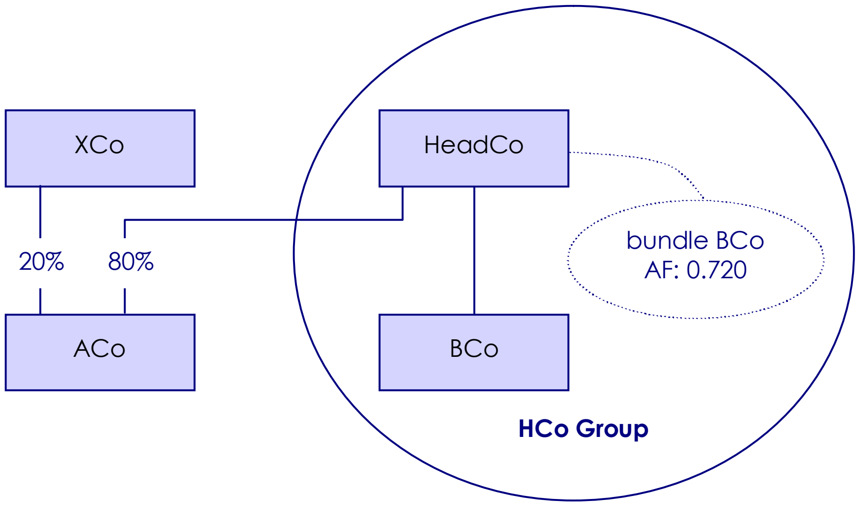


Figure 2: ACo leaves the HCo Group (1 December 2003)



Calculation

Market values ascertained for the purpose of calculating the adjustment required under item 4 are shown in table 1.

Table 1: Three separate market values of HCo Group

Valuation	$
Market value of HCo Group just before the injection of capital	360
Market value of HCo Group just after the injection of capital	400
Hypothetical market value of HCo Group just after the injection of capital, as if the event did not occur	360

In this case, the first and third market values are the same because the valuer considered that the only factor impacting on the HCo Group's market value around the time of the event was the issuing of the new shares in ACo to XCo.

Applying the four-step method to reduce the available fraction

Table 2: Establishing the reduced available fraction for bundle BCo

Step	Explanation	Amount
1	Market value before event	\$360
2	Amount of the increase	\$40
3	Factor	\$360 / (\$360 + \$40) = 0.9
4	Adjust available fraction	0.800 × 0.9 = 0.720

The available fraction for bundle BCo is adjusted on 1 December 2003 to 0.720.

As the adjustment has taken place part-way through the 2004 income year, utilisation of the loss in bundle BCo must be apportioned. → section 707-335, ITAA 1997

Apportionment recognises that an available fraction has only applied for a part of the income year. → 'Apportioning the use of transferred losses', C3-4-610

References

Income Tax Assessment Act 1997:

- sections 701-1, 703-15, 703-33
- item 4 in the table in subsection 707-320(2)
- subsection 707-325(4), paragraph 707-325(4)(a)
- section 707-335

Income Tax Assessment Act 1936:

- section 318

Taxation Ruling TR 2004/9

Revision history

Section C3-4-341 first published 6 April 2006.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Adjusting available fraction – post-consolidation injection of capital where head company issues shares in scrip for scrip merger

Description

This example shows the application of adjusting event 4 to an injection of capital into a consolidated group when the head company issues new shares in itself to acquire membership interests in another entity (scrip for scrip merger or takeover). Item 4 in the table in subsection 707-320(2) of the ITAA 1997 may operate to reduce the available fraction for an existing bundle of losses of the consolidated group. The adjustment required, if any, will depend on the impact of the injection of capital on the market value of the group.

This example shows the head company using the short cut option to determine the reduction.

Note

For more information:

- 'Adjusting the available fraction – post-consolidation events that increase market value of group', C3-4-340 (explanation)
- 'Adjusting available fraction – post-consolidation injection of capital into subsidiary member', C3-4-341 (worked example)
- 'Market valuation guidelines', C4-1

Commentary

The available fraction for a bundle of losses is reduced if the market value of the company[86] to which the losses were most recently transferred is increased as a result of either of these events:

- an injection of capital[87] into the group or an associate of the group, or
- a non-arm's length transaction that involves the group or an associate[88] of the group.→ subsection 707-325(4), ITAA 1997

When applying item 4 in the table in subsection 707-320(2) (adjusting event 4) to an existing consolidated group, each available fraction is reduced just after the event by multiplying it by the following factor:

$$\frac{\text{Market value of the company just before the event}}{\text{Market value of the company just before the event} + \text{Amount of the increase}}$$

[86] This will generally be the head company of a consolidated group or MEC group. In a situation where the consolidated group or MEC group has ceased to exist, this will be the former head company of that group.

[87] Taxation Ruling TR 2004/9 provides the Tax Office view on the meaning of the expression 'injection of capital'.

[88] 'Associate' is defined in section 318, ITAA 1936.

The reference to an increase in the market value of the company will mean an increase in the market value of the entire consolidated group where the company still meets the definition of a head company in section 703-15. This is as a result of the operation of the single entity rule.[89] As this worked example focuses on adjusting event 4 applying to a head company, the term 'market value of the group' is used hereafter for ease of understanding.

Timing of the event – merger effected by way of a court ordered scheme of arrangement

A reduction to the available fractions of existing loss bundles may be necessary in a scrip for scrip merger or takeover, where the head company of a consolidated group issues additional shares in itself in return for the acquisition of 100% of the membership interests in an entity. This is considered to be an event (an injection of capital) for the purposes of adjusting event 4 in subsection 707-320(2).[90]

A merger of entities can occur by way of a court ordered scheme of arrangement. For such an arrangement, the event described in subsection 707-325(4) is taken to have occurred on the merger implementation date. This is when the shares in the target company are transferred to the bidder company. It is at this time the bidder entity will beneficially own the assets of the target.

Four-step process to calculate reduced available fractions

There are four steps to determine the reduced available fraction for each bundle of losses in a situation where adjusting event 4 applies:

1. Determine the market value of the consolidated group just before the event.
2. Determine the increase in the market value of the consolidated group attributable to the injection of capital or non-arm's length transaction.
3. Divide the step 1 amount by the sum of the step 1 and step 2 amounts.
4. Multiply the available fraction for the bundle of losses by the step 3 factor. Repeat for each bundle of losses.

Impact on market value

A reduction to available fractions is required if there is an increase in the market value of the consolidated group as a result of the event. The market value of the group may increase as a consequence of the group's ownership and control of the acquired entity.

A method of establishing the amount of the increase in respect of an event is to obtain two valuations. The first would be undertaken as at the time just after the event occurs. The second valuation would be undertaken as at that time on the assumption the event did not take place. This second valuation establishes

[89] For a MEC group, ATO Interpretative Decision 2004/961 states that a reference to the 'market value of the company' in item 4 in the table in subsection 707-320(2) is a reference to the market value of the entire MEC group.

[90] Paragraphs 13 and 59 of Taxation Ruling TR 2004/9.

what the market value would have been had the event not occurred. The difference between these two valuations establishes the amount of the increase.

In arriving at an assessment of the impact of the event on the market value, the Tax Office expects taxpayers to clearly demonstrate, where required, how the valuation has been calculated. Assumptions made in arriving at a valuation should be documented and supportable.

Short cut option

A short cut option is available where all the shares in the head company are ordinary shares and listed on the Australian Stock Exchange (ASX).

If the short cut option is chosen, both elements of the short cut must be adopted.

(1) Market value just before the event

The Tax Office will accept, as the market value of the consolidated group just before the event (the step 1 amount), the amount obtained by multiplying the ASX share price at that time by the number of shares.

(2) Amount of the increase – scrip for scrip mergers or takeovers

Where the event is a scrip for scrip merger or takeover that is effected by way of a court ordered scheme of arrangement, the Tax Office will accept the listed ASX share price at the end of the merger implementation date multiplied by the amount of new shares issued to effect the merger as the amount of the increase.

Example

Facts

The HCo Group, a consolidatable group consisting of HeadCo and its wholly-owned subsidiary ACo, consolidates on 1 July 2003.

A tax loss is transferred from ACo to HeadCo at the time the consolidated group is formed. The available fraction calculated for the bundle containing the loss (bundle ACo) is 0.600.

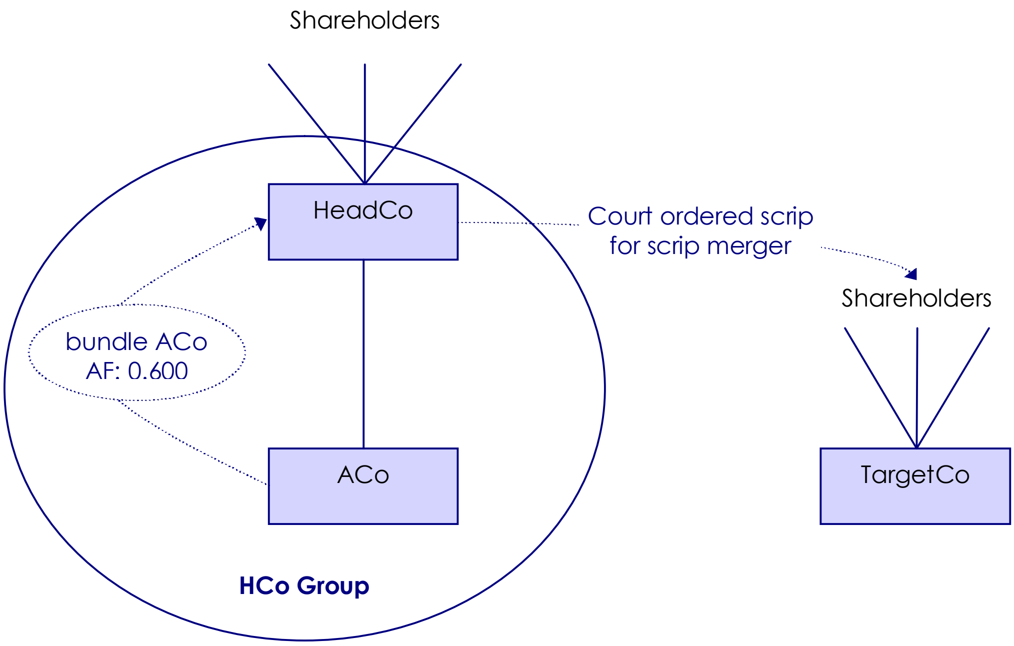
On 1 November 2003, HeadCo is granted, by way of a court ordered scheme of arrangement, the right to acquire all of the shares in TargetCo. Shareholders of TargetCo are entitled to receive $2.00 and three HeadCo shares for each TargetCo share. There are 300,000 issued shares in TargetCo.

The merger implementation date occurs on 1 December 2003, when HeadCo allocates the cash and new shares to TargetCo's shareholders and TargetCo's shares are transferred to HeadCo.

The issue of new shares by HeadCo in return for acquiring TargetCo is considered an event[91] for the purposes of adjusting event 4 in subsection 707-320(2) in relation to HeadCo. This event is taken to have occurred on the merger implementation date (i.e. 1 December 2003).

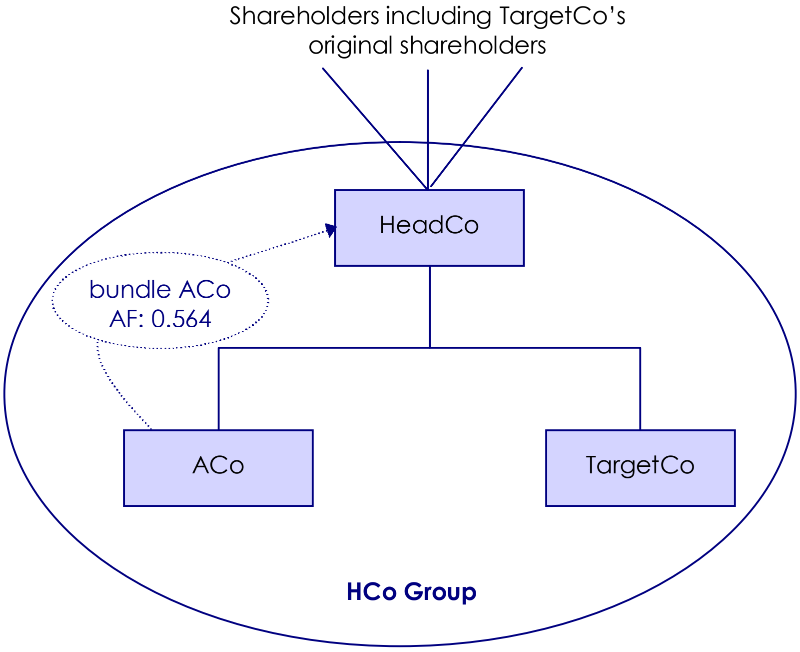
The event has a positive impact on the value of HeadCo as a consequence of the group's ownership and control of TargetCo. As a result, the available fraction for bundle ACo must be reduced under adjusting event 4. These facts are represented in figures 1 and 2 and below.

Figure 1: HCo Group and the scrip for scrip merger (1 November 2003)



[91] An injection of capital under paragraph 707-325(4)(a) – refer paragraphs 13 and 59 of TR 2004/9.

Figure 2: HCo group after the scrip for scrip merger (1 December 2003)



Calculation

HeadCo chooses to use the available short cuts to determine the adjustment required. Data extracted from the share register of HeadCo is shown in table 1.

Table 1: Share register of HCo

Date	Issued shares	Share Price ($)
30.11.03	15,000,000	0.32
01.12.03	15,900,000	0.36

Applying the short cut option:

Table 2: Establishing the reduced available fraction for bundle ACo

Step	Explanation	Amount
1	Market value just before event	$4.8 million (15,000,000 x $0.32)
2	Amount of the increase	$324,000 (900,000 x $0.36)
3	Factor	$4.8 million / ($4.8 million + $324,000) = 0.94
4	Adjust available fraction	0.600 × 0.94 = 0.564

The available fraction for bundle ACo is adjusted on 1 December 2003 to 0.564.

As the adjustment has taken place part-way through the 2004 income year, utilisation of the loss in bundle ACo must be apportioned. → section 707-335, ITAA 1997

Apportionment recognises that an available fraction has only applied for a part of the income year. → 'Apportioning the use of transferred losses', C3-4-610

References

Income Tax Assessment Act 1997:

- item 4 in the table in subsection 707-320(2)
- subsection 707-325(4)
- section 707-335

Income Tax Assessment Act 1936:

- section 318

Taxation Ruling TR 2004/9

ATO Interpretative Decision 2004/961

Revision history

Section C3-4-343 first published 6 April 2006.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Adjusting available fraction – multiple adjustments under a scrip for scrip acquisition

Description

Available fractions are adjusted to ensure they continue to approximate the proportion of the consolidated group's income that can be said to be generated by the relevant loss entity or loss group.

This example shows how the available fraction for an existing loss bundle in a consolidated group is adjusted under items 3 and 4 of the table in subsection 707-320(2) of the *Income Tax Assessment Act 1997* (ITAA 1997) where the head company of another consolidated group joins the group as a result of a scrip for scrip acquisition.

Note

For more information on adjusting the available fraction see → 'Adjusting available fraction – another loss entity joins the group', C3-4-330 and 'Adjusting available fraction – post-consolidation injection of capital where head company issues shares in scrip for scrip merger', C3-4-342.

Commentary

The available fraction for an existing loss bundle can be adjusted under various adjustment items in subsection 707-320(2). This worked example focuses on adjustments required under adjustment items 3 and 4 where the head company of a consolidated group is acquired by another consolidated group via a scrip for scrip transaction.

Adjustment item 3 applies where losses in an incoming bundle or bundles are transferred to the acquiring head company.

Adjustment item 4 applies where a group's market value has increased as a result of an injection of capital or a non-arm's length transaction involving entities external to the group. A scrip for scrip transaction is considered to be an injection of capital → paragraphs 13, 59 and 92 of Taxation Ruling TR 2004/9.

Adjustment items 3 and 4 can both apply to the acquiring head company's existing loss bundles in a scrip for scrip acquisition, where a head company issues additional shares in itself as consideration for the acquisition of the membership interests in the head company of another consolidated group that has losses.

Subsection 707-320(3) stipulates that if a loss transfer under Subdivision 707-A triggers more than one adjustment event, the adjustment calculations are made in the same order as they appear in the table in subsection 707-320(2). Where there is an injection of capital, as in a scrip for scrip transaction, subsection

707-320(3) is not relevant in respect of adjustment item 4 because the loss transfer does not cause the capital injection event to occur.

Under a scrip for scrip transaction, the issue of new shares by the acquiring head company to the former shareholders of the target head company may occur at the same time as the acquisition of all the shares in the target head company by the acquiring consolidated group. This would mean that the time of transfer of incoming bundles of losses from the target head company to the acquiring head company would coincide with the timing of the capital injection.

In this situation, it is appropriate that adjustment item 4 is applied only in respect of pre-existing loss bundles held by the acquiring head company and before other adjustment items. This will ensure that the newly established available fraction for an incoming bundle of losses transferred from the target head company is not subject to an adjustment because of the injection of capital.

Example

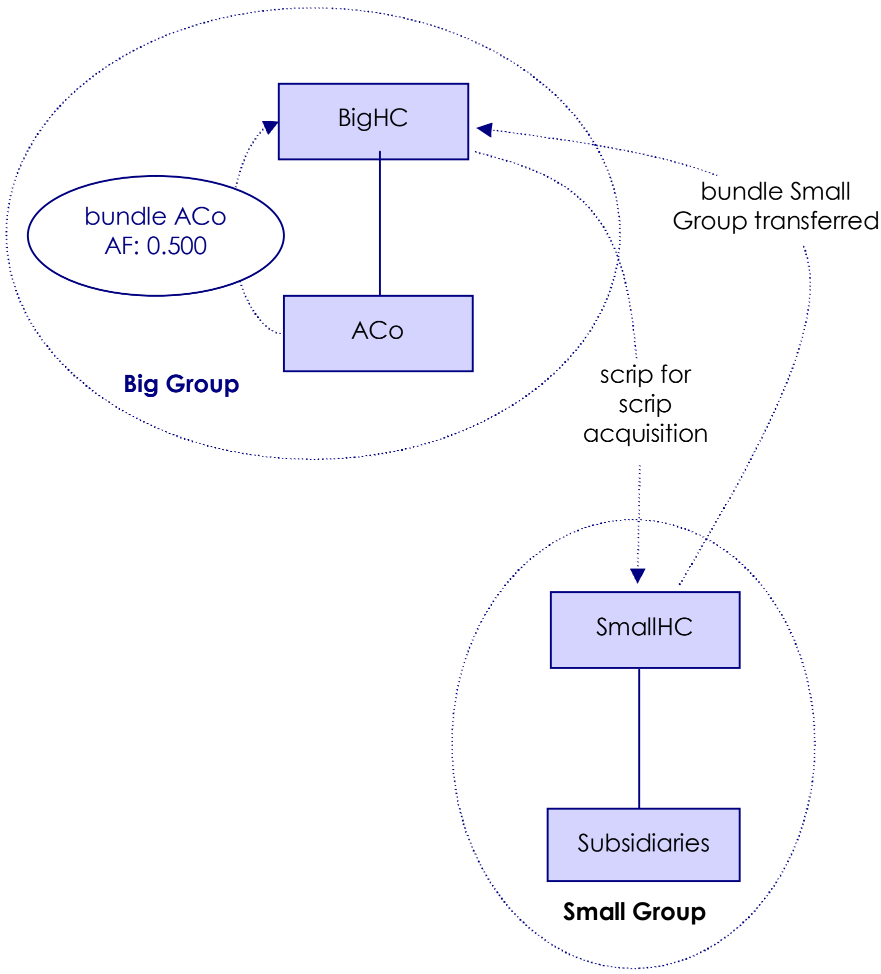
Facts

A consolidated group, Big Group, consists of head company BigHC and subsidiary member ACo. A loss made by ACo was transferred to BigHC when ACo joined the consolidated group. An available fraction of 0.500 is established for the bundle containing the loss (bundle ACo) at the initial transfer time.

Subsequently, Big Group, via a scrip for scrip transaction, acquires another consolidated group, Small Group, with SmallHC as head company. SmallHC has a group loss that is transferred to BigHC at the joining time.

This sequence of events is shown in figure 1. Big Group must establish an available fraction for the incoming loss bundle (SmallHC's group loss) and adjust the existing available fraction for bundle ACo under adjustment items 3 and 4.

Figure 1: Scrip for scrip acquisition of Small Group by Big Group



Calculation

Values ascertained at the relevant times are as follows:

Valuation	$
Market value of Big Group just before the capital injection	600
Market value of Small Group at the joining time	400
Market value of the new joined group (including the market value of Small Group) at the joining time	1,000

Step 1 – Apply adjustment item 4 to the available fraction for bundle ACo by multiplying it by the relevant factor (in this case the amount of the increase is the same as the market value of Small Group at the joining time)

$$0.500 \times [600/(600 + 400)] = 0.300$$

Step 2 – Establish the available fraction for the group loss bundle transferred from Small Group

$$400/1000 = 0.400$$

(This available fraction does not get adjusted under item 4 in subsection 707-320(2) because BigHC did not hold this group loss bundle before the capital injection event.)

Step 3 – Apply adjustment item 3 to the available fraction for bundle ACo by multiplying it by the relevant factor

0.300 x (1 – 0.400) = 0.180

The available fractions for the new joined group's bundles of losses are as follows:

Bundles	AF
Small Group (group loss bundle)	0.400
ACo	0.180

References

Income Tax Assessment Act 1997, subsections 707-320(2), 707-320(3)

Taxation Ruling TR 2004/9

Revision history

Section C3-4-360 first published 15 April 2010.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Adjusting available fraction – sum of available fractions is more than one

Description

Available fractions are adjusted to ensure they approximate the proportion of the group's income that can be said to be generated by the relevant entity or group that transferred the loss. The total of the available fractions for existing loss bundles cannot exceed one.

This example shows how to adjust the available fraction for each loss bundle in a consolidated group where the sum of the available fractions would otherwise be more than one.

Note

For more information about:

- loss bundles and calculating the available fraction → 'Treatment of losses', C3-1; 'Consolidation loss provisions', C3-2-110 (high-level worked example)
- working out modified market value → 'Modified market value of a single joining entity', C3-4-110 (worked example)
- market values → 'Market valuation guidelines', C4-1

Commentary

In working out an available fraction for a bundle of losses where the denominator is zero, the numerator is instead divided by one → subsection 707-320(5). This means the available fraction at first calculation will equal the amount of the joining entity's modified market value.

Also, if the modified market value of a joining entity exceeds the adjusted market value of the group[92], the available fraction at first calculation will be greater than one.

Having a group's available fractions total more than one incorrectly indicates that the group can generate more income than it actually does. In such a case, the group's available fractions are proportionally reduced.

Under item 5 in the table in subsection 707-320(2) of the *Income Tax Assessment Act 1997*, each available fraction is adjusted by multiplying it by the following factor:

$$\frac{1}{\text{total of all available fractions}}$$

[92] Where the adjusted market value is a positive amount.

Example

Facts

HCo is the head company of a consolidated group that forms on 1 July 2002. On consolidation, losses are transferred to HCo from ACo and BCo.

ACo has a modified market value of $10 and BCo has a modified market value of $40.

The adjusted market value of the group is nil.

Calculation

The denominator in the available fraction formula – adjusted market value of the group – is 1 instead of 0. → subsection 707-320(5)

Initially, the available fractions for the ACo loss bundle and the BCo loss bundle are:

ACo $$\frac{10}{1} = 10$$

BCo $$\frac{40}{1} = 40$$

Under adjusting event 5 in subsection 707-320(2), each of these available fractions is multiplied by the following factor:

$$\frac{1}{10 + 40} = 0.02$$

This results in the following available fractions, which are used in determining how much of the losses in each bundle can be utilised:

ACo	10×0.02	$= 0.200$
BCo	40×0.02	$= 0.800$

References

Income Tax Assessment Act 1997 – as amended by *New Business Tax System (Consolidation) Act (No.1) 2002* (No. 68 of 2002), Schedule 1:

- item 5 in the table in subsection 707-320(2)
- subsection 707-320(5)

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 8

Revision history

Section C3-4-350 first published 2 December 2002.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Amount of transferred losses that can be utilised

Description

This example shows how to determine, under the available fraction method, the limits for utilisation of losses transferred to the head company of a consolidated group. It also shows how these limits are applied in calculating a group's actual taxable income.

Note

For more information about:

- loss bundles and calculating the available fraction → 'Treatment of losses', C3-1; 'Consolidation loss provisions', C3-2-110 (high-level worked example)

Commentary

The available fraction for a loss bundle is applied to each category of group income or gains as reduced by any relevant deductions, including group losses (that is, losses generated by the consolidated group as opposed to transferred losses). The results are taken to be the head company's only income or gains of each type. Based on that assumption, the head company works out the maximum amount of losses of each sort it can use from the loss bundle.

In working out the group's actual taxable income, group losses of one sort are generally used ahead of transferred losses of the same sort.

Example

Facts

A consolidated group is working out the group's taxable income for the 2004 income year.

- The group's capital gains for the income year are $1,200.
- The group's capital losses for the income year are $200.
- The group's only other assessable income is $4,000.
- Its deductions relating to that income are $800.
- There is a group net capital loss of $400 carried forward from the 2003 income year.
- There is a group tax loss (not film) of $700 carried forward from the 2003 income year.

The group's transferred losses and their available fractions are shown in table 1.

Table 1: Transferred losses and available fractions

Loss bundle	Available fraction	Unused transferred losses
Bundle A	0.150	$150 net capital losses
		$900 tax losses (not film)
Bundle B	0.275	$2,000 tax losses (not film)

The head company satisfies the recoupment tests for the utilisation of all the group losses and all the transferred losses.

Calculation

A. Determine limits for utilisation of transferred losses

Step 1: Work out the categories of group income or gains – subsection 707-310(3)

Table 2: Categories of group income or gains (step 1)

Column 1 Income or gains	Column 2 Gross amount ($)	*Less:* allowable deductions/ reductions ($)	*Less:* group/ concessional losses of that kind ($)	Column 2 Income/ gains available for bundle ($)
Capital gains	1,200	200	400	600
Other assessable income	4,000	800	700	2,500

Step 2: Calculate the fraction of the income/gains that is attributable to each bundle – subsection 707-310(3)

Table 3: Fraction of income/gains attributable to each bundle (step 2)

Column 1 Income or gains	Loss bundle	Column 2 Income/ gains available for bundle	*Multiplied by:* available fraction (AF)	AF amount for the bundle
Capital gains	Bundle A	$600	0.150	$90
	Bundle B	$600	0.275	$165
Other assessable income	Bundle A	$2,500	0.150	$375
	Bundle B	$2,500	0.275	$688

Step 3(a): Work out a notional taxable income for bundle A – subsection 707-310(2)

Table 4: Net capital gain (step 3a)

Capital gains	$	Losses applied	$
Capital gain	90	Transferred net capital losses	90
Total	**90**	**Total**	**90**

The (notional) net capital gain is $0 ($90 – $90).

Table 5: Taxable income (step 3a)

Assessable income	$	Deductions	$
Net capital gain	0	Transferred tax losses (not film)	375
Other assessable income	375		
Total	**375**	**Total**	**375**

Transferred losses 'used' in working out notional taxable income for bundle A are:

- transferred net capital losses $90
- transferred tax losses (not film) $375

These are the limits for utilisation of these transferred losses when determining the actual taxable income for the group.

Step 3(b): Work out a notional taxable income for bundle B – subsection 707-310(2)

Table 6: Net capital gain (step 3b)

Capital gain	$	Losses applied	$
Capital gain	165	Transferred net capital losses	0
Total	**165**	**Total**	**0**

The (notional) net capital gain is $165 ($165 – $0).

Table 7: Taxable income (step 3b)

Assessable income	$	Deductions	$
Net capital gain	165		
Other assessable income	688	Transferred tax losses (not film)	853
Total	**853**	**Total**	**853**

The amount of transferred losses 'used' in working out notional taxable income for bundle B is:

- transferred tax losses (not film) $853

This is the limit for utilisation of transferred losses when determining the actual taxable income for the group.

B. Determine group's actual taxable income

Table 8: Net capital gain

Capital gains	$	Capital losses	$
Capital gains	1,200	Current-year group capital losses	200
		Group net capital losses	400
		Transferred net capital losses (bundle A)	90
Total	**1,200**	**Total**	**690**

Therefore, the group's net capital gain is $510 ($1,200 – $690).

Table 9: Taxable income

Assessable income	$	Deductions	$
Net capital gain	510	Deductions	800
		Group tax loss	700
Other assessable income	4,000	Transferred tax losses (bundle A)	375
		Transferred tax losses (bundle B)	853
Total	**4,510**	**Total**	**2,728**

The group's taxable income is $1,782 ($4,510 – $2,728).

References

Income Tax Assessment Act 1997, Subdivision 707-C; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 8

Revision history

Section C3-4-410 first published (excluding drafts) 2 December 2002.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Amount of transferred losses that can be utilised – franking offsets

Description

This example shows how to determine, under the available fraction method, the limit for utilisation of tax losses transferred to the head company of a consolidated group where the head company is in receipt of a franked distribution for the income year.

Note

For more information about:

- loss bundles and calculating the available fraction → 'Treatment of losses', C3-1; 'Consolidation loss provisions', C3-2-110 (high-level worked example).

Commentary

Amendments to Division 36 of the *Income Tax Assessment Act 1997* (ITAA 1997) enable corporate tax entities to choose the amount of prior year tax losses they wish to deduct in a later year of income, subject to certain limits → section 36-17. Also, a current year tax loss that would otherwise be 'wasted' against franked dividend income can be carried forward to a later year of income. The quantum of the tax loss is determined by reference to the amount of excess franking offsets for the income year → section 36-55.

Consolidation loss rules are designed so that group tax losses and concessional tax losses are used before transferred tax losses[93]. Consequential amendments[94] have been made to section 707-310 to ensure that this principle is maintained in the amended tax loss rules for corporate tax entities.

First, the amount of 'other assessable income' in item 6 in the table in subsection 707-310(3) is calculated by making a reduction for the grossed-up amount of franking offsets[95]. This ensures that any franking offsets are appropriately taken into account in determining the amount of transferred tax losses able to be deducted.

Second, the limit on the amount of transferred tax losses able to be utilised by a consolidated group is set on the assumption that the choice is made to use all available other tax losses without restriction → paragraph 707-310(3A)(a). This prevents a notional choice being made to use a lesser or nil amount of other tax losses in order to increase the transferred tax loss limit.

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[93] There are exceptions to this rule – see C3-4-430.

[94] The amendments discussed in this example apply to an income year that includes 1 July 2002 and later income years.

[95] The meaning of franking offsets is given in paragraph 707-310(3A)(c): franking offsets is the amount of the entitlement to two tax offsets – franking credits and venture capital credits.

Once transferred loss limits have been established under section 707-310, the head company is able to determine its actual taxable income position, incorporating the actual choices made for the deduction of its utilisable tax losses.

Example

Facts

The head company of a consolidated group is working out its taxable income for the income year ended 30 June 2004.

The group's 'other assessable income' is $5,000. The group incurred allowable deductions of $800 in relation to that income.

The other assessable income includes a franked distribution of $1,400 plus the franking credit on the distribution of $600.[96]

There is a group tax loss (not film) of $1,150 carried forward from the 2003 income year.

The group's transferred losses are as shown in table 1.

Table 1: Transferred losses and available fractions

Loss bundle	Available fraction	Unused transferred losses
Bundle A	0.316	$1,450 tax loss (not film)
Bundle B	0.418	$1,825 tax loss (not film)

Transferred losses are to be utilised in accordance with the available fraction method.

The head company satisfies the recoupment tests for the utilisation of all losses in the 2004 income year and chooses to deduct all utilisable losses from its taxable income.

[96] Section 207-20.

Calculation

A. Apply the three-step available fraction method

Step 1: Work out the categories of group income or gains – subsection 707-310(3)

Table 2: Categories of group income or gains (step 1)

Category of income or gains	Gross amount ($)	*Less:* other allowable deductions/ reductions ($)	*Less:* group/ concessional losses of the relevant sort ($)	*Less:* transferee's grossed-up franking offset amount (applies only for item 6) ($)	Income/ gains available for the bundle ($)
Other assessable income	5,000	800	1,150	2,000*	1,050

* Determined per paragraph 707-310(3A)(c) as: 1/0.3 X $600

Step 2: Calculate the fraction of the income/gains that is attributable to each bundle – subsection 707-310(3)

Table 3: Fraction of income/gains attributable to each bundle (step 2)

Category of income or gains	Loss bundle	Step 1 amount ($)	*Multiplied by:* available fraction (AF)	AF amount for the bundle ($)
Other assessable income	Bundle A	1,050	0.316	332
	Bundle B	1,050	0.418	439

Step 3(a): Work out a notional taxable income for bundle A – subsection 707-310(2)

Table 4: Taxable income (step 3a)

Assessable income	$	Deductions/losses	$
Other assessable income	332	Transferred tax loss	332
Total	**332**	**Total**	**332**

The (notional) taxable income for bundle A is $0 ($332 – $332).

$332 of the tax loss in bundle A can be utilised by the group when it determines its actual taxable income for the 2004 income year.

Step 3(b): Work out a notional taxable income for bundle B – subsection 707-310(2)

Table 5: Taxable income (step 3b)

Assessable income	$	Deductions/losses	$
Other assessable income	439	Transferred tax loss	439
Total	**439**	**Total**	**439**

The (notional) taxable income for bundle B is $0 ($439 – $439).

$439 of the tax loss in bundle B can be utilised by the group when it determines its actual taxable income for the 2004 income year.

B. Determine the head company's actual taxable income

Table 6: Taxable income

Assessable income	($)	Deductions/losses	($)
Other assessable income	5,000	Deductions	800
		Group tax loss (2003)	1,150
		Transferred tax loss (bundle A)	332
		Transferred tax loss (bundle B)	439
Total	**5,000**		**2,721**

The group's taxable income is $2,279 ($5,000 – $2,721).

Tax payable for the 2004 income year is shown in table 7.

Table 7: Tax payable

Taxable income ($)	Tax on taxable income (30c corp. tax rate)	*Less:* tax offsets ($)	Tax payable ($)
2,279	683.70	600	83.70

The loss bundles as at the start of the 2005 income year will contain the losses shown in table 8.

Table 8: Loss bundles

Bundle	Loss	Available fraction	Sort
A	$1,118 ($1,450 – $332)	0.316	Tax loss (not film)
B	$1,386 ($1,825 – $439)	0.418	Tax loss (not film)

If other assessable income was not reduced by the transferee's grossed-up franking offset amount of $2,000, the transferred tax loss limits for bundle A and bundle B would be inappropriately higher by $1,468[97]. Given a corporate tax entity can deduct tax losses only to the extent that there will not be any amount of excess franking offsets, the head company in this example would have been able to choose to utilise its transferred tax losses ahead of the group tax loss.

References

Income Tax Assessment Act 1997, Section 707-310; as amended by *Taxation Laws Amendment Act (No.5) 2003* (No. 142 of 2003), Schedule 8

Income Tax Assessment Act 1997, Division 36; as amended by *Taxation Laws Amendment Act (No.5) 2003* (No. 142 of 2003), Schedule 8

Income Tax Assessment Act 1997, Section 207-20

Income Tax (Transitional Provisions) Act 1997, Section 707-350

Revised Explanatory Memorandum to Taxation Laws Amendment Bill (No. 5) 2003, paragraphs 5.50–4

Revision history

Section C3-4-415 first published 23 April 2004.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

[97] $2,000 x 0.316 plus $2,000 x 0.418 = $1,468.

Worked example

Amount of transferred losses that can be utilised – application of paragraph 36-17(5)(a)

Description

This example illustrates the application of the restriction in paragraph 36-17(5)(a) of the *Income Tax Assessment Act 1997* (ITAA 1997) to a choice made by a head company to deduct a transferred tax loss against its taxable income.

Note

For more information about:

- loss utilisation and franking offsets → 'Amount of transferred losses that can be utilised – franking offsets', C3-4-415
- the restriction in paragraph 36-17(5)(b) → 'Amount of transferred losses that can be utilised – application of paragraph 36-17(5)(b)', C3-4-417.

Commentary

Amendments to Division 36 of the ITAA 1997 enable corporate tax entities to choose the amount of prior year tax losses they wish to deduct in a later year of income, subject to certain restrictions → section 36-17. Also, a current year tax loss that would otherwise be 'wasted' against franked dividend income can be carried forward to a later year of income. The quantum of the tax loss is determined by reference to the amount of excess franking offsets[98] for the income year → section 36-55.

Where a corporate tax entity chooses to deduct a prior year tax loss against its taxable income of a later income year, the restriction in paragraph 36-17(5)(a) applies. This paragraph states that if a corporate tax entity would have excess franking offsets in the later income year – disregarding the earlier year tax loss and any other tax losses – the entity must choose a nil amount of the tax loss.

This is so regardless of the limit for utilisation of a transferred tax loss as worked out under the available fraction method.

Example

Facts

The head company of a consolidated group is working out its taxable income for the income year ended 30 June 2004.

The group's capital gains for the income year are $1,000. There is a group net capital loss of $200 carried forward from the 2003 income year.

[98] An amount of excess franking offsets is worked out in accordance with subsection 36-55(1).

The group's 'other assessable income' is $1,500. The group incurred allowable deductions of $1,800 in relation to that income.

The other assessable income includes a franked distribution of $630 plus the franking credit on the distribution of $270.[99]

The group's transferred losses are as shown in table 1.

Table 1: Transferred losses and available fractions

Loss bundle	Available fraction	Unused transferred losses
Bundle A	0.500	$300 net capital loss $250 tax loss (not film)

Transferred losses are to be utilised in accordance with the available fraction method.

The head company satisfies the recoupment tests for the utilisation of all losses in the 2004 income year and seeks to utilise losses to the maximum extent possible.

Calculation

A. Apply the three-step available fraction method

Step 1: Work out the categories of group income or gains – subsection 707-310(3)

Table 2: Categories of group income or gains (step 1)

Category of income or gains	Gross amount ($)	*Less*: other allowable deductions/ reductions ($)	*Less*: group/ concessional losses of the relevant sort ($)	*Less*: transferee's grossed-up franking offset amount (applies only for item 6) ($)	Income/gains available for the bundle ($)
Capital gains	1,000	–	200	–	800
Other assessable income	1,500	1,500*	–	Nil**	Nil

*Although allowable deductions are $1,800, only $1,500 needs to be deducted as this reduces the other assessable income category to nil.

**This amount would normally be determined as per paragraph 707-310(3A)(c), i.e. 1/0.3 x $270 = $900. However it is nil in this example as the other assessable income category has been reduced to nil by allowable deductions.

[99] Section 207-20.

Step 2: Calculate the fraction of the income/gains that is attributable to the bundle – subsection 707-310(3)

Table 3: Fraction of income/gains attributable to each bundle (step 2)

Categories of income or gains	Loss bundle	Step 1 amount ($)	*Multiplied by*: available fraction (AF)	AF amount for the bundle ($)
Capital gains	Bundle A	800	0.500	400
Other assessable income	Bundle A	Nil	0.500	Nil

Step 3: Work out a notional taxable income for the bundle – subsection 707-310(2)

Table 4: Net capital gain (step 3)

Capital gains	$	Losses applied	$
Capital gains	400	Transferred net capital loss	300
Total	**400**	**Total**	**300**

The notional net capital gain is $100 ($400 – $300).

Table 5: Taxable income (step 3)

Assessable income	$	Deductions	$
Net capital gain	100	Transferred tax loss (not film)	100
Other assessable income	0		
Total	**100**	**Total**	**100**

The notional taxable income is $0 ($100 – $100).

The limits for utilisation of the transferred losses in bundle A by the head company when it determines its actual taxable income for the 2004 income year are as follows:

- transferred net capital loss $300
- transferred tax loss $100.

B. Determine the head company's actual taxable income

Table 6: Net capital gain

Capital gains	$	Losses applied	$
Capital gains	1,000	Group capital loss	200
		Transferred net capital loss	300
Total	**1,000**	**Total**	**500**

The group's net capital gain is $500 ($1,000 – $500).

Table 7: Taxable income

Assessable income	$	Deductions	$
Net capital gain	500	Deductions	1,800
Other assessable income	1,500	Transferred tax loss (not film)	0*
Total	**2,000**	**Total**	**1,800**

* In step 3 it is determined that the limit for utilisation of the transferred tax loss in bundle A by the head company when it determines its actual taxable income for the 2004 income year is $100. However, paragraph 36-17(5)(a) prevents the head company from deducting any of this amount. This is so because when disregarding the transferred tax loss, the head company would have an amount of excess franking offsets for the income year of $210 (as shown in table 8). Therefore, the head company must choose a nil amount of the transferred tax loss when working out its taxable income for the income year.

The group's taxable income is $200 ($2,000 – $1,800).

The amount of tax payable for the 2004 income year is shown in table 8.

Table 8: Tax payable and excess franking offset

Taxable income ($)	Tax on taxable income (30% corp. tax rate) ($)	*Less*: tax offsets ($)	Tax payable ($)	Excess franking offsets* ($)
200	60	270	Nil	210 (270 – 60)

* In accordance with subsection 36-55(1).

Applying the method statement in subsection 36-55(2), the amount of excess franking offsets – that is, $210 – generates a tax loss of $700, as shown in table 9.

Table 9: Converting excess franking offsets into tax loss

Steps in subsection 36-55(2)	$
Step 1. Work out the amount (if any) that would have been the entity's tax loss for the year under section 36-10 (ignoring net exempt income).	0
Step 2. Divide the amount of excess franking offsets by the corporate tax rate of 30%.	700 (210/0.3)
Step 3. Add the results of steps 1 and 2.	700 (700 + 0)
Step 4. Reduce step 3 result by net exempt income (if any). This is the group tax loss for the 2004 income year.	700 (700 – 0)

Carry-forward losses for the 2004 income year are shown in table 10.

Table 10: Carry-forward losses

Sort	Year incurred	Bundle	$
Group tax loss	2004	–	700
Transferred net capital loss	2003	Bundle A	0 (300 – 300)
Transferred tax loss	2003	Bundle A	250 (250 – 0)

References

Income Tax Assessment Act 1997, section 707-310; as amended by *Taxation Laws Amendment Act (No. 5) 2003* (No. 142 of 2003), Schedule 8

Income Tax Assessment Act 1997, Division 36; as amended by *Taxation Laws Amendment Act (No. 5) 2003* (No. 142 of 2003), Schedule 8:

- section 36-17
- section 36-55

Income Tax Assessment Act 1997, section 207-20

Explanatory Memorandum to Taxation Laws Amendment Bill (No. 5) 2003, Chapter 5

Revision history

Section C3-4-416 first published 10 December 2004.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Amount of transferred losses that can be utilised – application of paragraph 36-17(5)(b)

Description

This example illustrates the application of the restriction in paragraph 36-17(5)(b) of the *Income Tax Assessment Act 1997* (ITAA 1997) to a choice made by a head company to deduct a transferred tax loss against its taxable income.

Note

For more information about:

- loss utilisation and franking offsets → 'Amount of transferred losses that can be utilised – franking offsets', C3-4-415
- the restriction contained in paragraph 36-17(5)(a) → 'Amount of transferred losses that can be utilised – application of paragraph 36-17(5)(a)', C3-4-416.

Commentary

Amendments to Division 36 of the ITAA 1997 enable corporate tax entities to choose the amount of prior year tax losses they wish to deduct in a later year of income, subject to certain restrictions → section 36-17. Also, a current year tax loss that would otherwise be 'wasted' against franked dividend income can be carried forward to a later year of income. The quantum of the tax loss is determined by reference to the amount of excess franking offsets[100] for the income year → section 36-55.

Where a corporate tax entity chooses to deduct a prior year tax loss against its taxable income of a later income year, the restriction in paragraph 36-17(5)(b) applies. This paragraph states that if a corporate tax entity has no excess franking offsets in the later income year – disregarding the earlier year tax loss and any other tax losses – the entity must not choose a tax loss amount that would result in it having excess franking offsets for that year.

Where there are franking offsets[101], the maximum tax loss amount able to be deducted will result in a positive amount of taxable income equivalent to the grossed-up amount of the franking offsets. Therefore, there are circumstances where a head company can deduct only part of the amount worked out, under the available fraction method, as the limit for utilisation of a transferred tax loss.

[100] An amount of excess franking offsets is worked out in accordance with subsection 36-55(1).

[101] The meaning of franking offsets is given in paragraph 707-310(3A)(c): franking offsets is the amount of the entitlement to two tax offsets – franking credits and venture capital credits.

Example

Facts

The head company of a consolidated group is working out its taxable income for the income year ended 30 June 2004.

The group's capital gains for the income year are $1,000. There is a group net capital loss of $200 carried forward from the 2003 income year.

The group's 'other assessable income' is $1,500. The group incurred allowable deductions of $1,070 in relation to that income.

The other assessable income includes a franked distribution of $630 plus the franking credit on the distribution of $270.[102]

The group's transferred losses are as shown in table 1.

Table 1: Transferred losses and available fractions

Loss bundle	Available fraction	Unused transferred losses
Bundle A	0.500	$300 net capital loss
		$250 tax loss (not film)

Transferred losses are to be utilised in accordance with the available fraction method.

The head company satisfies the recoupment tests for the utilisation of all losses in the 2004 income year and seeks to utilise losses to the maximum extent possible.

Calculation

A. Apply the three-step available fraction method

Step 1: Work out the categories of group income or gains – subsection 707-310(3)

Table 2: Categories of group income or gains (step 1)

Category of income or gains	Gross amount ($)	*Less*: other allowable deductions/ reductions ($)	*Less*: group/ concessional losses of the relevant sort ($)	*Less*: transferee's grossed-up franking offset amount (applies only for item 6) ($)	Income/gains available for the bundle ($)
Capital gains	1,000	–	200	–	800
Other assessable income	1,500	1,070	–	430*	Nil

* This amount would normally be determined as per paragraph 707-310(3A)(c), i.e. 1/0.3 x $270 = $900. However, in this example, only $430 needs to be deducted as this reduces the other assessable income category to nil.

[102] Section 207-20.

Step 2: Calculate the fraction of the income/gains that is attributable to the bundle – subsection 707-310(3)

Table 3: Fraction of income/gains attributable to each bundle (step 2)

Categories of income or gains	Loss bundle	Step 1 amount ($)	*Multiplied by*: available fraction (AF)	AF amount for the bundle ($)
Capital gains	Bundle A	800	0.500	400
Other assessable income	Bundle A	Nil	0.500	Nil

Step 3: Work out a notional taxable income for the bundle – subsection 707-310(2)

Table 4: Net capital gain (step 3)

Capital gains	$	Losses applied	$
Capital gains	400	Transferred net capital loss	300
Total	**400**	**Total**	**300**

The notional net capital gain is $100 ($400 – $300).

Table 5: Taxable income (step 3)

Assessable income	$	Deductions	$
Net capital gain	100	Transferred tax loss (not film)	100
Other assessable income	0		
Total	**100**	**Total**	**100**

The notional taxable income is $0 ($100 – $100).

The limits for utilisation of the transferred losses in bundle A by the head company when it determines its actual taxable income for the 2004 income year are as follows:

- transferred net capital loss $300
- transferred tax loss $100.

B. Determine the head company's actual taxable income

Table 6: Net capital gain

Capital gains	$	Losses applied	$
Capital gains	1,000	Group capital loss	200
		Transferred net capital loss	300
Total	**1,000**	**Total**	**500**

The group's net capital gain is $500 ($1,000 – $500).

Table 7: Taxable income

Assessable income	$	Deductions	$
Net capital gain	500	Deductions	1,070
Other assessable income	1,500	Transferred tax loss (not film)	30*
Total	**2,000**	**Total**	**1,100**

* In step 3 it is determined that the limit for utilisation of the transferred tax loss in bundle A by the head company when it determines its actual taxable income for the 2004 income year is $100. However, paragraph 36-17(5)(b)[103] does not allow the head company to deduct an amount of transferred tax loss that is greater than $30 as this would result in an amount of excess franking offsets.[104]

The group's taxable income is $900 ($2,000 – $1,100).

The amount of tax payable for the 2004 income year is shown in table 8.

Table 8: Tax payable and excess franking offsets

Taxable income ($)	Tax on taxable income (30% corp. tax rate) ($)	*Less*: tax offsets ($)	Tax payable ($)	Excess franking offsets* ($)
900	270	270	Nil	0 (270 – 270)

* In accordance with subsection 36-55(1).

Carry-forward losses for the 2004 income year are shown in table 9.

Table 9: Carry-forward losses

Sort	Year incurred	Bundle	$
Transferred net capital loss	2003	Bundle A	0 (300 – 300)
Transferred tax loss	2003	Bundle A	220 (250 – 30)

[103] Paragraph 36-17(5)(b) applies because, disregarding the transferred tax loss, the head company would not have an amount of excess franking offsets for the 2004 income year.

[104] If the head company deducts $100 of the transferred tax loss (which is the limit worked out in step 3) when working out its taxable income for the 2004 income year, the taxable income would then be $830 ($2,000 – $1,170). This would result in an amount of excess franking offsets of $21 [$270 – (830 x 0.3)], which is not allowed in accordance with paragraph 36-17(5)(b).

References

Income Tax Assessment Act 1997, section 707-310; as amended by *Taxation Laws Amendment Act (No. 5) 2003* (No. 142 of 2003), Schedule 8

Income Tax Assessment Act 1997, Division 36; as amended by *Taxation Laws Amendment Act (No. 5) 2003* (No. 142 of 2003), Schedule 8:

- section 36-17
- section 36-55

Income Tax Assessment Act 1997, section 207-20

Explanatory Memorandum to Taxation Laws Amendment Bill (No. 5) 2003, Chapter 5

Revision history

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Proposed changes to consolidation

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- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Amount of transferred losses that can be utilised – exempt income

Description

This example shows how to determine, under the available fraction method, the limits for utilisation of losses transferred to the head company of a consolidated group where the group's income includes exempt income. It also shows how these limits are applied in calculating a group's actual taxable income.

Note

For more information about:

- loss bundles and calculating the available fraction → 'Treatment of losses', C3-1; 'Consolidation loss provisions', C3-2-110 (high-level worked example)

Commentary

The available fraction for a loss bundle is applied to each category of group income or gains as reduced by any relevant deductions, including group losses (that is, losses generated by the consolidated group as opposed to transferred losses). The results are taken to be the head company's only income or gains of each type. Based on that assumption, the head company works out the maximum amount of losses of each sort it can use from the loss bundle.

Tax losses must first be deducted against exempt income. Therefore, the available fraction is also applied to a group's exempt income. Transferred tax losses are notionally offset against exempt income (to which the available fraction has been applied, i.e. the available fraction amount of exempt income). Any remaining transferred tax losses are then notionally deducted against assessable income to determine the total limit of transferred tax losses from the bundle that is able to be utilised.

In working out the group's actual taxable income, transferred tax losses can begin to be offset against assessable income once they have been used against the available fraction amount of exempt income.

Example

Facts

A group consolidates on 1 July 2002 and is working out its taxable income for the income year ending 30 June 2003.

The group's transferred losses (all in one bundle with an available fraction of 0.500) are as shown in table 1.

Table 1: Transferred losses

Sort	Amount ($)
Film losses	100
Tax losses (not film)	700

Table 2 shows the amounts of income generated by the group for the 2003 income year.

Table 2: Group income 2003

Income	Amount ($)
Assessable film income	200
Other assessable income	2,200 (deductions of $200)
Net exempt film income	300
Other net exempt income	500

All the transferred losses are to be utilised using the available fraction method.

The head company satisfies the recoupment tests for the utilisation of all the transferred losses.

Calculation

A. Determine limits for utilisation of transferred losses

Step 1: Work out the categories of group income or gains – subsection 707-310(3)

Table 3: Categories of group income or gains (step 1)

Column 1 Income or gains	Gross amount ($)	*Less:* allowable deductions/ reductions ($)	*Less:* group/ concessional losses of that kind ($)	Column 2 Income/ gains available for bundle ($)
Exempt film income	300	–	–	300
Assessable film income	200	–	–	200
Exempt other income	500	–	–	500
Other assessable income	2,200	200	–	2,000

Step 2: Calculate the fraction of the income/gains that is attributable to the bundle – subsection 707-310(3)

Table 4: Fraction of income/gains attributable to the bundle (step 2)

Column 1 Income or gains	Column 2 Income/gains available for bundle	Multiplied by: available fraction (AF)	AF amount for the bundle
Exempt film income	$300	0.500	$150
Assessable film income	$200	0.500	$100
Exempt other income	$500	0.500	$250
Other assessable income	$2,000	0.500	$1,000

Step 3: Work out a notional taxable income for the bundle – subsection 707-310(2)

Table 5: Exempt income (step 3)

Exempt income	$	Deductions	$
Exempt film income	150	Transferred film losses	100
Exempt other income	250	Transferred tax losses (not film)	300
Total	**400**	**Total**	**400**

Note: Tax losses are deducted from net exempt income before they are deducted from assessable income as per subsection 36-15(3) of the *ITAA 1997*.

Table 6: Taxable income (step 3)

Assessable income	$	Deductions	$
Assessable film income	100	Transferred film loss	0
Other assessable income	1,000	Transferred tax loss (not film)	400
Total	**1,100**	**Total**	**400**

The (notional) taxable income is $700 ($1,100 – $400).

Transferred losses 'used' in working out notional taxable income for the bundle are:

- transferred film losses $100 (against exempt film income)
- transferred tax losses (not film) $300 (against exempt income)
  $400 (against assessable income)

These are the limits for utilisation of these transferred losses when determining the actual taxable income for the group.

B. Determine group's actual taxable income

Table 7: Exempt income

Exempt income	$	Deductions	$
Net exempt film income	300	Transferred film losses	100

Exempt income	$	Deductions	$
Other net exempt income	500	Transferred tax losses (not film)	300
Total	**800**	**Total**	**400**

Net exempt income remaining is $400 ($800 – $400).

Note that section 707-340 allows transferred tax losses to be deducted against assessable income even though the group has net exempt income remaining.

Table 8: Taxable income

Assessable income	$	Deductions	$
Assessable film income	200	Deductions	200
Other assessable income	2,200	Transferred tax losses (not film)	400
Total	**2,400**	**Total**	**600**

The group's taxable income is $1,800 ($2,400 – $600).

Losses in the bundle remaining as at 30 June 2003 are:

- transferred film losses $100 – $100 = $0
- transferred tax losses (not film) $700 – $300 – $400 = $0

As there are no losses remaining in the bundle it now ceases to exist (by the operation of subsection 707-315(3)).

References

Income Tax Assessment Act 1997, Subdivision 36-A

Income Tax Assessment Act 1997, sections 707-310, 707-315, 707-340; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 8

Revision history

Section C3-4-420 first published 2 December 2002.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Amount of losses that can be utilised – transferred tax losses utilised before group tax losses

Description

This example shows:

- how to determine the limits for utilisation of losses transferred to a head company, and
- in a situation where there are both group tax losses and transferred tax losses, how these losses are applied in calculating a group's actual taxable income.

Note

For more information about:

- loss bundles and calculating the available fraction → 'Treatment of losses', C3-1; 'Consolidation loss provisions', C3-2-110 (high-level worked example)

Commentary

The available fraction for a loss bundle is applied to each category of group income or gains as reduced by any relevant deductions, including group losses (that is, losses generated by the consolidated group as opposed to transferred losses). The results are taken to be the head company's only income or gains of each type. Based on that assumption, the head company works out the maximum amount of losses of each sort it can use from the loss bundle.

In working out the group's taxable income, the 'earliest losses first' rule (→ subsection 36-17(7), *Income Tax Assessment Act 1997*) applies if there is a choice between using transferred tax losses and group tax losses.

As shown in this example, there are some circumstances where transferred tax losses are able to be utilised before group tax losses.

Note

'Transferred tax losses'

This worked example refers to transferred tax losses whose utilisation is subject to the available fraction method. Transferred losses utilised under the concessional method in section 707-350 of the *Income Tax (Transitional Provisions) Act 1997* must be utilised each income year only after utilisation of group losses of the same sort.

Example

Facts

A group consolidates on 1 July 2002 and is working out its taxable income for the 2005 income year.

The group's income for the 2005 income year is shown in table 1.

Table 1: Group income 2005

Income	Amount ($)	
Capital gains	1,300	(current year capital losses of $200)
Other assessable income	2,000	(deductions of $1,700)

The group's losses (group losses) are shown in table 2.

Table 2: Group losses

Sort	Amount ($)	Year incurred
Net capital loss	100	2003
Tax loss (not film)	1,500	2004

The group's remaining transferred loss (in a loss bundle with an available fraction of 0.300) is a transferred tax loss (not film) of $250, which was transferred to the head company when the group consolidated in the 2003 income year.

The transferred tax loss is to be utilised using the available fraction method.

The head company satisfies the recoupment tests for utilisation of the transferred tax loss.

Calculation

A. Determine limit for utilisation of transferred tax loss

Step 1: Work out the categories of group income or gains – subsection 707-310(3)

Table 3: Categories of group income or gains (step 1)

Column 1 Income or gains	Gross amount ($)	*Less:* allowable deductions / reductions ($)	*Less:* group / concessional losses of that kind ($)	Column 2 Income / gains available for bundle ($)
Capital gains	1,300	200	100	1,000
Other assessable income	2,000	1,700	300	nil

Although the group tax loss is $1,500, only $300 needs to be deducted as this reduces the other assessable income category to nil.

Step 2: Calculate the fraction of the income/gains that is attributable to the bundle – subsection 707-310(3)

Table 4: Fraction of income/gains attributable to each bundle (step 2)

Column 1 Income or gains	Column 2 Income / gains available for bundle	Multiplied by: available fraction (AF)	AF amount for the bundle
Capital gains	$1,000	0.300	$300
Other assessable income	$0	0.300	$0

Step 3: Work out a notional taxable income for the bundle – subsection 707-310(2)

Table 5: Net capital gain (step 3)

Capital gains	$	Losses applied	$
Capital gain	300	Transferred net capital losses	0
Total	**300**	**Total**	**0**

The notional net capital gain is $300 ($300 – nil).

Table 6: Taxable income (step 3)

Assessable income	$	Deductions	$
Net capital gain	300	Transferred tax loss (not film)	250
Other assessable income	0		
Total	**300**	**Total**	**250**

The notional taxable income is $50 ($300 – $250).

Transferred losses 'used' in working out the notional taxable income for the bundle are:

- transferred tax loss (not film) $250

This is the limit for utilisation of this transferred tax loss when determining the actual taxable income for the group.

B. Determine group's actual taxable income

Table 7: Net capital gain

Capital gains	$	Losses applied	$
Capital gains	1,300	Current year net capital losses	200
		Group net capital loss	100
Total	**1,300**	**Total**	**300**

The group's net capital gain is $1,000 ($1,300 – $300).

Table 8: Taxable income

Assessable income	$	Deductions	$
Net capital gain	1,000	Deductions	1,700
Other assessable income	2,000	Transferred tax loss (not film)	250
		Group tax loss (not film)	1,050
Total	**3,000**	**Total**	**3,000**

As the transferred tax loss is treated as having been incurred in the 2003 income year, it is fully deducted before deducting any of the group tax loss incurred in the 2004 income year. There is no specific consolidation provision to override the 'earliest losses first' rule in this situation.

References

Income Tax Assessment Act 1997, subsection 36-17(7)

Income Tax Assessment Act 1997, section 707-310; as amended by *New Business Tax System (Consolidation) Act (No.1) 2002* (No. 68 of 2002), Schedule 1

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 8

Revision history

Section C3-4-430 first published 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
10.12.04	Insert sentence in 'Commentary' clarifying the applicability of the worked example, particularly in relation to the order in which tax losses must be utilised.	Clarification.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

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Worked example

Determining if a transferred loss can be utilised – COT transfer case

Description

A head company of a consolidated group is subject to special rules in determining whether it can utilise a loss transferred to it because the continuity of ownership test (COT) was satisfied. The head company is considered to meet the COT if the 'test company' (generally, the company from which the loss was first transferred) satisfies the COT based on certain assumptions.

This example shows how the test company is identified and explains the application of the COT and same business test (SBT) to the head company.

Commentary

To determine whether a transferred loss can be utilised, the general loss recoupment tests for companies are modified by Subdivision 707-B.

Section 707-210 modifies the rules regarding satisfaction of the COT[105] for a loss transferred to the head company as a COT transfer. For this purpose, a COT transfer is defined[106] as a transfer of a loss from a company that occurs because:

- the COT is satisfied, and
- the control test conditions in section 165-15 do not exist.

In determining whether the head company is taken to have satisfied the COT in respect of a loss transferred to it as a COT transfer, ownership changes before and after the joining time are recognised.

If the loss has been transferred, as a COT transfer, for the first time to the head company from a joining company, the test company is that joining company. If the loss has been transferred to the head company in consecutive COT transfers, the test company is the first joining company in that series of loss transfers.

If the test company meets the COT based on the assumptions in subsection 707-210(4), the head company is taken to have satisfied the COT. If the test company fails the COT, the head company is taken to have failed the COT at the first time the test company does not meet the relevant conditions in section 165-12. The result of ownership testing of the test company is therefore attributed to the head company.

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[105] Section 165-12.

[106] Subsection 707-210(1A).

The assumptions made for the purposes of applying the COT to the test company are that, effectively:

1 the test company is reinstated as the owner of the loss
2 the loss year is the income year in which the test company made the loss
3 the test company is a wholly-owned subsidiary of the head company at all times from the date of transfer
4 if the loss is transferred to another head company, the test company is a wholly-owned subsidiary of the new head company from the time of that later transfer.

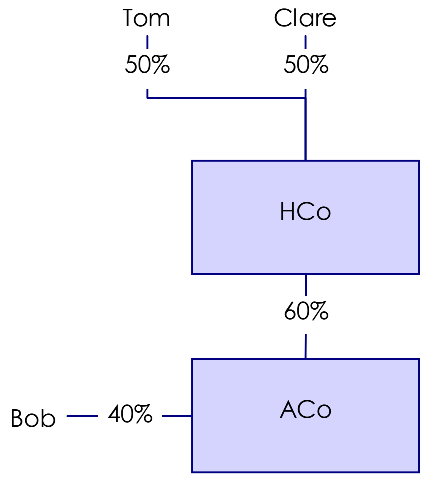
Assumptions 3 and 4 effectively 'freeze' the ownership structure below the applicable head company as at the date of transfer, so that only ownership changes above the applicable head company after that time are relevant. If the test company ceases to be a subsidiary member of the consolidated group after the date of transfer, this exit from the group is ignored for the purposes of determining whether it satisfies the COT.

Example

Facts

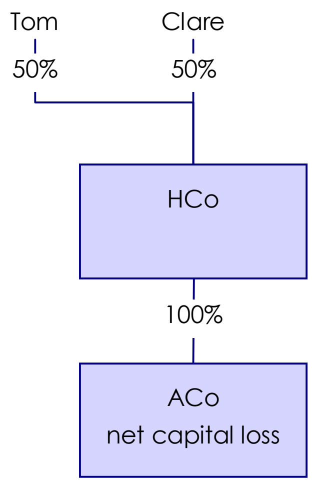
At 1 July 1999, ACo is owned 60% by HCo and 40% by Bob. The membership interests in HCo are owned 50% by Tom and 50% by Clare.

Figure 1: Ownership structure at 1 July 1999



ACo incurs a net capital loss for the year ended 30 June 2000. On 15 December 2001, ACo becomes a wholly-owned subsidiary of HCo when HCo acquires Bob's 40% membership interest.

Figure 2: Ownership structure at 15 December 2001

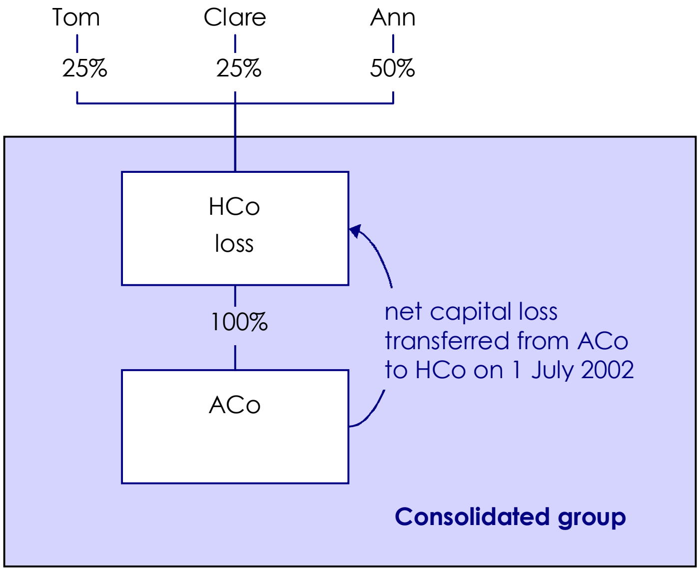


HCo chooses to form a consolidated group on 1 July 2002, with ACo as a subsidiary member. The net capital loss incurred by ACo for the 2000 income year is transferred to HCo as a COT transfer.

The consolidated group makes capital gains in both the 2003 and 2004 income years. These capital gains total less than the transferred net capital loss.

On 15 March 2004, Ann acquires one-half of each of Tom and Clare's membership interests in HCo.

Figure 3: Ownership structure at 15 March 2004



Can HCo apply the transferred net capital loss in determining its net capital gain for each of the 2003 and 2004 income years?

Calculation

To determine if HCo satisfies the COT for the loss transferred from ACo, the COT must be applied to the test company under the assumptions in subsection 707-210(4). The test company in this case is ACo, the joining company that actually incurred the net capital loss.[107]

The assumptions in determining if ACo satisfies the COT in the 2003 and 2004 income years are that:

1 ACo made the loss

2 the loss year is the 2000 income year and not the year of the transfer, and

3 ACo is a wholly-owned subsidiary of HCo from 1 July 2002.

2003 income year

ACo's ownership test period for COT purposes is from 1 July 1999 (the beginning of the loss year) to 30 June 2003 (the end of the recoupment income year). Throughout this period there are two continuing shareholders, Tom and Clare. For the entire ownership test period, Tom and Clare between them have continuously maintained the 60% interest in ACo, held indirectly through HCo, that existed at the beginning of the loss year.

The third assumption means that ACo is treated as being a subsidiary member of HCo's consolidated group from 1 July 2002. (In this case, ACo actually does continue to be wholly-owned by HCo.)

ACo satisfies the COT as continuing underlying majority ownership has been maintained.

As the test company, ACo, satisfies the COT, HCo is taken to have satisfied the COT. HCo is able to utilise an amount of the transferred net capital loss in accordance with the limit under the available fraction method in Subdivision 707-C.

2004 income year

ACo's ownership test period for COT purposes is from 1 July 1999 (the beginning of the loss year) to 30 June 2004 (the end of the recoupment income year). Throughout this period there are two continuing shareholders, Tom and Clare.

Ann's acquisition of 50% of the membership interests in HCo on 15 March 2004 means that Tom and Clare between them did not maintain a majority of the voting power and relevant rights in ACo at all times during the entire ownership test period[108]. As a result, ACo fails the COT.

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[107] Subsection 707-210(3).

[108] Tom and Clare each had a maximum membership interest at all times during the ownership test period of 25% in HCo and HCo always had at least a 60% interest in ACo. Therefore Tom and Clare each had a maximum continuous indirect interest of 15% (25% × 60%) in ACo, applying the 'same share same interest rule' in section 165-165. Because Ann acquires a 50% interest in ACo on 15 March 2004, the 'savings rule' in subsection 165-12(7) is not

HCo is therefore taken to have failed the COT on 15 March 2004 and will only be able to utilise an amount of the transferred net capital loss if it meets the SBT.[109] In applying the SBT, the test time will be 15 March 2004 and the same business test period will be the 2004 income year.

References

Income Tax Assessment Act 1997:

- Subdivisions 707-A, 707-C
- sections 165-12, 165-13, 165-15, 165-165, 707-210

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 7

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 3

Revision history

Section C3-4-440 first published 3 December 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

applicable as there is not a continuity of majority underlying ownership by Tom and Clare, ignoring section 165-165.

[109] Section 165-13.

Worked example

Cessation of a consolidated group – application of the same business test to the former head company

Description

This example illustrates how the same business test (SBT) is applied to the former head company of a consolidated group[110] where:

- the consolidated group ceases to exist, and
- the former head company of the consolidated group seeks to utilise losses it held at the time the group ceased to exist.

This example specifically relates to the situation where:

- all of the membership interests of the head company of the consolidated group are acquired by a resident company, and
- the resident company does not make a choice to form another consolidated group.

Note

For more information about:

- eligibility to be a head company → 'Eligibility tests and rules', C1-1
- the head company's ability to utilise losses → 'Treatment of losses', C3-1

Commentary

Utilisation of losses by former head company

Where the head company of a consolidated group ceases to meet the requirements[111] to be the head company of a consolidated group, the consolidated group ceases to exist → subsection 703-5(2), ITAA 1997. This would occur, for example, where the head company is acquired by a resident company.

Where the consolidated group ceases to exist, the losses of the group are retained by the former head company.

[110] The principles set out in this example would also affect the application of the SBT to the former head company of a multiple entry consolidated (MEC) group.

[111] Set out in item 1 of the table in subsection 703-15(2).

If all of the membership interests in the former head company are acquired by a resident company that does not make a choice to form another consolidated group, the former head company will exist as a stand-alone entity. The consequences for the utilisation of losses in subsequent income years by the former head company are as follows:

- The continuity of ownership test (COT) would be failed (as a result of the 100% change in the membership interests of the head company) at the time the consolidated group ceased to exist in respect of each loss being sought to be utilised.
- The SBT in section 165-13 would need to be satisfied by the former head company for the losses to be utilised.

The single entity rule and the SBT

The single entity rule in section 701-1 applies when examining the business of the former head company at a time that it was the head company of the consolidated group. Under this rule, subsidiary members are taken to be part of the head company. This means the business of the head company consists of one overall business that includes all the activities conducted by subsidiary members of the group.

From the time the consolidated group ceases to exist the single entity rule does not apply. The business of the former head company then consists of the former head company's activities as a stand-alone entity.

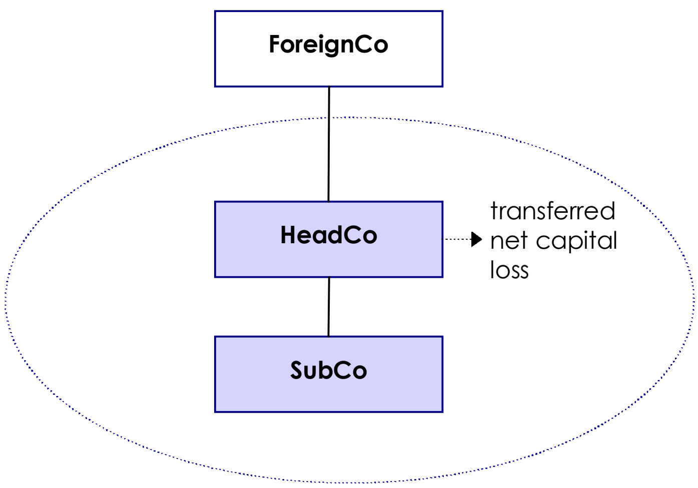
The former head company can only utilise its losses if the business it carried on at the relevant times remains unchanged.

Example

Facts

HCo and its wholly-owned subsidiary SubCo form a consolidated group on 1 July 2003 (Figure 1). HCo is wholly owned by the non-resident company ForeignCo. A net capital loss was transferred from HCo to itself at the time the group was formed.

Figure 1: ForeignCo and the HCo consolidated group, 1 July 2003 to 14 August 2004

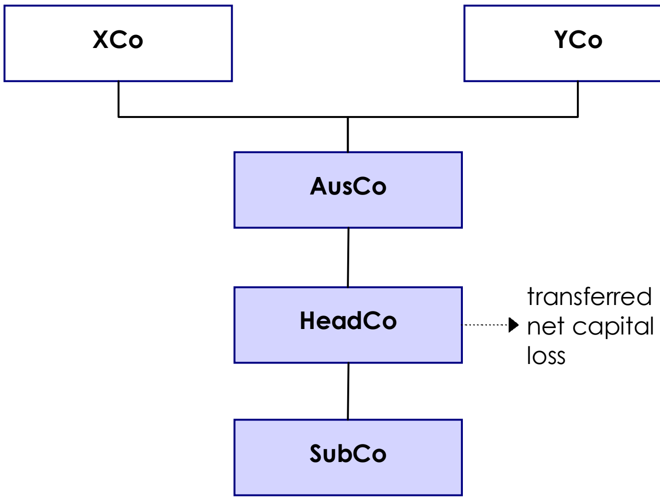


AusCo, a resident company[112], acquires 100% of the shares in HCo (Figure 2). This is the only ownership change that has impacted on the consolidated group since its formation. The change in beneficial ownership of the shares, for the purposes of the consolidation membership rules, occurs at the start of 15 August 2004. At that time, HCo is no longer eligible to be the head company of the consolidated group as it is a wholly-owned subsidiary of an entity that meets the requirements to be the head company of a consolidated group.

The consolidated group therefore ceases to exist from 15 August 2004 and the loss remains with HCo for possible utilisation. AusCo does not choose to form a consolidated group with its new wholly-owned subsidiaries.

HCo makes a capital gain in the year ended 30 June 2005 and seeks to utilise the transferred net capital loss.

Figure 2: HCo's ownership from 15 August 2004



Calculation

Loss utilisation test

The company loss recoupment rules in Division 165 determine whether the loss held by HCo may be utilised in the year ended 30 June 2005.

The change in beneficial ownership of HCo on 15 August 2004 (which resulted in the cessation of the consolidated group) means that HCo fails the COT in respect of the net capital loss being sought to be utilised. Therefore, the loss held by HCo can only be utilised if the SBT is satisfied.

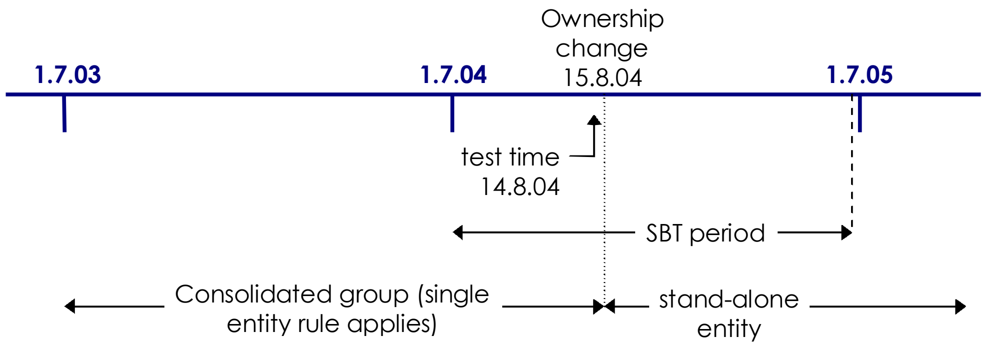
[112] That meets the requirements (in item 1 of the table in subsection 703-15(2)) to be a head company.

The SBT must be satisfied for:

- the **SBT period,** which is the income year ended 30 June 2005, and
- immediately before the **test time** on 14 August 2004 (the latest time that HCo could show that it satisfied the COT).

Figure 3 illustrates these testing points for HCo.

Figure 3: The same business test points



The business carried on by HCo immediately before the test time relates to a time that the consolidated group still exists. At that time, HCo is the head company of the consolidated group and, pursuant to the single entity rule, the business of the entire consolidated group (comprising HCo and SubCo) needs to be examined.

In the income year ended 30 June 2005 (the SBT period):

- the single entity rule applies to HCo for the time the consolidated group still exists – i.e. from 1 July 2004 to 14 August 2004 – and therefore the relevant business for that time comprises the activities of the entire consolidated group, and
- the single entity rule does not apply to HCo from the time that the consolidated group ceases to exist on 15 August 2004, and therefore the business for the time from 15 August 2004 to 30 June 2005 comprises the activities of HCo as a stand-alone entity and excludes the activities of SubCo.

The net capital loss can only be utilised by HCo in the year ended 30 June 2005 if the business of HCo for these testing times has remained unchanged.

References

Income Tax Assessment Act 1997:

- Division 165
- sections 165-212A, 165-13, 701-1
- subsections 703-5(2), 703-15(2)

Revision history

Section C3-4-450 first published 26 June 2007.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Transferred loss utilisation using value donor concession with transferred foreign losses

Description

This example shows how to determine, under the available fraction method, the limits for utilisation of losses transferred to the head company of a consolidated group. It also shows how the value donor concession is applied and how to treat foreign losses.

Note

For more information about:

- loss bundles and calculating the available fraction → 'Treatment of losses', C3-1; 'Consolidation loss provisions', C3-2-110 (high-level worked example)
- working out modified market value → 'Modified market value of a single joining entity', C3-4-110 (worked example)
- market values → 'Market valuation guidelines', C4-1
- the value donor concession → 'Adding to modified market value to reflect loss transferability', C3-4-210
- excluding entities with unrecouped foreign losses → worked example 'Transitional foreign loss makers' C3-4-550

Commentary

The available fraction for a loss bundle is applied to each category of group income or gains as reduced by any relevant deductions, including group losses (that is, losses generated by the consolidated group as opposed to transferred losses). The results are taken to be the head company's only income or gains of each type. Based on that assumption, the head company works out the maximum amount of losses of each sort it can use from the loss bundle.

Under the transitional value donor concession, a loss entity (the 'real loss-maker'), in calculating its available fraction, may add to its modified market value the modified market value of another company (the 'value donor'). This concession is set out in Subdivision 707-C of the *Income Tax (Transitional Provisions) Act 1997*.

This value donor concession has effect for working out the available fraction of a bundle of losses only so far as it affects the utilisation of a tax loss, film loss or net capital loss. It does not affect the utilisation of an overall foreign loss. The available fraction for a foreign loss in either the real loss-maker's bundle or the value donor's bundle is unaffected. This means the available fractions for the real loss-maker's and value donor's foreign losses are what they would have been had value not been donated.

Example

Facts

Assume the consolidated group structure as at the joining time (1 July 2002) as shown in figure 1.

ACo and BCo have been wholly owned by HCo since incorporation – both ACo and BCo are eligible to transfer tax losses to HCo under Division 170 group loss transfer provisions. The group's transferred losses are shown in table 1.

The consolidated group is working out its taxable income for the 2003 income year. Its income and gains for 2003 are shown in table 2.

Figure 1: Consolidated group at joining time (1 July 2002)

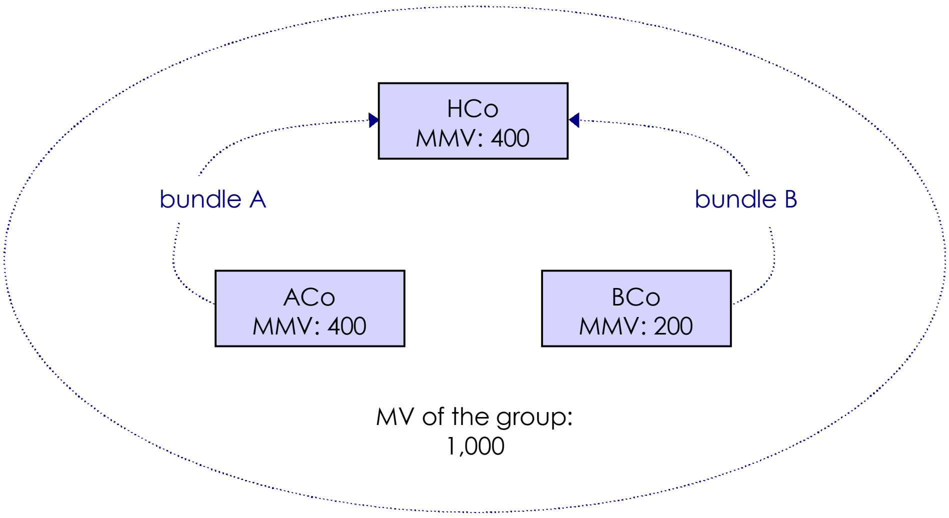


Table 1: Transferred losses

Loss bundle	Amount ($)	Sort
A	1,000	Tax loss (not film)
	300	Foreign loss
B	500	Tax loss (not film)
	200	Foreign loss

Table 2: Group income and gains for 2003 income year

Income/gains	Amount ($)
Assessable foreign income	600 (deductions are nil)
Other assessable income	1,000 (deductions are nil)

Both of the transferred foreign losses are in respect of the same class of assessable foreign income that was derived in the 2003 income year.

All the transferred losses are to be utilised using the available fraction method.

The head company satisfies the recoupment tests for the utilisation of all the transferred losses.

Under the value donor concession, HCo chooses to:

(a) add 50% of HCo's modified market value to ACo in calculating the available fraction for ACo's loss bundle; and

(b) add 50% of HCo's modified market value to BCo in calculating the available fraction for BCo's loss bundle.

Assume that, where applicable, HCo makes an election under section 79DA of the *ITAA 1936* to deduct transferred tax losses against assessable foreign income.

Note

This example is designed to illustrate how to determine the limits on utilisation of transferred losses using the available fraction method and calculation of the actual taxable income for the group. The choices made by HCo here are not purported to represent the best outcome for the group in every case where similar scenarios may exist.

Calculation

1. Applying the value donor concession

Adding modified market value to ACo:

- ACo's transferred losses (not foreign loss) are transferable to HCo. 50% of HCo's modified market value is added to ACo's.
- As a result, ACo's available fraction (AF) is:

$$(400 + [0.5 \times 400]) \div 1{,}000 = 0.6$$

Adding modified market value to BCo:

- BCo's transferred losses (not foreign loss) are transferable to HCo. 50% of HCo's modified market value is added to BCo's.
- As a result, BCo's available fraction (AF) is:

$$(200 + [0.5 \times 400]) \div 1{,}000 = 0.4$$

In determining the limit for utilising transferred losses, other than foreign losses, the available fractions to be used are 0.6 for bundle A and 0.4 for bundle B. In this example there are only transferred tax losses that have limits determined using these available fractions.

The available fractions to be used to determine the limit for utilising transferred foreign losses are determined on the basis that the modified market value is not donated. These available fractions are 0.4 for bundle A (i.e. 400/1,000) and 0.2 for bundle B (i.e. 200/1,000).

2. Determine limits for utilisation of transferred tax losses

Step 1: Work out the categories of group income or gains – subsection 707-310(3)

Table 3: Categories of group income or gains (step 1)

Column 1 Income or gains	Gross amount	*Less:* allowable deductions/ reductions	*Less:* group/ concessional losses of that kind	Column 2 Income/ gains available for bundle
Assessable foreign income	$600	–	–	$600
Other assessable income	$1,000	–	–	$1,000

Step 2: Calculate the fraction of the income/gains that is attributable to each bundle – subsection 707-310(3)

Table 4: Fraction of income/gains attributable to each bundle (step 2)

Column 1 income or gains	Loss bundle	Column 2 income/gains available for bundle	Multiplied by: available fraction (AF)	AF amount for the bundle
Assessable foreign income	Bundle A	$600	0.6	$360
	Bundle B	$600	0.4	$240
Other assessable income	Bundle A	$1,000	0.6	$600
	Bundle B	$1,000	0.4	$400

Step 3(a): Work out a notional taxable income for bundle A – subsection 707-310(2)

Table 5: Assessable foreign income (step 3a)

Foreign income	$	Losses applied	$
Assessable foreign income	360	Transferred foreign loss	300
Total	**360**	**Total**	**300**

The (notional) assessable foreign income is $60 ($360 – $300).

Table 6: Taxable income (step 3a)

Assessable income	$	Deductions	$
Assessable foreign income	60	Transferred tax loss	660
Other assessable income	600		
Total	**660**	**Total**	**660**

The notional taxable income is nil ($660 – $660).

The utilisation of bundle A's transferred tax loss in step 3 in determining the relevant notional taxable income is as follows:

- transferred tax loss $660

This is the limit for utilisation of this transferred loss when determining the actual taxable income for the group.

Step 3(b): Work out a notional taxable income for bundle B – subsection 707-310(2)

Table 7: Assessable foreign income (step 3b)

Foreign income	$	Losses applied	$
Assessable foreign income	240	Transferred foreign loss	200
Total	**240**	**Total**	**200**

The (notional) assessable foreign income is $40 ($240 – $200)

Table 8: Taxable income (step 3b)

Assessable income	$	Deductions	$
Assessable foreign income	40	Transferred tax loss	440
Other assessable income	400		
Total	**440**	**Total**	**440**

The (notional) taxable income is nil ($440 – $440)

The utilisation of bundle B's transferred tax loss in step 3 in determining the relevant notional taxable income is as follows:

- transferred tax loss $440

This is the limit for utilisation of this transferred loss when determining the actual taxable income for the group.

3. Determine limits for utilisation of transferred foreign losses

Step 1: Work out the categories of group income or gains – subsection 707-310(3)

Table 9: Categories of group income or gains (step 1)

Column 1 income or gains	Gross amount	*Less:* allowable deductions/ reductions	*Less:* group/ concessional losses of that kind	Column 2 income/ gains available for bundle
Assessable foreign income	$600	–	–	$600
Other assessable income	$1,000	–	–	$1,000

Step 2: Calculate the fraction of the income/gains that is attributable to each bundle – subsection 707-310(3)

Table 10: Fraction of income/gains attributable to each bundle (step 2)

Column 1 income or gains	Loss bundle	Column 2 income/gains available for bundle	Multiplied by: available fraction (AF)	AF amount for the bundle
Assessable foreign income	Bundle A	$600	0.4	$240
	Bundle B	$600	0.2	$120
Other assessable income	Bundle A	$1,000	0.4	$400
	Bundle B	$1,000	0.2	$200

Step 3(a): Work out a notional taxable income for bundle A – subsection 707-310(2)

Table 11: Assessable foreign income (step 3a)

Foreign income	$	Losses applied	$
Assessable foreign income	240	Transferred foreign loss	240
Total	**240**	**Total**	**240**

The (notional) assessable foreign income is nil ($240 – $240).

The calculation of notional taxable income is not necessary in this instance because foreign losses can only be utilised against assessable foreign income.

The utilisation of bundle A's transferred foreign loss in step 3 is as follows:

- transferred foreign loss $240

This is the limit for utilisation of this transferred loss when determining the actual taxable income for the group.

Step 3(b): Work out a notional taxable income for bundle B – subsection 707-310(2)

Table 12: Assessable foreign income (step 3b)

Foreign income	$	Losses applied	$
Assessable foreign income	120	Transferred foreign loss	120
Total	**120**	**Total**	**120**

The (notional) assessable foreign income is nil ($120 – $120).

The calculation of notional taxable income is not necessary in this instance because foreign losses can only be utilised against assessable foreign income.

The utilisation of bundle B's transferred foreign loss in step 3 is as follows:

- transferred foreign loss $120

This is the limit for utilisation of this transferred loss when determining the actual taxable income for the group.

4. Determine group's actual taxable income

Table 13: Assessable foreign income

Foreign income	$	Losses applied	$
Assessable foreign income	600	Transferred foreign loss (bundle A)	240
		Transferred foreign loss (bundle B)	120
Total	**600**	**Total**	**360**

The group's assessable foreign income is $240 ($600 – $360).

Table 14: Taxable income

Assessable income	$	Deductions	$
Assessable foreign income	240		
Other assessable income	1,000	Transferred tax loss – bundle A	660
		Transferred tax loss – bundle B	440
Total	**1,240**	**Total**	**1,100**

The group's taxable income is $140 ($1,240 – $1,100).

Transferred losses that are carried forward are:

- transferred foreign loss (bundle A) $60
- transferred foreign loss (bundle B) $80
- transferred tax loss (bundle A) $340
- transferred tax loss (bundle B) $60

References

Income Tax Assessment Act 1997, Division 170

Income Tax Assessment Act 1997, Subdivision 707-C; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Income Tax (Transitional Provisions) Act 1997, Subdivision 707-C; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 2

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapters 8 and 9

Income Tax (Transitional Provisions) Act 1997, Division 701D; as inserted by *Taxation Laws Amendment Act No. 1, 2004* (No. 101 of 2004)

Income Tax Assessment Act 1997, subsection 713-225(6A); as inserted by *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (No. 83 of 2004), Schedule 2, Part 5

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 2) Bill 2004, paragraphs 2.61 – 2.62

Revision history

Section C3-4-510 first published 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on recent and proposed changes to consolidation rules.	Recent and proposed legislative amendments.
26.10.05	Reference to entities with unrecouped foreign losses, p. 1, removal of note on recent and proposed changes to consolidation rules.	Legislative amendments.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Concessional method for utilising transferred losses

Description

This example shows how to apply the concessional method for utilising losses, which is available for certain losses ('concessional losses') transferred to a consolidated group during the transitional period (that is, 1 July 2002 to 30 June 2004). This method replaces the limits on utilisation that would otherwise apply under the available fraction method.

Commentary

Concessional losses can be used by the head company of the group over three years, subject to it having sufficient income or gains against which those losses can be offset (and provided the relevant recoupment tests are satisfied).

Concessional losses are losses that:

- were originally made outside the group by a company (the real loss-maker) for an income year ending on or before 21 September 1999
- are transferred by the real loss-maker to the head company when the group consolidates before 1 July 2004
- are transferred because the continuity of ownership test (COT) and the control test were satisfied, and
- have not been previously transferred to a group.

The concessional method is optional and, if chosen, applies to all eligible losses in a loss bundle.

Example

Facts

A consolidated group forms on 1 July 2002. A $600 net capital loss incurred by a company in the 1998 income year is transferred to the head company because the COT and the control test are satisfied. The head company does not have any other net capital losses.

The group has capital gains in income years as follows:

- $180 in 2003
- $250 in 2004
- $300 in 2005.

The group does not have any capital losses in these income years.

The head company satisfies the recoupment tests for utilisation of the transferred net capital loss in each of these three income years. The head company chooses to use the concessional method to utilise this loss.

Calculation

The transferred net capital loss satisfies the conditions to be a concessional loss. The limits on utilising the loss are calculated below.

2003 income year

The limit on utilisation of the loss is $200, being one-third of the amount of the loss.

$180 of the loss can be utilised in the 2003 income year, being the amount of the group's capital gains for that year.

2004 income year

The limit on utilisation of the concessional loss is $220, being the difference between:

- two-thirds of the loss ($400), and
- the amount of $180 utilised in the 2003 income year.

As the group's capital gains are greater than this limit, the head company can utilise $220 of the loss in the 2004 income year.

2005 income year

The limit on utilisation of the concessional loss is $200, being the difference between:

- the amount of the loss ($600), and
- the amounts utilised in the 2003 income year ($180) and the 2004 income year ($220).

As the group's capital gains are greater than this limit, the head company can utilise the remaining $200 of the loss in the 2005 income year.

References

Income Tax Assessment Act 1997, section 707-120; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Income Tax (Transitional Provisions) Act 1997, Subdivision 707-C; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 2

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 9

Revision history

Section C3-4-520 first published (excluding drafts) 2 December 2002.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Concessional method for utilising transferred losses – consolidation part-way through income year

Description

This example shows how to apply the concessional method for utilising losses, which is available for certain losses ('concessional losses') transferred to the head company of a consolidated group during the transitional period (that is, 1 July 2002 to 30 June 2004). This method replaces the limits on utilisation that would otherwise apply under the available fraction method.

Commentary

Under section 707-350, concessional losses can be used by the head company of the group over three years, subject to it having sufficient income or gains against which those losses can be offset (and provided the relevant recoupment tests are satisfied).

Concessional losses are losses that:

- were originally made outside the group by a company (the real loss-maker) for an income year ending on or before 21 September 1999
- are transferred from the real loss-maker to the head company when the group consolidates before 1 July 2004
- are transferred because the continuity of ownership test (COT) and the control test were satisfied, and
- have not been previously transferred to a consolidated group.

The concessional method is optional and, if chosen, applies to all eligible losses in a loss bundle.

The apportionment rules in section 707-335 do not apply to the utilisation of concessional losses. Provided it has sufficient income or gains, the head company can utilise one-third of concessional losses in the first income year ending after the date of consolidation, even when the group consolidates part-way through the income year. → Taxation Determination TD 2004/90

Example

Facts

A consolidated group forms on 1 January 2003. The head company, HCo, balances at the end of each financial year (30 June). A $900 net capital loss incurred by a company in the 1997 income year is transferred to HCo because the COT and the control test are satisfied. HCo does not have any other net capital losses.

HCo has capital gains in income years as follows:

- $450 in 2003
- $250 in 2004
- $800 in 2005.

HCo does not have any capital losses in these income years.

HCo satisfies the recoupment tests for utilisation of the transferred net capital loss in each of these three income years. It chooses to use the concessional method to utilise this loss in the first year.

Calculation

The transferred net capital loss satisfies the conditions to be a concessional loss. The limits on utilising the loss are calculated below.

2003 income year

The limit on utilisation of the loss is $300, being one-third of the amount of the loss. There is no apportionment, even though the consolidated group formed six months into HCo's income year.

As HCo's capital gains are greater than this limit, it can utilise $300 of the loss in the 2003 income year.

HCo will bring to account a net capital gain of $150 for the 2003 income year.

2004 income year

The limit on utilisation of the loss is $300, being the difference between:

- two-thirds of the loss ($600), and
- the amount of $300 utilised in the 2003 income year.

Accordingly, $250 of the loss can be utilised in the 2004 income year, being the amount of HCo's capital gains for the year.

HCo has neither a net capital gain nor net capital loss for the 2004 income year.

2005 income year

The limit on utilisation of the loss is $350, being the difference between:

- the amount of the loss ($900), and
- the amounts utilised in the 2003 income year ($300) and 2004 income year ($250).

As HCo's capital gains are greater than this limit, it can utilise the remaining $350 of the loss in the 2005 income year.

HCo will bring to account a net capital gain of $450 for the 2005 income year.

References

Income Tax Assessment Act 1997, section 707-335; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Income Tax (Transitional Provisions) Act 1997, section 707-350; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 2

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 9

Taxation Determination TD 2004/90 – Income tax: consolidation: is there any apportionment under section 707-335 of the *Income Tax Assessment Act 1997* to the limits calculated under subsection 707-350(3) of the *Income Tax (Transitional Provisions) Act 1997* regarding the utilisation of losses?

Revision history

Section C3-4-525 first published 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
26.10.05	Reference to new taxation determination.	

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Utilisation of transferred losses using both concessional and available fraction methods

Description

This example shows how to determine the amount of transferred losses that can be utilised, and apply these limits in calculating a group's actual taxable income, where the losses are utilised under both the concessional and available fraction methods.

Note

For more information about:

- loss bundles and calculating the available fraction → 'Treatment of losses', C3-1; 'Consolidation loss provisions', C3-2-110 (high-level worked example)
- the concessional method → 'Concessional method for utilising transferred losses', C3-4-520

Commentary

The utilisation of losses transferred to the head company of a consolidated group is generally subject to limits determined under the available fraction method. A concessional method for utilising losses is available for certain losses ('concessional losses') transferred to a consolidated group during the transitional period (that is, 1 July 2002 to 30 June 2004). If chosen, the concessional method will replace the limits on utilisation that would otherwise apply under the available fraction method for those losses.

The available fraction for a loss bundle is applied to each category of group income or gains as reduced by any relevant deductions, including group losses (that is, losses generated by the consolidated group as opposed to transferred losses) and concessional losses of the relevant sort (but *not* transferred losses whose use is limited by the available fraction method).

In working out the group's taxable income, concessional losses of a sort are effectively used before other transferred losses of the same sort. Those transferred tax losses subject to the available fraction method can then be utilised against the remaining assessable income but only after being applied against the relevant amount of exempt income.

Example

Facts

A consolidated group forms on 1 July 2002 and is working out its taxable income for the 2004 income year. The group does not generate any film income in the 2003 income year.

The group's income for the 2004 income year consists of:

- assessable film income $1,000
- net exempt film income $100
- other assessable income $1,000

The group's transferred losses (included in one bundle) and their available fraction are shown in table 1.

Table 1: Transferred losses

Loss bundle	Loss amount	Sort	Available fraction	Able to be utilised concessionally?
Bundle A	$900	film	0.400	yes
	$500	film	0.400	no

The head company satisfies the recoupment tests in respect of the utilisation of the transferred film losses in the 2004 income year.

The transferred film losses of $900 satisfy the conditions to be treated as concessional losses and the head company chooses to use the concessional method of utilisation.

Calculation

A. Determine limits for utilisation of transferred losses

Step 1: Work out the categories of group income or gains – subsection 707-310(3)

Table 2: Categories of group income or gains (step 1)

Column 1 Income or gains	Net amount ($)	*Less:* group / concessional losses of that kind ($)	Column 2 Income / gains available for bundle ($)
Exempt film income	100	100*	0
Assessable film income	1,000	500*	500
Other assessable income	1,000		1,000

* Worked out as 900 x 2/3 = 600. As the 2004 income year is the second year ending after the initial transfer time, the limit on utilising the concessional loss is worked out in accordance with Item 2 of the table in subsection 707-350(3).

Step 2: Calculate the fraction of the income/gains that is attributable to bundle A – subsection 707-310(3)

Table 3: Fraction of income/gains attributable to each bundle (step 2)

Column 1 Income or gains	Column 2 amount	Multiplied by: available fraction (AF)	AF amount for the bundle
Exempt film income	$0	0.400	$0
Assessable film income	$500	0.400	$200
Other assessable income	$1,000	0.400	$400

Step 3: Work out a (notional) taxable income for bundle A – subsection 707-310(2)

Table 4: Taxable income (step 3)

Assessable income	$	Deductions	$
Assessable film income	200	Transferred film losses	200*
Other assessable income	400		
Total	**600**	**Total**	**200**

* Film losses are only deductible against film income.

The (notional) taxable income is $400 ($600 – $200).

Transferred losses 'used' in working out notional taxable income for bundle A are:

- transferred film losses $200

This is the limit for utilisation of transferred losses when determining the actual taxable income for the group.

B. Determine the group's actual taxable income

Table 5: Exempt income

Exempt income	$	Deductions	$
Net exempt film income	100	Concessional film losses	100
Total	**100**	**Total**	**100**

Net exempt income remaining is $0.

Table 6: Taxable income

Assessable income	$	Deductions	$
Assessable film income	1,000	Concessional film losses	500*
Other assessable income	1,000	Transferred film losses	200*
Total	**2,000**	**Total**	**700**

* Film losses are only deductible against film income.

The group's taxable income for the 2004 income year is $1,300 ($2,000 – $700).

The balance of unutilised transferred losses as at 1 July 2004 is:

- transferred film losses (concessional) $300 ($900 – $600)
- transferred film losses (other) $300 ($500 – $200)

References

Income Tax Assessment Act 1997, subsections 707-310(2), 707-310(3); as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Income Tax (Transitional Provisions) Act 1997, subsection 707-350(2); as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 2

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapters 8 and 9

Revision history

Section C3-4-530 first published 2 December 2002.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Amount of CGT event L1 capital loss that can be utilised

Description

As shown in this example, a capital loss made under CGT event L1 is available to be claimed by the head company over five years.

Commentary

The reduction amount calculated under section 705-57[1] is treated as a capital loss, which is referred to as a 'CGT event L1 capital loss'. This capital loss is spread over five income years, starting in the income year in which the entity becomes a subsidiary member of the consolidated group.[2]

Generally, net capital losses are applied in the order they are made (→ section 102-15). The CGT event L1 capital loss forms part of the net capital loss for the year in which the event happens. The ordering rule applies to this net capital loss even though the ability to use that part of the net capital loss attributable to the CGT event L1 capital loss is spread over five years.

Example

Facts

HCo is the head company of a consolidated group.

In the 2005–06 income year, HCo makes the following capital gains and losses:

• capital gains	$200,000
• CGT event L1 capital loss	$500,000
• other current year capital losses	$80,000

In the 2006–07 income year, HCo makes a net capital loss of $100,000.

In the 2007–08 income year, HCo makes capital gains of $240,000.

[1]Under section 705-57, there is a reduction in the tax cost setting amount for the head company of certain assets of an entity joining a consolidated group where the group's membership interests in the entity were previously pre-CGT membership interests.

[2] There are transitional provisions whereby a CGT event L1 capital loss may be claimed in less than five years in certain circumstances.

Calculation

Table 1 shows how HCo works out its net capital gain for the three income years.

Table 1: HCo net capital gain

	2006 ($)	2007 ($)	2008 ($)
(CGT event L1 capital loss: $500,000)			
Capital gains	200,000	Nil	240,000
less Current year group capital loss	80,000	100,000	Nil
less CGT event L1 capital loss	100,000*	–	–
less Prior year net capital losses	–	–	240,000**
Net capital gain for the income year	20,000	–	Nil
Net capital loss for the income year	400,000†	100,000	–
Carried forward net capital losses	400,000	100,000 (2007)	60,000 (2007)
		400,000 (2006)	200,000 (2006)

* This is calculated as: 1/5 x 500,000 = 100,000 (subsection 104-500(4)).

** This comprises:

(a) $200,000 of the 2006 net capital loss, attributable to the CGT event L1 capital loss, calculated as:

(3/5 x 500,000) - 100,000 = 200,000 (item 2, subsection 104-500(5)), and

(b) $40,000 of the 2007 net capital loss.

† The remaining $400,000 of the CGT event L1 capital loss forms part of the net capital loss for the 2006 income year. As the group capital loss for this year was fully applied, all of the 2006 net capital loss is attributable to the CGT event L1 capital loss. HC has both a net capital gain and a net capital loss for this income year.

References

Income Tax Assessment Act 1997, sections 104-500, 705-57; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 4

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, Chapter 1

Revision history

Section C3-4-540 first published 2 December 2002.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Transitional foreign loss makers

Description

This example shows how the transitional foreign loss maker provisions in Division 701D of the *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A) apply.

Commentary

The transitional foreign loss maker provisions allow an entity that has foreign losses to remain outside a consolidated group for a period of up to three years, or until its foreign losses are utilised, as opposed to being subject to the loss utilisation regime of Subdivision 707-C of the ITAA 1997.

The excluded entity is called a 'transitional foreign loss maker'. The time that it is excluded from the group is the 'transitional time'.

A head company of a consolidated group[113] can choose to exclude an entity from the group for a transitional time if the conditions in section 701D-10 of the IT(TP)A are satisfied:

- the group forms before 1 July 2004
- the transitional time is not later than three years after the group forms
- the transitional foreign loss maker would otherwise be a subsidiary member of the group at the transitional time
- the transitional foreign loss maker is a wholly-owned subsidiary of the head company throughout the period from the start of 1 July 2002 to the transitional time → the 'continuous ownership condition', subsection 701D-10(2)
- the transitional foreign loss maker incurred an overall foreign loss[114] in the 2001–02 income year or earlier and this loss:
  - remains unutilised in any income year ending before the transitional time
  - is one that would have been transferred[115] to the head company had the transitional foreign loss maker become a subsidiary member of the consolidated group at the formation time, and

    → the 'foreign loss condition', subsection 701D-10(3)
- the transitional foreign loss maker does not hold a membership interest in another entity that, but for these provisions, would be a subsidiary member of the consolidated group → the 'no-subsidiary condition', subsection 701D-10(4).

[113] Includes a MEC group. Refer to section 719-15 which has the effect of modifying subsection 701D-10(2) of the IT(TP)A with respect to a MEC group.

[114] As defined in section 160AFD of the *Income Tax Assessment Act 1936*.

[115] After satisfying relevant transfer tests in Subdivision 707-A of the ITAA 1997.

The head company must notify the Tax Office, in accordance with section 701D-15 of the IT(TP)A, that it has chosen to exclude the transitional foreign loss maker from the consolidated group. The notification must be made by the later of 30 July 2004 and the date of lodgement of the head company's first consolidated return (or if a return is not required, the date it would otherwise have been due). The choice cannot be revoked. → subsections 701D-15(3) and (4), IT(TP)A 1997

Although the transitional foreign loss maker is excluded from the consolidated group, it remains a member of the relevant *consolidatable* group. This means that it cannot, while it is outside the group, be the recipient company or originating company in a roll-over under Subdivision 126-B, ITAA 1997. Nor can it participate in a transfer of a tax loss or capital loss between companies under Division 170, ITAA 1997 or choose to have treated as part of itself an Australian branch of a foreign bank under the thin capitalisation rules. → subsection 701D-10(5), IT(TP)A 1997

Example

Facts

A wholly-owned group consists of a head company (HCo) and three subsidiaries, ACo, TFLM1 and TFLM2. The group existed before 1 July 2002. HCo elects to form a consolidated group from 1 July 2003 (within the transitional period) and makes the choice to exclude TFLM1 and TFLM2 from the consolidated group under section 701D-15 of the IT(TP)A.

As at 1 July 2003 (commencement of the transitional time) all of the conditions outlined in section 701D-10 of the IT(TP)A are satisfied.

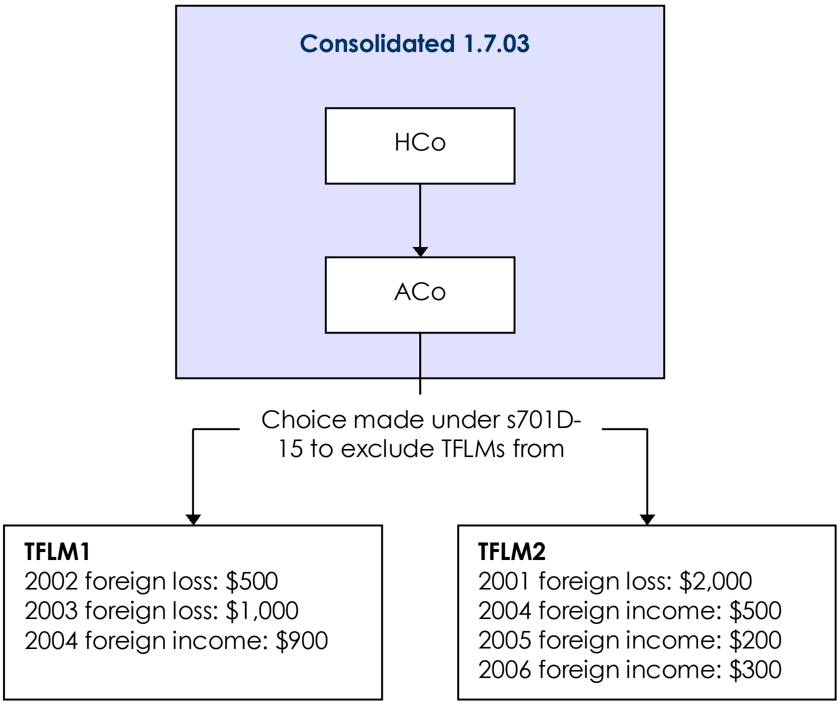
Table 1 shows the foreign income and losses of the two transitional foreign loss makers for the income years 2001–2006.

Table 1: Foreign income and losses of transitional foreign loss makers

	2001	2002	2003	2004	2005	2006
TFLM1						
Unrecouped foreign loss	–	$500	$1,000	–	–	–
Foreign income	–	–	–	$900	–	–
TFLM2						
Unrecouped foreign loss	$2,000	–	–	–	–	–
Foreign income	–	–	–	$500	$200	$300

Note: For each transitional foreign loss maker, all foreign losses and foreign income are of the same class.

Figure 1: Exclusion of transitional foreign loss makers



Calculation

TFLM1

In the year ended 30 June 2004, TFLM1 fully recoups the 2002 foreign loss of $500. The 2003 foreign loss is partially utilised to the extent of $400 and the remaining $600 is carried forward to the 2005 income year. As TFLM1 has fully recouped its 2002 foreign loss, it no longer satisfies the foreign loss condition. Therefore, the transitional time ends before the maximum three years allowed under the provisions, and TFLM1 must become a member of the consolidated group from 1 July 2004.

The remaining $600 is transferred to HCo at the joining time, provided the transfer tests[116] are satisfied.

TFLM2

This company does not fully recoup its 2001 foreign loss of $2,000 before 1 July 2006. Assuming that all of the conditions in section 701D-10 of the IT(TP)A continue to be satisfied, TFLM2 remains outside the consolidated group for the maximum three-year transitional time, until 30 June 2006. TFLM2 becomes a member of the consolidated group on 1 July 2006. The unrecouped foreign loss of $1,000 is transferred to HCo at the joining time, provided the transfer tests are satisfied.[117]

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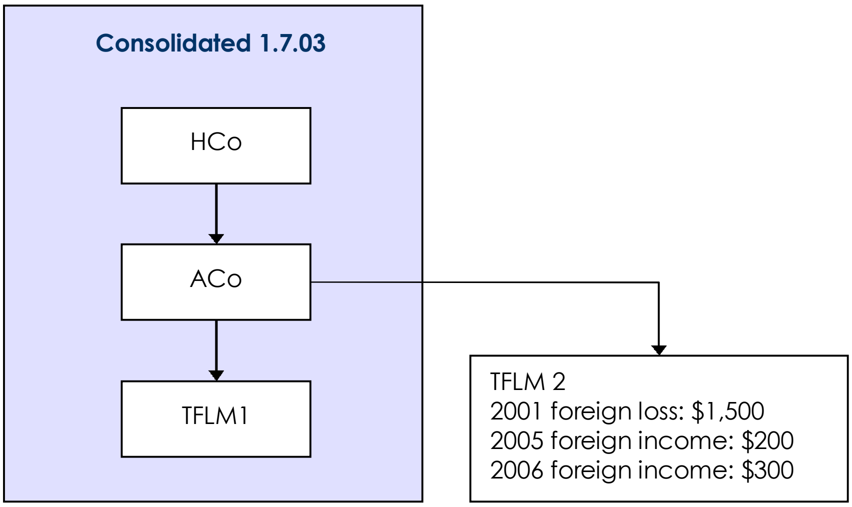
[116] Subdivision 707-A, ITAA 1997.

[117] Subdivision 707-A, ITAA 1997.

Figure 2: TFLM1 joins consolidated group 1.7.04



Losses that are transferred to the head company trigger an adjustment to existing available fractions (if any) in the consolidated group.

→ 'Adjusting available fraction – another loss entity joins the group', C3-4-330

This adjustment can be avoided if the head company chooses to cancel the transfer of the unutilised foreign loss → section 707-145. Losses that are not transferred to the head company cannot be utilised by any entity for an income year ending after the joining time → section 707-150.

Transitional period concessions

As TFLM1 was excluded from the consolidated group for a period prior to joining the group, it is not eligible for any of the transitional concessions → Subdivision 707-C. These concessions are only available to entities that become members of a group at the formation time.

References

Income Tax (Transitional Provisions) Act 1997 – as amended by *Taxation Laws Amendment Act (No. 1) 2004*:

- Division 701D
- Subdivision 707-C:
  - paragraph 707-325(1)(ca)
  - paragraph 707-350(1)(da)
- section 719-15

Income Tax Assessment Act 1997:

- Subdivision 707-A
- Subdivision 707-C

Income Tax Assessment Act 1936:

- Section 160AFD

Explanatory Memorandum to Taxation Laws Amendment Bill (No. 7) 2003, Chapter 4

Revision history

Section C3-4-550 first published 10 December 2004.

Further revisions are described below.

Date	Amendment	Reason
26.10.05	Reference to notification requirement, p. 2.	Legislative amendment.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Amount of transferred losses that can be utilised – foreign loss component of a tax loss

Description

This example shows the application of the available fraction method in determining the limits for utilisation of transferred losses where there is a foreign loss component of a tax loss.

Note

For more information about the available fraction method → 'Treatment of losses', C3-1; 'Consolidation loss provisions', C3-2-110; 'Amount of transferred losses that can be utilised', C3-4-410.

Commentary

Under changes made to the tax treatment of foreign losses:

- The foreign loss quarantining rules have been repealed. Foreign losses are not quarantined from domestic assessable income (or from assessable foreign income of a different class).
- Resident taxpayers, including the head company of a consolidated group, can offset domestic losses against assessable foreign income.
- Transitional rules provide for the conversion of past foreign losses to a tax loss with a limit on utilisation in the four year transitional period.
- Special transitional rules apply to consolidated groups.

These changes apply from the first income year starting on or after 1 July 2008 (the commencement year).

Generally, unrecouped foreign losses for an earlier income year are grouped together and converted to a tax loss.[118] This tax loss will have a foreign loss component, being the amount of the convertible foreign loss for that income year.

If an entity would otherwise have a tax loss for that income year, its tax loss is the sum of that amount plus the convertible foreign loss.

The available fraction method does not limit the utilisation of the foreign loss component of a converted tax loss in the first four years beginning with the

[118] Only overall foreign losses that were originally made in any of the most recent 10 income years (disregarding the operation of section 707-140 of the ITAA 1997) ending before the start of the commencement year are eligible to be converted to tax losses → subsection 770-5(2), IT(TP)A. Furthermore, certain reductions are required to each overall foreign loss in relation to a class of assessable foreign income in accordance with the method statement in section 770-10 of the IT(TP)A.

commencement year. Instead, an annual deduction limit in section 770-30 of the IT(TP)A will apply.[119] After the four year transitional period, any remaining foreign loss component is utilised subject to the available fraction method.

For the purpose of working out how much of the remaining tax losses in a bundle the head company can utilise in an income year in the four year transitional period, the head company applies the available fraction for the bundle to income remaining after deductions for all foreign loss components (both group and transferred). → subsection 770-105(3), IT(TP)A

Example

Facts

A consolidated group is working out its taxable income for the 2008-09 income year.

The group's carry forward transferred losses at the start of the 2008-09 income year are set out in table 1 and its income and gains for the income year are shown in table 2. Assume all losses were transferred to the head company at the same joining time, namely the date of consolidation 1 July 2003.[120]

Assume that the loss recoupment tests are satisfied in respect of all the losses sought to be deducted.

Table 1: Transferred losses

Loss bundle	Amount ($'000)	Sort	Available fraction
A	1,000 300	Tax loss Foreign loss	0.6
B	500 200	Tax loss Foreign loss	0.4

Table 2: Group income and gains for 2008-09 income year

Income/gains	Amount ($'000)
Other assessable income (domestic and foreign)	1,600 (deductions are nil)

[119] Subsection 770-105(2) of the IT(TP)A. The annual deduction limit does not apply where the sum of all convertible foreign losses is $10,000 or less. → section 770-15, IT(TP)A

[120] These losses are therefore taken to have been made in the 2003-04 income year by the operation of subsection 707-140 of the ITAA 1997.

Calculation

1. Determine deduction limit for the foreign loss component of tax losses

Convertible foreign loss amounts of the relevant tax losses are aggregated to arrive at a starting total, which is then divided into 5 equal portions. The head company can use a maximum of one portion in the commencement year
→ subsection 770-30(1), IT(TP)A.

The deduction limit for the foreign loss component is shown in table 3.

Table 3: Deduction limit for foreign loss component of tax losses

Loss bundle	Convertible foreign loss ($'000)	Starting total (sum of convertible foreign losses) ($'000)	*Multiplied* by 1/5	*equals* allowable deduction ($'000)
A	300	500	100	100
B	200			

2. Determine limits for utilisation of transferred tax losses

Step 1: Work out the categories of group income or gains – subsection 707-310(3)

Table 4: Categories of group income or gains (step 1)

Column 1 Income or gains	Gross amount ($'000)	*Less:* allowable deductions/ reductions ($'000)	*Less:* group/ concessional losses of that kind ($'000)	Column 2 Income/ gains available for bundle ($'000)
Other assessable income	1,600	100	–	1,500

The head company chooses that the $100,000 deduction for foreign loss component comprises $60,000 from bundle A and $40,000 from bundle B, being 1/5th of the starting amount for each bundle.

Step 2: Calculate the fraction of the income/gains that is attributable to each bundle – subsection 707-310(3)

Table 5: Fraction of income/gains attributable to each bundle (step 2)

Column 1 income or gains	Loss bundle	Column 2 income/gains available for bundle ($'000)	*Multiplied by:* available fraction (AF)	AF amount for the bundle ($'000)
Other assessable income	Bundle A	1,500	0.6	900
	Bundle B	1,500	0.4	600

Step 3(a): Work out a notional taxable income for bundle A – subsection 707-310(2)

Table 6: Notional taxable income – bundle A

Assessable income	($'000)	Deductions	($'000)
Other assessable income	900	Transferred tax loss	900
Total	**900**	**Total**	**900**

The notional taxable income is nil ($900,000 – $900,000).

The transferred tax loss amount of $900,000 is the limit for utilisation of bundle A's transferred loss when determining the actual taxable income for the group.

Step 3(b): Work out a notional taxable income for bundle B – subsection 707-310(2)

Table 7: Notional taxable income – bundle B

Assessable income	($'000)	Deductions	($'000)
Other assessable income	600	Transferred tax loss	500
Total	**600**	**Total**	**500**

The (notional) taxable income is $100,000 ($600,000 – $500,000).

The transferred tax loss amount of $500,000 is the limit for utilisation of bundle B's transferred loss when determining the actual taxable income for the group.

4. Determine group's actual taxable income

Table 8: Taxable income

Assessable income	($'000)	Deductions	($'000)
Other assessable income	1,600	Transferred tax loss – foreign loss component	100
		Transferred tax loss – bundle A	900
		Transferred tax loss – bundle B	500
Total	**1,600**	**Total**	**1,500**

The group's taxable income is $100,000 ($1,600,000 – $1,500,000).

Transferred losses carried forward are:

- transferred tax loss (bundle A): $100,000 ($1,000,000 – $900,000)
- transferred tax loss (bundle B): $0 ($500,000 – $500,000)
- foreign loss component of a converted tax loss: $400,000 (comprising $240,000 for bundle A and $160,000 for bundle B)

Note that in the fourth income year after 2008-09, the undeducted amount of the foreign loss component is utilised under the available fraction method using the available fractions of 0.6 and 0.4 for bundles A and B respectively (subject to any adjustments in the meantime).[121]

[121] The purpose of section 770-1 of the IT(TP)A is to permit a taxpayer to convert, to a tax loss, unrecouped overall foreign losses such that they can be deducted, subject to a drip-feed method, from assessable income for income years starting on or after the commencement year. It follows that any remaining foreign loss component after the transitional period has expired is deductible subject to the available fraction calculated in respect of tax losses contained in the respective bundles (in this case, $100,000 plus any remaining foreign loss component from the deduction limit during the previous four years in the transitional period). This requires tracking of the utilisation of each loss while subject to the drip-feed approach such that loss balances can be established at the expiry of the transitional period.

References

Income Tax Assessment Act 1997, Subdivision 707-C

Income Tax (Transitional Provisions) Act 1997, Subdivisions 770-A and 770-B

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapters 8 and 9
Explanatory Memorandum to the Tax Laws Amendment (2007 Measures No.4) Bill 2007, Chapter 1

Revision history

Section C3-4-560 first published 30 June 2009.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Transfer and utilisation of a tax loss with a foreign loss component where the loss maker joins part-way through the head company's income year

Description

This example shows the application of the transfer rules under Subdivision 707-A of the *Income Tax Assessment Act 1997* (ITAA 1997) and the deduction limit under section 770-30 of the *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A) where a subsidiary member with a convertible foreign loss joins part-way through the head company's income year.

Note

For more information on:

- transferring losses to a consolidated group see → 'Treatment of losses', C3-1; 'Consolidation loss provisions', C3-2-110 (high-level worked example); and worked examples C3-3-105 to C3-3-270.
- the application of the available fraction method in determining the limits for utilisation of transferred losses where there is a foreign loss component of a tax loss see → 'Amount of transferred losses that can be utilised – foreign loss component of a tax loss', C3-4-560.

Commentary

Subdivision 707-A of the ITAA 1997 sets out the rules governing the transfer of unutilised losses from a joining entity to a head company. As per paragraph 707-115(1)(a), the Subdivision only applies in respect of a 'sort of loss'. As a convertible foreign loss is treated as a tax loss, this requirement is satisfied.

In addition, paragraph 707-115(1)(b) of the ITAA 1997 requires that the 'sort of loss' must be made by the joining entity in an income year ending before the joining time. Specifically section 707-120 of the ITAA 1997 requires a loss to be tested as if the joining entity was in a position to utilise the loss itself in the context of the trial year and had sufficient income or gains to do so. To the extent that the loss could be so utilised, it is transferred as at the joining time.

As section 770-1 of the IT(TP)A treats the convertible foreign loss of an earlier income year as a tax loss only for the purposes of the commencement year and later income years, a modification is made so that the joining entity is not prevented from satisfying the requirement where the joining time is in the commencement year. This modification, in section 770-90 of the IT(TP)A, ensures that section 770-1 operates in relation to the trial year in such circumstances.[122]

When a tax loss having a foreign loss component is transferred to the head company of a consolidated group, the head company inherits the following history:

- the foreign loss component of the tax loss, and
- the starting total (ie, the sum of all convertible foreign losses for which an entity is taken to have a tax loss → section 770-20, IT(TP)A) for the loss parcel to which the tax loss belongs.

→ section 770-95, IT(TP)A

Where a subsidiary member has a non-membership period, it will deduct the foreign loss component of the tax loss up to the deduction limit in section 770-30 of the IT(TP)A (subject to the usual loss recoupment tests) in that non-membership period. This is because a non-membership period is treated as an income year under subsection 701-30(3) of the ITAA 1997.

If the non-membership period ends before the end of the head company's income year mentioned in an item in the table in subsection 770-30(1) of the IT(TP)A, the head company must reduce its deduction limit by the amount utilised by the joining entity in that non-membership period.
→ section 770-100, IT(TP)A

Example

Facts

SubCo joins a consolidated group part-way through the head company's income year on 1 January 2009. SubCo has a tax loss with a 100% foreign loss component in a loss parcel with a starting total of $500,000. SubCo has a deduction limit of 1/5 of the starting total ($500,000 x 1/5 = $100,000 → subsection 770-30(1)) in its commencement year, 1 July 2008 to 31 December 2008 (the non-membership period). Due to insufficient income, SubCo could only deduct $50,000 of the loss in the non-membership period.

It is necessary to determine the extent to which this tax loss with the foreign loss component can be transferred from SubCo to HCo, the head company, under Subdivision 707-A of the ITAA 1997 and how much of the tax loss can be utilised by HCo in the 2009 income year. (As the first income year starting on or after 1 July 2008, this is also the commencement year.)

[122] Note that the deduction limit imposed on the foreign loss component of a tax loss does not prevent the whole of the tax loss (or the undeducted amount) from being transferred from a joining entity to a head company – section 770-85 of the IT(TP)A.

Calculation

1. Determine the unutilised amount of the foreign loss component at the joining time

$500,000 – $50,000* = $450,000

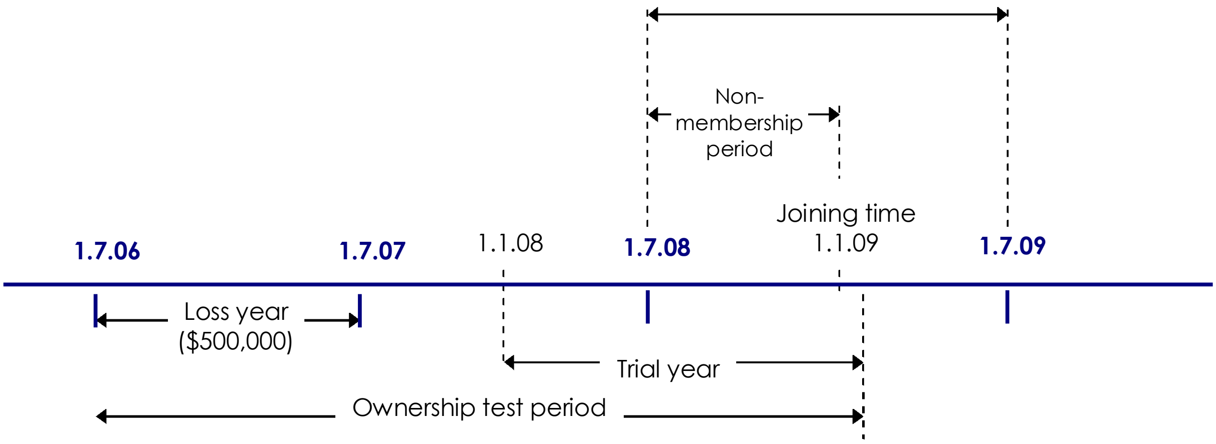
(*SubCo could only deduct $50,000 in the non-membership period due to insufficient income.)

2. Transferring the tax loss to HCo at the joining time

Sections 165-12 and 165-15 of the ITAA 1997 require the company to test for same owners and same control throughout the ownership test period – from the start of the loss year to the end of the income year. In this case, assume:

- the loss year is 1 July 2006 to 30 June 2007, and
- the income year is represented by the trial year 1 January 2008 to just after 1 January 2009.

Figure 1: Ownership test period



As part of the trial year occurs before the start of the commencement year, section 770-90 of the IT(TP)A applies to ensure that the conversion of the foreign loss to a tax loss under section 770-1 of the IT(TP)A is possible in relation to the trial year. The convertible foreign loss is therefore treated as a tax loss for an income year beginning before the commencement year.

If the testing process concludes that there is no ownership or control failure over the relevant test period, the $450,000 tax loss is transferred to the head company.

3. Utilising the transferred tax loss

If the \$450,000 tax loss is transferred to HCo on SubCo joining the consolidated group, HCo is treated as having made the loss in the 2009 income year.

Section 770-95 ensures the following pre-transfer characteristics of the tax loss are retained:

- the foreign loss component of the tax loss is \$450,000
- the starting total is \$500,000.

As the 2009 income year is the commencement year, HCo's deduction limit in respect of the transferred tax loss is calculated in accordance with item 1 of the table in subsection 770-30(1) of the IT(TP)A, as follows:

(\$500,000 x 1/5) = \$100,000

Subsection 770-100(2) of the IT(TP)A then reduces this limit by the amount worked out under subsection 770-100(3). In effect, this limit is reduced by the amount utilised by SubCo in respect of its non-membership period as follows:

\$100,000 – \$50,000 = \$50,000

References

Income Tax Assessment Act 1997, Subdivision 707-A

Income Tax (Transitional Provisions) Act 1997, Subdivisions 770-A and 770-B

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 6

Explanatory Memorandum to the Tax Laws Amendment (2007 Measures No.4) Bill 2007, Chapter 1

Revision history

Section C3-4-570 first published 15 April 2010.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Apportioning the use of transferred losses

Description

As shown in this example, the use of transferred losses is apportioned if the available fraction for a bundle of losses applies for only part of the income year or the available fraction changes during the income year.

Note

For more information about:

- loss bundles and calculating the available fraction → 'Treatment of losses', C3-1; 'Consolidation loss provisions', C3-2-110 (high-level worked example)
- adjustments to available fractions → C3-4-310, C3-4-320, C3-4-330, C3-4-340, C3-4-350, C10-2-310 (worked examples)

Commentary

Apportionment applies if:

- losses in a bundle are transferred to the head company by a subsidiary member that is joining the group part-way through the head company's income year, or
- available fractions are adjusted during the year. Adjustments to available fractions are required if additional loss bundles are transferred to the head company at a later transfer time or because there has been a capital injection or a non-arm's length transaction → subsection 707-320(2). In these cases, available fractions have different numerical values for different periods of the income year.

Apportionment where a new loss entity joins a group ensures that a subsidiary's losses are only offset against income generated by the group after the subsidiary became a member of the group.

This apportionment does not apply to losses transferred by a company to itself in its capacity as a head company. → 'Apportioning the use of the head company's own losses', C3-4-620

Apportionment where available fractions have been adjusted during the year ensures that an adjusted available fraction that is less than the previous fraction only applies from the date of the event that initiated the adjustment[123]. This allows the group the benefit of the previous higher available fraction for the period of its application.

[123] An adjustment can only result in the same or a reduced fraction.

The apportionment rule in section 707-335 is drafted as a general principle so that if apportionment is required the group cannot use more of its transferred losses than is reasonable having regard to the relevant matters listed.

The relevant matters listed at section 707-335 ensure:

- apportionment is consistent with the available fraction method of determining the use of transferred losses → section 707-310
- the number of days the head company holds the bundle in the income year is taken into account[124], and
- the number of days the available fraction has a particular value is taken into account.

One approach would be, for each loss bundle, to work out the 'full-year' utilisation amount for each relevant available fraction, and then apportion each amount by the relevant 'number of days' proportion applicable to the available fraction used.

Another approach would be to work out a single 'weighted-average' available fraction for each loss bundle. The weighting would reflect the number of days in the income year that each fraction is relevant. The weighted-average fraction could then be used in applying the available fraction method.

This worked example illustrates each of these approaches.

Example

Facts

A consolidated group forms on 1 January 2004, half-way through the head company's income year. A loss is transferred to the head company (HC) from subsidiary member ACo at the formation time. An available fraction of 0.418 is established for bundle ACo at the initial transfer time.

The group acquires another subsidiary member, BCo, on 1 March 2004. A loss is transferred from BCo to HC at the joining time and the available fraction calculated for the bundle is 0.372. This sequence of events is represented in figures 1 and 2.

[124] Referred to as the 'transferee's loss-holding period'

Figure 1: The group acquires BCo

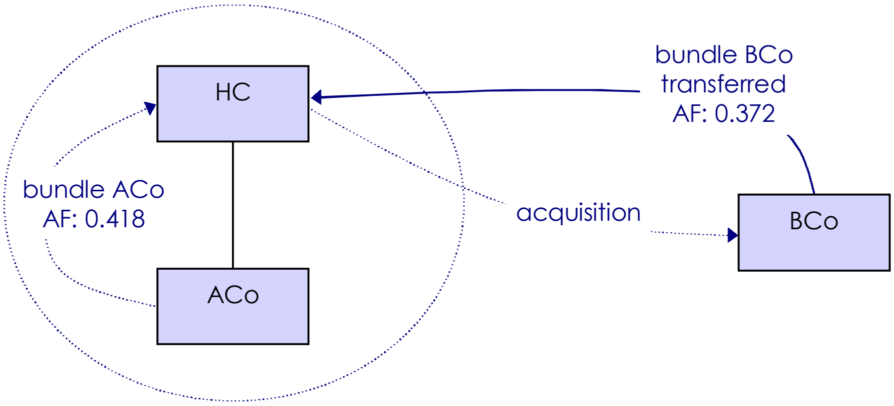
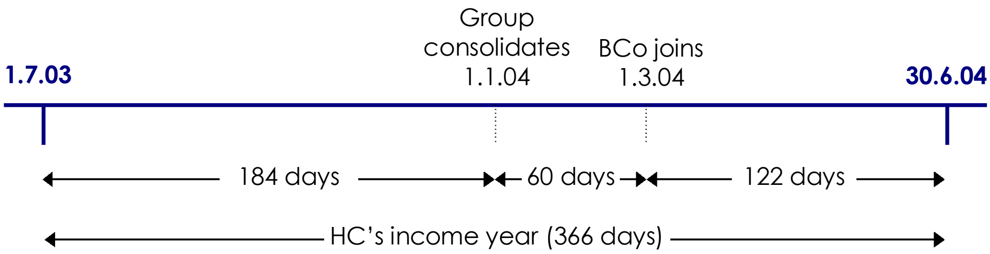


Figure 2: The 2004 income year



HC's transferred losses for the 2004 income year are shown in table 1.

Table 1: Transferred losses

Loss bundle	Unused transferred losses
Bundle ACo	$350 tax loss (not film)
Bundle BCo	$200 tax loss (not film)

HC satisfies the recoupment tests for the utilisation of both transferred losses in the 2004 income year.

HC generates $2,750 of assessable income. Its deductions in relation to that income are $1,150.

Calculation

The group must first adjust the available fraction for bundle ACo as a result of the later transfer of bundle BCo. This is done in accordance with item 3 in the table in subsection 707-320(2).

The available fraction for bundle ACo is multiplied by the item 3 factor:

ACo : 0.418 x [1 – 0.372] = 0.263

Method 1: Apportion the full-year amount

A. Apply the 3-step available fraction method

Step 1 – *Work out the categories of group income or gains – subsection 707-310(3)*

Table 2: Categories of group income or gains (step 1)

Category of income or gains	Gross amount ($)	*Less:* other allowable deductions/ reductions ($)	*Less:* group/ concessional losses of that kind($)	Income/ gains available for the bundle ($)
Other assessable income	2,750	1,150	–	1,600

Step 2 – *Calculate the fraction of the income/gains that is attributable to each bundle – subsection 707-310(3)*

Table 3: Fraction of income/gains attributable to each bundle (step 2)

Category of income or gains	Loss bundle	Step 1 amount	*Multiplied by:* available fraction (AF)	*Multiplied by:* apportionment fraction	AF amount for the bundle	
Other assessable income	Bundle ACo	$1,600	0.418	60/366	$110	$250
		$1,600	0.263	122/366	$140	
	Bundle BCo	$1,600	0.372	122/366	$198	

Step 3(a) – *Work out a notional taxable income for bundle ACo – subsection 707-310(2)*

Table 4: Taxable income (step 3a)

Assessable income	$	Deductions/losses	$
Other assessable income	250	Transferred tax loss	250
Total	**250**	**Total**	**250**

The (notional) taxable income for bundle ACo is $0 ($250 – $250).

$250 of the loss in bundle ACo can be used by HC when it determines its actual taxable income for the 2004 income year.

Step 3(b) *– Work out a notional taxable income for bundle BCo – subsection 707-310(2)*

Table 5: Taxable income (step 3b)

Assessable income	$	Deductions/losses	$
Other assessable income	198	Transferred tax loss	198
Total	**198**	**Total**	**198**

The (notional) taxable income for bundle BCo is $0 ($198 – $198).

$198 of the loss in bundle BCo can be used by HC when it determines its actual taxable income for the 2004 income year.

B. Determine group's actual taxable income

Table 6: Taxable income

Assessable income	$	Deductions/losses	$
Other assessable income	2,750	Deductions	1,150
		Transferred tax losses (bundle ACo)	250
		Transferred tax losses (bundle BCo)	198
Total	**2,750**	**Total**	**1,598**

The group's taxable income is $1,152 ($2,750 – $1,598).

The loss bundles as at the start of the 2005 income year contain the losses shown in table 7.

Table 7: Losses in loss bundles at start of 2005 income year

Bundle	Loss	Available fraction	Sort
ACo	$100 ($350 – $250)	0.263	Tax loss (not film)
BCo	$2 ($200 – $198)	0.372	Tax loss (not film)

Method 2: Apply a weighted-average available fraction to the bundle

A. Determine the weighted-average fraction for each bundle

Table 8: Weighted-average available fraction for each bundle

Loss bundle	Available fraction (AF)	*Multiplied by:* apportionment fraction	Apportioned AF	*Sum:* weighted-average AF
Bundle ACo	0.418	60/366	0.069	0.157
	0.263	122/366	0.088	
Bundle BCo	0.372	122/366	0.124	0.124

B. Apply the 3-step available fraction method using the weighted-average AF

***Step 1** – Work out the categories of group income or gains – subsection 707-310(3)*

Table 9: Categories of group income or gains (step 1)

Category of income or gains	Gross amount ($)	*Less:* other allowable deductions/ reductions ($)	*Less:* group/ concessional losses of that kind($)	Income/ gains available for the bundle ($)
Other assessable income	2,750	1,150	–	1,600

***Step 2** – Calculate the fraction of the income/gains that is attributable to each bundle – subsection 707-310(3)*

Table 10 Fraction of income/gains attributable to each bundle (step 2)

Category of income or gains	Loss bundle	Step 1 amount	*Multiplied by:* weighted-average AF	AF amount for the bundle
Other assessable income	Bundle ACo	$1,600	0.157	$251
	Bundle BCo	$1,600	0.124	$198

***Step 3(a)** – Work out a notional taxable income for bundle ACo – subsection 707-310(2)*

Table 11: Taxable income (step 3a)

Assessable income	$	Deductions/losses	$
Other assessable income	251	Transferred tax loss	251
Total	**251**	**Total**	**251**

The (notional) taxable income for bundle ACo is $0 ($251 – $251).

$251 of the loss in bundle ACo can be used by HC when it determines its actual taxable income for the 2004 income year.

***Step 3(b)** – Work out a notional taxable income for bundle BCo – subsection 707-310(2)*

Table 12: Taxable income (step 3b)

Assessable income	$	Deductions/losses	$
Other assessable income	198	Transferred tax loss	198
Total	**198**	**Total**	**198**

The (notional) taxable income for bundle BCo is $0 ($198 – $198).

$198 of the loss in bundle BCo can be used by HC when it determines its actual taxable income for the 2004 income year.

C. Determine group's actual taxable income

Table 13: Taxable income

Assessable income	$	Deductions/losses	$
Other assessable income	2,750	Deductions	1,150
		Transferred tax losses (bundle ACo)	251
		Transferred tax losses (bundle BCo)	198
Total	**2,750**	**Total**	**1,599**

The group's taxable income is $1,151 ($2,750 – $1,599).

The loss bundles as at the start of the 2005 income year contain the losses shown in table 14.

Table 14: Losses in loss bundles at start of 2005 income year

Bundle	Loss	Available fraction	Sort
ACo	$99 ($350 – $251)	0.263	Tax loss (not film)
BCo	$2 ($200 – $198)	0.372	Tax loss (not film)

References

Income Tax Assessment Act 1997 – as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1:

- section 707-310
- subsection 707-320(2)
- section 707-335

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 8

Revision history

Section C3-4-610 first published 2 December 2002.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Apportioning the use of the head company's own losses

Description

A head company's use of its own prior year losses, transferred to itself on formation of the consolidated group, is unrestricted in relation to the pre-formation period. Its use of these losses for the post-formation period is subject to the available fraction applicable to those losses.

This example shows how to apportion the utilisation of such prior year losses where a consolidated group forms part-way through the head company's income year.

Note

For more information about:

- loss bundles and calculating the available fraction → 'Treatment of losses', C3-1; 'Consolidation loss provisions', C3-2-110 (high-level worked example)
- apportioning the use of transferred losses → C3-4-610 (worked example)

Commentary

On formation of a consolidated group, losses made by the head company in its capacity as a single entity may be transferred to itself in its capacity as the head company of the group → subsection 707-120(1). An available fraction is calculated for the bundle containing those losses, which is used to limit their annual rate of use by the group.

In determining the utilisation of the head company's own prior year transferred losses, when the head company joins part-way through the income year, the apportionment rule in paragraph 707-335(3)(e) ensures that:

- the available fraction calculated on formation only applies to group income and gains attributable to the post-formation period, and
- the head company's use of its own prior year transferred losses is unrestricted in respect of income or gains attributable to the pre-formation period.

The number of days in the pre-formation period is relevant in determining this apportionment. Apportioning the head company's use of its own losses in this way also better matches the treatment of subsidiary members who are able to use their own losses without restriction for their non-membership period prior to joining.

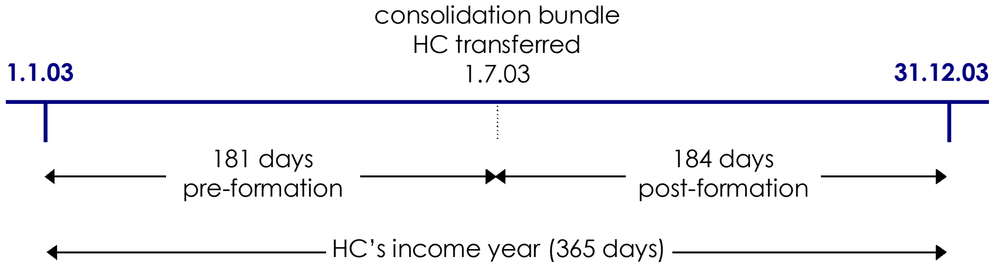
The apportionment rule in paragraph 707-335(3)(e) is drafted so that the head company can use its own losses in respect of the pre-formation period as though the losses had been in a bundle from the start of the income year and an available fraction of 1 had applied to that bundle up until the time of transfer.

Example

Facts

A head company (HC) has a substituted accounting period (income year) ending on 31 December. It forms a consolidated group on 1 July 2003, part-way through its income year. A prior year tax loss of $6,000 is transferred to HC from itself at the formation time. The loss is transferred in bundle HC. An available fraction of 0.126 is established for bundle HC at the initial transfer time.

Figure 1: Formation year



HC's transferred loss for the 2003 income year is shown in table 1.

Table 1: HC transferred losses

Loss bundle	Unused transferred losses
Bundle HCo	$6,000 tax loss (not film)

The head company satisfies the recoupment tests for utilisation of the transferred loss in the 2003 income year.

The head company generates $26,275 of assessable income. Its deductions in relation to that income are $15,678.

Calculation

A. Apply the 3-step available fraction method

Step 1 – *Work out the categories of group income or gains – subsection 707-310(3)*

Table 2: Categories of group income or gains (step 1)

Category of income or gains	Gross amount ($)	*Less:* other allowable deductions/ reductions ($)	*Less:* group/ concessional losses of that kind($)	Income/ gains available for the bundle ($)
Other assessable income	26,275	15,678	–	10,597

Step 2 – *Calculate the fraction of the income/gains that is attributable to each bundle – subsection 707-310(3)*

Table 3: Fraction of income/gains attributable to each bundle (step 2)

Category of income or gains	Loss bundle	Step 1 amount	*Multiplied by:* available fraction (AF)	*Multiplied by:* apportionment fraction	AF amount for the bundle
Other assessable income	Bundle HC	$10,597	1.000	181/365	$5,255
		$10,597	0.126	184/365	$673

Step 3 – *Work out a notional taxable income for bundle HC – subsection 707-310(2)*

Table 4: Taxable income (step 3)

Assessable income	$	Deductions/losses	$
Other assessable income	5,928	Transferred tax loss	5,928
Total	**5,928**	**Total**	**5,928**

The (notional) taxable income for bundle HC is $0 ($5,928 – $5,928).

$5,928 of the loss in bundle HC can be used by HC when it determines its actual taxable income for the 2003 income year.

B. Determine group's actual taxable income

Table 5: Taxable income

Assessable income	$	Deductions/losses	$
Other assessable income	26,275	Deductions	15,678
		Transferred tax losses (bundle HC)	5,928
Total	**26,275**	**Total**	**21,606**

The group's taxable income is $4,669 ($26,275 – $21,606).

Bundle HC as at the start of the 2004 income year contains the unrecouped loss shown in table 6.

Table 6: Unrecouped loss in bundle HC at start of 2004 income year

Bundle	Loss	Available fraction	Sort
HC	$72 ($6,000 – $5,928)	0.126	Tax loss (not film)

References

Income Tax Assessment Act 1997, sections 707-310, 707-335; as amended by *New Business Tax System (Consolidation) Act (No.1) 2002* (No. 68 of 2002), Schedule 1

Income Tax Assessment Act 1997, paragraph 707-335(3)(e); as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 6

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, Chapter 8

Revision history

Section C3-4-620 first published 2 December 2002 and updated 28 May 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Apportioning the use of transferred losses in formation year

Description

The use of transferred losses is apportioned where a consolidated group forms part-way through the head company's income year.

This example shows an apportionment method for the formation year as an alternative to a strict pro rata approach.

Note

For more information about:

- loss bundles and calculating the available fraction → 'Treatment of losses', C3-1; 'Consolidation loss provisions', C3-2-110 (high-level worked example)
- apportioning the use of transferred losses → 'Apportioning the use of transferred losses', C3-4-610 (worked example)

Commentary

Section 707-335 limits the utilisation of losses in a bundle when losses are transferred to the head company after the start of the income year. This ensures that a subsidiary's losses are only offset against income generated by the group after the subsidiary became a member of the group[125].

The apportionment rule in section 707-335 is drafted so that if apportionment is required the group cannot use more of its transferred losses than is reasonable having regard to the matters listed in subsection 707-335(3). The matters provide that:

- apportionment is consistent with the available fraction method of determining the use of transferred losses → section 707-310
- the number of days the head company holds the bundle in the income year is taken into account[126]
- the number of days the available fraction has a particular value is taken into account, and
- any other relevant matters are taken into account.

In the formation year, a relevant matter can be that pre-formation period income is only derived by the head company as a single entity, whereas post-

[125] This apportionment does not apply to losses transferred by a company to itself in its capacity as a head company → 'Apportioning the use of the head company's own losses', C3-4-620.

[126] Referred to as the 'transferee's loss-holding period'.

formation income is derived by all members of the group. This means apportionment on a strict 'number of days' basis may not properly reflect group income generated in the post-formation period.

The formula below determines the fraction of head company income attributable to the post-formation period. This fraction is multiplied by the 'full-year limit' of the loss bundle[127] to give the utilisation limit for that particular bundle in the formation year.

The formula is based on income (net of deductions) being earned uniformly throughout the formation year by the head company alone as a proportion of income (net of deductions) earned by all group members. Whether the formula is appropriate to use in a particular case can depend on the economic position of the head company and group during the formation year. For example, an injection of capital into the group that significantly changes the head company's contribution to group profitability could result in the formula being inappropriate.

The limit of transferred losses using the formula must be 'reasonable' to satisfy section 707-335.

The formula is:

$$\text{Fpost} = \frac{1}{1 + [\text{AF(HC)} \times \text{Dpre/Dpost}]}$$

where:

Fpost is the fraction of head company income attributable to the post-formation period

AF(HC) is the available fraction as if the head company had transferred losses to itself at consolidation

Dpre is the number of days in the pre-formation period

Dpost is the number of days in the post-formation period

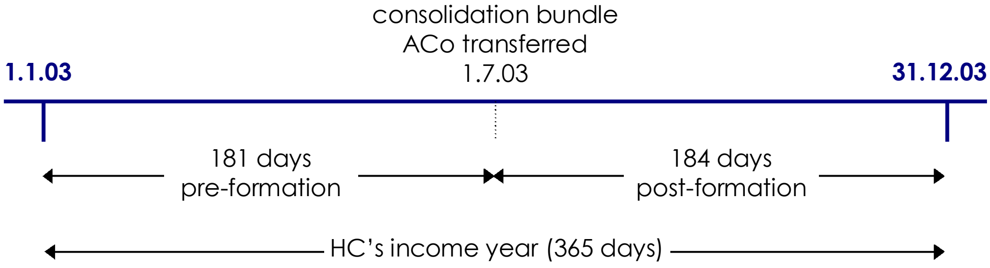
Example

Facts

A head company (HC) has a substituted accounting period (income year) ending on 31 December. It forms a consolidated group on 1 July 2003, part-way through its income year. A prior year tax loss of $6,000 is transferred to HC from subsidiary member ACo at the formation time. The loss is transferred in bundle ACo. An available fraction of 0.750 is established for bundle ACo at the initial transfer time of 1 July 2003.

[127] The 'full-year limit' is the limit worked out under section 707-310 ignoring the application of section 707-335.

Figure 1: Formation year



HC's transferred loss for the 2003 income year is shown in table 1.

Table 1: HC transferred losses

Loss bundle	Unused transferred losses
Bundle ACo	$6,000 tax loss (not film)

HC satisfies the recoupment tests for utilisation of the transferred loss in the 2003 income year.

In the 2003 income year HC generates $26,300 of assessable income and its deductions in relation to that income are $15,700.

HC as a single entity has contributed to group income (net of deductions) at the same rate throughout the formation year ended 31 December 2003. Accordingly, although HC did not transfer a loss to itself at consolidation, it is still necessary to calculate an available fraction for HC as if it had transferred a loss to itself at consolidation. This is the 'AF(HC)' component in the formula on page 2. If HC had transferred a loss to itself at group formation, the available fraction calculated for bundle HC at that time would have been 0.075.

Calculation

A. Apply the three-step available fraction method

Step 1 – *Work out the categories of group income or gains – subsection 707-310(3)*

Table 2: Categories of group income or gains (step 1)

Category of income or gains	Gross amount ($)	*Less:* other allowable deductions/ reductions ($)	*Less:* group/ concessional losses of that kind($)	Income/ gains available for the bundle ($)
Other assessable income	26,300	15,700	–	10,600

Step 2 *– Calculate the fraction of the income/gains that is attributable to each bundle – subsection 707-310(3)*

Table 3: Fraction of income/gains attributable to each bundle (step 2)

Category of income or gains	Loss bundle	Step 1 amount	*Multiplied by:* available fraction (AF)	*Multiplied by:* apportionment fraction	AF amount for the bundle
Other assessable income	Bundle ACo	$10,600	0.750	0.931	$7,401

The apportionment fraction is the fraction of head company income attributable to the post-formation period as calculated by the formula:

$$\text{Fpost} = \frac{1}{1 + [0.075 \times 181/184]} = 0.931$$

Step 3 *– Work out a notional taxable income for bundle ACo – subsection 707-310(2)*

Table 4: Taxable income (step 3)

Assessable income	$	Deductions/losses	$
Other assessable income	7,401	Transferred tax loss	6,000
Total	**7,401**	**Total**	**6,000**

The (notional) taxable income for bundle ACo is $1,401 ($7,401 – $6,000).

All of the $6,000 tax loss in bundle ACo can be used by HC when it determines its actual taxable income for the 2003 income year.

B. Determine group's actual taxable income

Table 5: Taxable income

Assessable income	$	Deductions/losses	$
Other assessable income	26,300	Deductions	15,700
		Transferred tax losses (bundle ACo)	6,000
Total	**26,300**	**Total**	**21, 700**

The group's taxable income is $4,600 ($26,300 – $21,700).

As there are no losses remaining in bundle ACo, it now ceases to exist (by the operation of subsection 707-315(3)).

References

Income Tax Assessment Act 1997 – as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1:

- section 707-310
- section 707-335
- section 707-315

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 8

Revision history

Section C3-4-630 first published 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
10.12.04	Clarify necessity for HC to calculate an available fraction for itself to use the formula on page 2, even though HC did not transfer a loss at consolidation.	Clarification.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Transfer of tax losses from head company of consolidated group to Australian branch of a foreign bank

Description

Amendments to Division 170 of the *Income Tax Assessment Act 1997* ensure that transfers of tax losses and net capital losses occur only in limited circumstances. Loss transfers continue to be permitted between members of the same wholly-owned group where one of the parties to the transfer is an Australian branch of a foreign bank, and the other is either the head company of a consolidated group, the head company of a MEC group, or a non-member of a consolidatable group[128].

This example shows how a loss that was transferred at the joining time to the head company from a subsidiary member is subsequently transferred post-consolidation to an Australian branch of a foreign bank within the same wholly-owned group.

Commentary

Although an Australian branch of a foreign bank was eligible to be part of a wholly-owned group for the purpose of loss transfers[129] under Division 170 prior to the amendments, it is not eligible to be a member of a consolidated or consolidatable group under section 703-15. Accordingly, Division 170 was retained and amended to ensure that loss transfers involving an Australian branch of a foreign bank could continue to be made in certain circumstances.

While company groups that do not choose to consolidate may not transfer losses, modifications to Subdivisions 170-A and 170-B enable loss transfers involving losses made by either a branch or a company prior to consolidation to continue after consolidation provided certain conditions are met. Their treatment depends in part on whether the transfer is from a head company of a consolidated group to a branch or from a branch to a head company.

Losses incurred after consolidation are still eligible to be transferred between a company and a foreign bank branch under Division 170 without modification.

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[128] Generally, the amendments to Division 170 apply for income years or non-membership periods starting after 30 June 2003. For companies joining a consolidated or MEC group, the amendments apply for income years or non-membership periods starting on or after the date of consolidation in certain circumstances.

[129] Sections 160ZZZG (tax losses) and 160ZZZH (net capital losses) of the *Income Tax Assessment Act 1936*.

Transfer of previously transferred losses from a head company to a foreign bank branch

Losses that have been transferred to the head company of a consolidated group are able to be transferred to a foreign bank branch if all the conditions of Division 170 as amended are satisfied. The amendments modify the conditions for the relationship test and the utilisation test.

Relationship test

Generally, each loss owner, while it owned the loss, is required to have been in existence and a member of the same wholly-owned group as the branch[130]. That is:

- the original loss company must be a member of the same wholly-owned group as the branch during the loss year while both are in existence and until the loss is transferred to the head company of the consolidated group, and
- the head company and the branch must maintain the same wholly-owned group relationship from the time the loss is transferred to the head company until the end of the income year in which the loss is transferred to the branch (the deduction year) or while they are both in existence during that period.

There is no requirement that the original loss-maker, or any later 'owner' of the loss, be a member of the consolidated group at the time the head company transfers the loss to the branch.

Utilisation test (foreign bank branch[131])

Passing the utilisation test in Division 170 requires that the branch would not be prevented by Divisions 165 or 175 from deducting or applying the loss if the branch had incurred the loss in the original loss year[132]. Since a head company is taken to have incurred a transferred loss for the income year of transfer (under section 707-140), a modification provides that the branch tests its ability to utilise the loss on the assumption that it made the loss in the original loss year, instead of the head company's loss year.

After the head company utilises its transferred losses for an income year in accordance with the limits determined in Subdivision 707-C, any amount of transferred losses remaining in a loss bundle are available in full for transfer to the foreign bank branch. This is also relevant for losses whose utilisation is limited by section 707-350 (concessional losses). Such transfers are available even where the head company's final tax position is such that it has a taxable

[130] Sections 170-32 and 170-132.

[131] The utilisation test also applies to the head company of the consolidated group (it is necessary to consider Subdivision 707-B when applying the utilisation test to the head company).

[132] Subsections 170-15(3) and 170-115(3).

income, or has excess exempt income remaining. The amount able to be transferred is limited by the amount the head company would carry forward to the next income year and the amount the foreign bank branch can utilise[133].

Ordering

A head company transferring losses to a branch must do so in the following order[134]:

1 group losses

2 COT concessional losses:

- these are transferred losses that are utilised in accordance with the transitional provisions in section 707-350, and

3 other transferred losses:

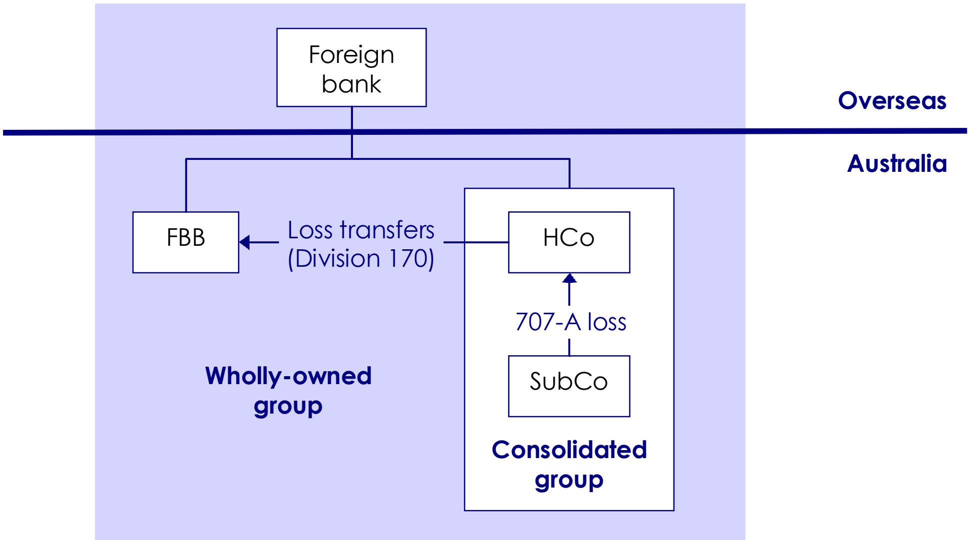
- these are losses transferred under Subdivision 707-A whose limit is calculated under Subdivision 707-C.

Example

Facts

A wholly-owned group controlled by a foreign bank (figure 1) consists of an Australian branch of a foreign bank (FBB), a head company of a consolidated group (HCo) and a subsidiary member (SubCo). The consolidated group formed on 1 July 2002. A pre-consolidation tax loss of $500 was transferred from SubCo to HCo at the joining time. This tax loss was originally incurred by SubCo during the income year ended 30 June 2000 and now forms a loss bundle consisting of one tax loss with an available fraction. For the income year ended 30 June 2003, HCo also incurs a group tax loss of $400.

Figure 1: Structure of wholly-owned group



[133] Sections 170-45 and 170-145.

[134] Subsections 170-55(3) to (5) and subsections 170-155(2) to (4) of the *Income Tax Assessment Act 1997*; sections 170-55 and 170-155 of the *Income Tax (Transitional Provisions) Act 1997*.

During the income year ended 30 June 2004, HCo has other assessable income of $1,000 and deductions relating to that income of $700. For the year ended 30 June 2004, HCo's taxable income is reduced to nil by its carry-forward group tax loss [$1,000 – ($700 in deductions + $300 in carry-forward group tax loss) = nil]. This leaves $100 of the group tax loss remaining to be carried forward to the 2005 income year ($400 – $300 = $100). HCo still has the Subdivision 707-A transferred tax loss of $500 to be carried forward to the 2005 income year.

For the year ended 30 June 2004, HCo seeks to transfer its carried forward group tax loss of $100 and its carried forward Subdivision 707-A transferred tax loss of $500 to FBB.

FBB, HCo and SubCo have all been part of the same wholly-owned group since 1 July 1995, with no changes to the underlying membership interests since that time.

Calculation

Before it can transfer any amount of its Subdivision 707-A tax loss to FBB, HCo must first determine whether it can transfer any of its unused group tax loss to FBB. On the assumption that the requirements in Division 170 are satisfied, HCo's group tax loss of $100 will be available for transfer to FBB for utilisation against FBB's assessable income or exempt income.

For HCo to transfer its Subdivision 707-A transferred tax loss to FBB under Division 170, the modified conditions in Subdivision 170-A must be satisfied. The modified tests that must be met before a transfer can take place are as follows.

Relationship test

To meet the relationship test, SubCo and FBB must have been members of the same wholly-owned group during the loss year and until the loss was transferred to HCo. HCo and FBB must have maintained the same wholly-owned group relationship from the time the loss was transferred to HCo from SubCo until the end of the income year in which the loss was transferred to FBB (the deduction year).

Table 1 lists the entity relationships and the time periods that they must have maintained these relationships to pass the test.

Table 1: Entity relationships

Relationship	Time period	Relationship maintained
SubCo and FBB	1 July 1999 to 30 June 2002	Yes
HCo and FBB	1 July 2002 to 30 June 2004	Yes

The relationship test has been passed because the wholly-owned group relationship between FBB, HCo and SubCo has been maintained throughout the period consisting of the loss year to the end of the deduction year.

Utilisation test (foreign bank branch)

Based on the modified utilisation test, FBB is taken to have incurred the transferred tax loss for the income year for which SubCo incurred it. This means that the utilisation test (application of Divisions 165 and 175), as it applies to the transferred tax loss that is to be transferred from HCo to FBB in accordance with the requirements of Division 170, applies from the time of the original loss year (that is, from 1 July 1999).

Passing the test requires that FBB would not be prevented by Divisions 165 or 175 from deducting that loss had the loss been incurred by FBB, instead of SubCo, during the income year ended 30 June 2000.

As there are no changes to the underlying membership interests within the wholly-owned group from the time the loss is first incurred by SubCo, FBB would be capable of utilising the loss because it would satisfy the modified test for utilisation[135].

The transferred loss is able to be transferred to FBB for the year ended 30 June 2004 after the group loss has been transferred. The group loss and the transferred loss can be transferred to the extent that FBB can deduct the loss against its assessable income or exempt income.

References

Income Tax Assessment Act 1936, sections 160ZZZG, 160ZZZH

Income Tax Assessment Act 1997:

- Division 165
- Division 170
- Subdivision 170-A
- Subdivision 170-B
- section 703-15
- Subdivision 707-A
- Subdivision 707-C
- section 707-140

Income Tax (Transitional Provisions) Act 1997, sections 170-55, 170-155, 707-350

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, Chapter 5

[135] HCo also satisfies the utilisation tests that would apply to it under Division 170.

Revision history

Section C3-4-710 first published 28 May 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Transfer of tax losses under Subdivision 170-A – consolidation part-way through the head company's income year

Note

Date on which existing grouping provisions cease to operate

Subdivision 170-A of the ITAA 1997 provides for tax losses to be transferred within wholly-owned groups of companies. Access to Subdivision 170-A generally ceases on 1 July 2003. However:

- groups that consolidate before 1 July 2003 are entitled to transfer tax losses only until the date of consolidation, and
- head companies with a substituted accounting period (SAP) that consolidate their group on the first day of their next income year after 1 July 2003 are entitled to transfer tax losses until the date of consolidation.

For further discussion of the removal of the grouping provisions → 'Substituted accounting period (SAP)', C9-4-110.

Background

As part of the introduction of the consolidation regime, the existing grouping rules applicable to wholly-owned groups of companies have only limited operation. The provisions of Subdivision 170-A of the *Income Tax Assessment Act 1997* (ITAA 1997), which allow tax losses to be transferred within wholly-owned groups of companies, have been significantly modified. Generally, from 1 July 2003 tax loss transfers are allowed only where one of the parties to the transaction is an Australian branch of a foreign bank.

The date at which the amendments to Subdivision 170-A of the ITAA 1997 apply, and the amount of transfers allowable for the income year prior to the amendments applying, is determined by the application provisions contained in Schedule 3, Items 37 to 39 of the *New Business Tax System (Consolidation) Act (No. 1) 2002*.

Items 37 and 38 determine the year in which the amendments to Subdivision 170-A apply. In summary, these amendments apply to a company – and therefore supersede the existing Subdivision 170-A provisions – for:

- income years starting on or after the date of consolidation if the company joins a consolidated group on its formation and the date of consolidation is either:
  - before 1 July 2003, or
  - the first day of the head company's next income year starting after 30 June 2003 (and before 1 July 2004), and
- income years starting after 30 June 2003 in other cases, including where the company does not join a consolidated group.

Item 39 operates to determine the amount of transfers allowable under Subdivision 170-A for the final income year before the amendments to Subdivision 170-A apply. The amount transferable is determined by reference to the 'apportioning day', which is either 1 July 2003 or the date of consolidation, depending on whether item 37 or 38 applies to the company. The object of item 39 is to ensure that the company can either:

- transfer a loss it makes for the final year only so far as the loss is attributable to the period in the final year elapsing before the apportioning day, or
- utilise a loss transferred to it to reduce income or gains for the final year only so far as the income or gains are attributable to the period in the final year elapsing before the apportioning day.

Formulas provided in item 39 give effect to these objects.

Tax loss transfers in the final year

Item 39 does not reduce the tax loss transfer allowable under Subdivision 170-A where consolidation occurs on the first day of the head company's income year[136]. In these situations the tax loss limit and the income limit are not apportioned – the group members have 'full access' to tax loss transfers in the final year before the amendments to Subdivision 170-A apply.

Item 39 may operate to reduce the amount transferable[137] where consolidation takes place part-way through the head company's income year. In these 'part-year' situations, item 39 applies only to *certain* transfers of tax losses.

In part-year situations, the following tax loss transfers can be made:

- a non-membership period tax loss of a subsidiary member may be transferred to another eligible subsidiary member with sufficient income in its non-membership period
- a prior year tax loss of a subsidiary member may be transferred to another eligible subsidiary member with sufficient income in its non-membership period, and
- the portion of a group tax loss of the head company referable to the period in the income year prior to consolidation may be transferred to an eligible subsidiary member with sufficient income in its non-membership period.

In part-year situations it is not possible to transfer a prior year tax loss of a head company to an eligible subsidiary, nor is it possible for a subsidiary to transfer either a non-membership period or a prior year tax loss to the head company under Subdivision 170-A.

The limited application of item 39 in part-year situations is a product of the dissimilar treatment of subsidiary members and head companies in the year of

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[136] Provided all subsidiary members have the same balancing date as the head company.

[137] As determined by Subdivision 170-A of the ITAA 1997.

consolidation. Specific provisions divide the consolidation year of subsidiary members into non-membership and membership periods. This 'rule-off' ensures income and tax loss amounts are calculated for the pre-consolidation period. Transfers of tax losses can be undertaken between subsidiary members for this pre-consolidation period and any surplus tax losses are then transferred to the head company at the joining time[138].

Conversely, head companies are *not* permitted to rule-off. Surplus tax loss amounts in the wholly-owned company group must be transferred under Subdivision 707-A of the ITAA 1997 to the head company at the joining time. In part-year situations, transfers take place before the end of the final year of the head company and hence restrict the operation of item 39. Losses that have been transferred to the head company under Subdivision 707-A must subsequently be utilised under the provisions contained in Subdivision 707-C (i.e. essentially subject to the available fraction method).

Similarly, at the joining time the head company must transfer to itself any prior year tax losses it has incurred. These head company tax losses (transferred to itself part-way through its income year) cannot be transferred to an eligible subsidiary member under Subdivision 170-A.

A group tax loss incurred in the year of consolidation can be transferred to an eligible subsidiary member in respect of its pre-consolidation income as it is a tax loss made in the final year and is able to be apportioned under item 39 based on the number of days pre and post consolidation.

→ worked examples C3-5-110, C3-5-120

Revision history

Section C3-5 first published 2 October 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

[138] Provided transfer tests are satisfied.

Worked example

Transfer of subsidiary member tax losses under Subdivision 170-A – consolidation part-way through the head company's income year

Description

This example shows how, in situations where a consolidated group forms part-way through the head company's income year, a prior year tax loss and a non-membership period tax loss of a subsidiary member may be transferred to another eligible subsidiary member under Subdivision 170-A of the *Income Tax Assessment Act 1997* (ITAA 1997). The example also illustrates that the balance of a subsidiary member's tax losses are transferred[139] to the head company under Subdivision 707-A of the ITAA 1997 and hence cannot be transferred to the head company under Subdivision 170-A.

Note

For more information about:

- transferring tax losses under Subdivision 170-A where consolidation occurs part-way through the head company's income year → C3-5
- transferring a head company group loss under Subdivision 170-A where consolidation occurs part-way through the head company's income year → C3-5-120 (worked example)
- the removal of the existing grouping provisions → 'Substituted accounting period (SAP)', C9-4-110.

Commentary

The date on which Subdivision 170-A tax loss transfers effectively cease for a particular company depends on:

- whether the company becomes a subsidiary member of a consolidated group, and
- whether the head company of the group chooses to consolidate on the first day of its income year, or on a day during its income year.

If a head company chooses to form a group part-way through its income year, subsidiary members of the group will have a non-membership period[140] for that part of the income year prior to consolidation. Where consolidation occurs on or before 1 July 2003 – with an extension for consolidated groups with a substituted accounting period (SAP) that consolidate on the first day of their next income year after 1 July 2003 – subsidiary members retain

[139] Provided the relevant transfer tests are satisfied.

[140] Paragraph 701-30(2)(b), ITAA 1997.

unapportioned access to Subdivision 170-A tax loss transfers for the non-membership period prior to the joining time.

This means:

- a prior year tax loss incurred by a subsidiary member may be transferred and deducted against income derived by another subsidiary member in its non-membership period, and
- a tax loss incurred by a subsidiary member in its non-membership period may be transferred and deducted against income derived by another subsidiary member in its non-membership period.

Where necessary, tax loss limits and income limits are required to be apportioned in accordance with provisions contained in item 39 of Schedule 3 to the *New Business Tax System (Consolidation) Act (No. 1) 2002*. This may be necessary, for example, where a group with a SAP consolidates after 1 July 2003 but not on the first day of its next income year.

Example

Facts

A consolidatable group consists of HCo and subsidiaries ACo and BCo. All members of the group have an early balancing SAP of 1 January – 31 December. HCo chooses to consolidate the group on 1 September 2003.

As the group consolidates after 1 July 2003 but not on 1 January 2004 (the first day of the head company's next income year), the subsidiary members effectively retain access to Subdivision 170-A tax loss transfers for the period 1 January 2003 – 30 June 2003.

ACo incurs a $30 tax loss in its non-membership period prior to joining the consolidated group. ACo also has a prior year tax loss of $70 that it has carried forward from a previous income year.

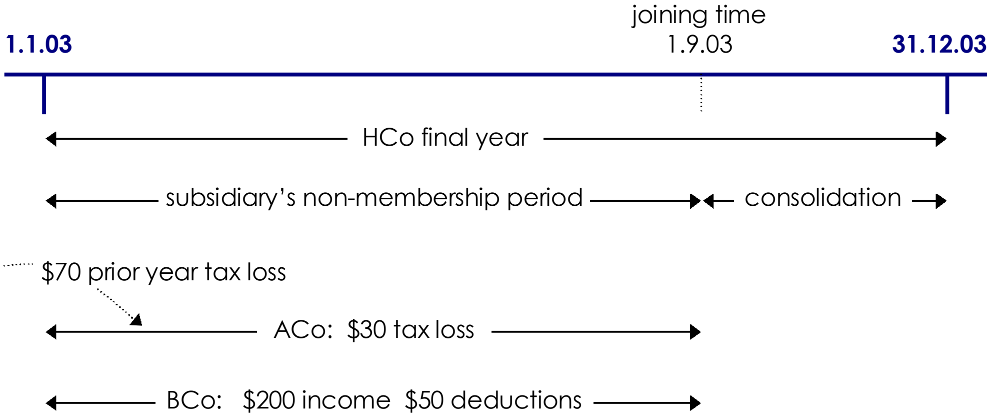
BCo generates $200 of assessable income and incurs $50 of deductions in its non-membership period prior to joining the consolidated group[141].

Tax loss transfers under Subdivision 170-A from ACo to BCo are to be made to the maximum extent possible.

These facts are represented in figure 1.

[141] BCo is a subsidiary member of the consolidated group from 1 September 2003 to 31 December 2003. Hence its entity core purposes for the 2004 income year will be for the period 1 January 2003 to 31 August 2003.

Figure 1: Group consolidation part-way through income year



Calculation

For each tax loss the maximum amount transferable is determined under section 170-45. Then, if necessary, the maximum amount must be apportioned by item 39 into pre and post consolidation amounts.

Loss limit

ACo is able to transfer all of the prior year tax loss. ACo can also transfer the portion of the non-membership period tax loss referable to the pre-1 July 2003 period.

The loss limit amount is determined under subsection 170-45(1):

- the prior year tax loss is $70, and
- the non-membership period tax loss is $30.

As the non-membership period tax loss is a tax loss made for the final year, it must be apportioned based on the number of days before the apportioning day[142]. In this example there are 243 days in the non-membership period, of which 181 are before the apportioning day of 1 July 2003.

$$\$30 \times \frac{181}{243} = \$22$$

[142] Subitem 39(4).

Income limit

BCo has $200 of assessable income and $50 of deductions in the non-membership period. For the prior year tax loss the maximum amount transferable to BCo under subsection 170-45(2) is:

$$\$200 - \$50 = \$150$$

Subitem 39(6) apportions this figure based on the number of days before the apportioning day:

$$\$150 \times \frac{181}{243} = \$112$$

By agreement, ACo transfers $70 (being the lesser of the loss limit and the income limit) of its prior year tax loss to BCo in respect of its apportioned non-membership period income.

The maximum amount transferable under subsection 170-45(2) in respect of the non-membership period tax loss is:

$$\$200 - \$50 - \$70 = \$80$$

Subitem 39(6) apportions this figure based on the number of days before the apportioning day:

$$\$80 \times \frac{181}{243} = \$60$$

By agreement, ACo transfers $22 (being the lesser of the loss limit and the income limit) of its non-membership period tax loss to BCo in respect of its apportioned non-membership period income.

The $8 non-membership period tax loss remaining is then transferred to HCo on 1 September 2003 under Subdivision 707-A. The transferred tax loss must be subsequently utilised by HCo for the 2004 income year and later income years using the provisions contained in Subdivision 707-C. For an example illustrating the utilisation of transferred losses → 'Amount of transferred losses that can be utilised', C3-4-410.

Provided there are no other tax losses transferred to BCo under Subdivision 170-A, BCo will lodge a 2004 income tax return declaring $58[143] of taxable income.

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[143] $200 – $50 – ($70 + $22)

References

Income Tax Assessment Act 1997, subsections 701-30(8) & (9); as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 19, item 2

Income Tax Assessment Act 1997, section 170-45; as in effect before amendments introduced by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002)

New Business Tax System (Consolidation) Act (No. 1) 2002 (No. 68 of 2002), Schedule 3, items 37, 38 and 39, as amended by:

- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 11, item 1
- *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 19, item 6

Revision history

Section C3-5-110 first published 2 October 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Transfer of a group tax loss under Subdivision 170-A – consolidation part-way through the head company's income year

Description

This example shows how, in situations where a consolidated group forms part-way through the head company's income year, a group tax loss may be transferred to a subsidiary member under Subdivision 170-A of the *Income Tax Assessment Act 1997* (ITAA 1997). The example also illustrates that a prior year head company tax loss must be transferred to itself under Subdivision 707-A of the ITAA 1997 and cannot be transferred to a subsidiary member under Subdivision 170-A.

Note

For more information about:

- transferring tax losses under Subdivision 170-A where consolidation occurs part-way through the head company's income year → C3-5
- transferring subsidiary tax losses under Subdivision 170-A where consolidation occurs part-way through the head company's income year → C3-5-110 (worked example)
- the removal of the existing grouping provisions → 'Substituted accounting period (SAP)', C9-4-110.

Commentary

Where a group consolidates part-way through the head company's income year, transfers of tax losses in that year under Subdivision 170-A involving the head company as either the income company or the loss company are limited to specific circumstances. This is because head companies, unlike subsidiary members, are not permitted to determine an actual tax position for the period in the income year prior to consolidation. Subsidiary members are required by section 701-30 of the ITAA 1997 to 'rule-off' at the joining time – allowing income and tax loss limits to be determined for the purposes of transfers under Subdivision 170-A.

Essentially, in part-year situations the head company of a consolidated group can transfer only a portion of a group tax loss it makes for the final year before the amendments to Subdivision 170-A apply (i.e. the year consolidation takes place). The head company cannot:

- transfer any prior year tax losses (as these losses are transferred to itself at the joining time under Subdivision 707-A and subsequently utilised by the consolidated group under Subdivision 707-C), or
- receive any prior year or non-membership period tax losses from subsidiary members in respect of the final year (as all unutilised losses are

transferred[144] to the head company at the joining time under Subdivision 707-A).

Example

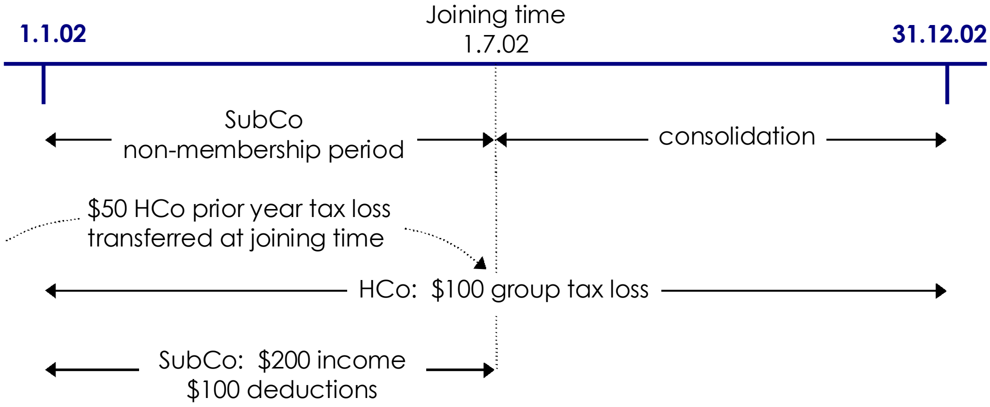
Facts

A consolidatable group consists of HCo and its subsidiary SubCo. Both companies have a substituted accounting period (SAP) of 1 January – 31 December. HCo chooses to consolidate the group on 1 July 2002.

- HCo incurs a $100 group tax loss in the 2003 income year[145].
- HCo transfers a $50 prior year tax loss to itself at the joining time.
- SubCo has $200 of assessable income and $100 of deductions in its non-membership period prior to joining the consolidated group.
- SubCo remains a subsidiary member of the consolidated group from 1 July 2002 to 31 December 2002.
- A portion of HCo's $100 group tax loss is to be transferred to SubCo to the maximum extent possible under Subdivision 170-A.

These facts are represented in figure 1.

Figure 1: Group consolidation part-way through the income year



Calculation

The maximum limit for transfer must first be determined under section 170-45. Then, the surplus amount of the group tax loss must be apportioned based on the number of days pre-consolidation.

144 Provided the transfer tests are satisfied.

145 The group tax loss is calculated by reference to the income or loss generated by HCo as a 'stand-alone' entity for the period 1 January 2002 to 30 June 2002 and the income or loss generated by the consolidated group from 1 July 2002 to 31 December 2002.

Loss limit

Applying the loss limit test in subsection 170-45(1), the maximum amount of the group tax loss that HCo would carry forward to the next income year is $100.

Subitem 39(4) of Schedule 3 to the *New Business Tax System (Consolidation) Act (No.1) 2002* apportions the group tax loss based on the number of days (in the income year) before the apportioning day. The apportioning day in this example is the consolidation day (1 July 2002), as HCo chooses to form the consolidated group before 1 July 2003; there are, therefore, 181 days before the apportioning day.

$$\$100 \times \frac{181}{365} = \$50$$

Income limit

SubCo has $200 of assessable income and $100 of deductions in the non-membership period. The maximum amount transferable to SubCo under subsection 170-45(2) is:

$$\$200 - \$100 = \$100$$

Subitem 39(6) apportions this figure based on the number of days before the apportioning day. The number of days for the final year of SubCo is 181 as a result of the operation of subitem 39(9):

$$\$100 \times \frac{181}{181} = \$100$$

By agreement, HCo transfers $50 (being the lesser of the loss limit and the income limit) of its group tax loss to SubCo.

As HCo's $50 prior year tax loss is transferred to itself at the joining time and subsequently utilised under Subdivision 707-C, it cannot be considered for transfer under Subdivision 170-A.

The remaining $50 group tax loss and the $50 prior year HCo tax loss are carried forward to the 2004 income year.

SubCo is able to deduct the loss under Division 36 of the ITAA 1997 for the purposes of its non-membership period.

Provided there are no other tax losses transferred to SubCo under Subdivision 170-A, SubCo will lodge a 2003 income tax return declaring $50[3] of taxable income.

[3] $200 – $100 – $50.

References

Income Tax Assessment Act 1997, subsections 701-30(8) & (9); as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 19, item 2

Income Tax Assessment Act 1997, section 170-45; as in effect before amendments introduced by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002)

New Business Tax System (Consolidation) Act (No. 1) 2002 (No. 68 of 2002), Schedule 3, items 37, 38 and 39, as amended by:

- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 11, item 1
- *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 19, item 6

Revision history

Section C3-5-120 first published 2 October 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Late loss transfers under Subdivision 170-A – consolidation and the Commissioner's discretion

Description

This example shows that 'late' loss transfer agreements can be made, where the Commissioner has granted an extension of time, even though a consolidated group has formed.

Commentary

The provisions of Subdivision 170-A of the *Income Tax Assessment Act 1997* (ITAA 1997) allow tax losses to be transferred within a wholly-owned group of companies.[147] Generally, loss transfer agreements must be made on or before the date of lodgment of the income company's income tax return. However, a 'late' loss transfer agreement can be made where the Commissioner exercises the discretion provided for in paragraph 170-50(2)(d) of the ITAA 1997.

In exercising the discretion to provide an extension of time the Commissioner is guided by administrative law principles. These principles are discussed in Taxation Ruling TR 98/12.[148]

In some cases, the income company and loss company will have joined a consolidated group by the time the request for an extension of time is received by the Commissioner. The fact that either company has joined a consolidated group will not, of itself, prevent the favourable exercise of the discretion.

Subdivision 707-A of the ITAA 1997

For the purposes of income years ending after the joining time, subsection 707-140(1) of the ITAA 1997 deems the head company to have made a transferred loss for the income year in which the transfer occurs. The joining entity is also taken not to have made the loss for the income year in which it was actually made. Subsection 707-140(2) of the ITAA 1997 provides that the head company may utilise the transferred loss in the income year of transfer. These provisions ensure that the loss can be used by the head company for all income years ending after the transfer time.

Although the head company is deemed to have made the loss, the joining entity can still be a loss company (as defined in Subdivision 170-A) in respect of income years[149] ending before the joining time. As such, Subdivision 170-A loss transfer agreements can still be effective in respect of pre-joining time

[147] Subdivision 170-A has been significantly modified, generally with effect from 1 July 2003. Transfers are now allowed only where one of the parties to the transaction is an Australian branch of a foreign bank → 'Transfer of tax losses under Subdivision 707-A', C3-5.

[148] Specifically paragraphs 17-20 and 81-94.

[149] Including non-membership periods, as defined by section 701-30 of the ITAA 1997, ending just before the joining time.

periods, even if they are made after the joining time, when both the loss company and income company may be members of a consolidated group.

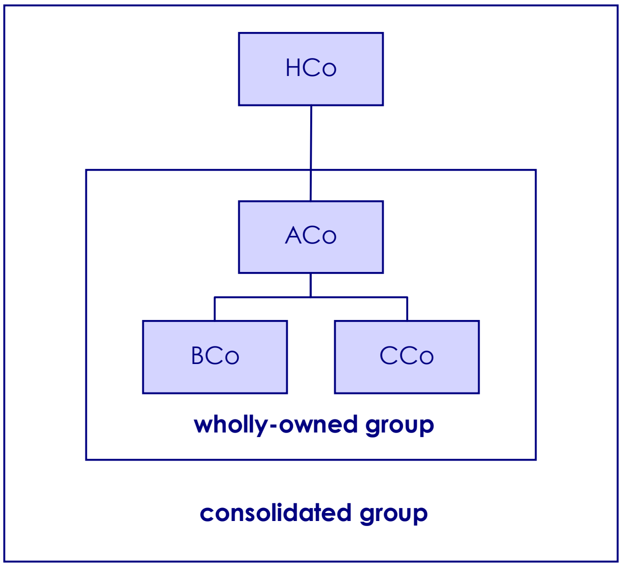
All valid loss transfer agreements under Subdivision 170-A, including those made after the joining time, will affect the quantum of losses transferred to the head company under Subdivision 707-A. Depending on the circumstances, amendments to assessments may be required for income years ending before and after the joining time. For example, the head company may have already deducted a transferred tax loss that exceeds the quantum actually transferred to it under Subdivision 707-A taking into account a late loss transfer agreement.

Example

Facts

A consolidated group forms on 1 July 2003 consisting of HCo, ACo, BCo and CCo.

Figure 1: HCo group



ACo, BCo and CCo have constituted a wholly-owned group[150] for a number of years. The companies transferred tax losses within that group under Subdivision 170-A for the 2003 income year.[151] HCo is not a member of the wholly-owned group in respect of the 2003 income year as it acquired 100% of the membership interests in ACo during the income year. Unused tax losses are transferred to HCo under Subdivision 707-A at the joining time.

[150] As defined in section 975-500 of the ITAA 1997.

[151] The income year prior to joining the HCo group.

Calculation

The following three scenarios illustrate how the quantum of losses transferred under Subdivision 707-A can change with the granting of the Commissioner's discretion to allow late loss transfer agreements.

Scenario 1: Reduction in the loss of a loss company

The taxable income/loss positions for ACo, BCo and CCo for the 2003 income year, prior to loss transfers, are shown in table 1.

Table 1: Taxable income/loss for the 2003 income year (before loss transfers)

Company	Taxable position	Amount
ACo	Loss	$300
BCo	Loss	$200
CCo	Income	$250

Under a valid loss transfer agreement, ACo transfers $250 of its 2003 tax loss to CCo.

Unused tax losses are transferred to HCo at the joining time, as shown in table 2.

Table 2: Transferred losses (initial position)

Loss bundle	Unused transferred losses	Sort
Bundle ACo	$50	Tax loss
Bundle BCo	$200	Tax loss

During the 2005 income year ACo asks the Commissioner to amend its 2003 assessment. The amendment reduces its tax loss for the 2003 income year from $300 to $200. Pursuant to subsection 170-65(1) of the ITAA 1997, only $200 is taken to have been transferred to CCo under the loss transfer agreement. ACo does not have any tax loss that can be transferred to HCo under Subdivision 707-A.

A request is made to enter into a late loss transfer agreement between BCo and CCo. The agreement specifies that $50 of BCo's 2003 tax loss be transferred to CCo, with the effect that CCo's taxable income is reduced to nil.

Provided the Commissioner's discretion is exercised[152] to allow the late loss transfer agreement, the corrected position is that a tax loss is transferred from BCo to HCo at the joining time. The transferred loss is shown in table 3.

[152] As per the principles outlined in Taxation Ruling TR 98/12.

Table 3: Transferred losses (corrected position)

Loss bundle	Unused transferred losses	Sort
Bundle BCo	$150	Tax loss

If HCo has lodged a 2004 income tax return and has utilised an amount of tax losses not reflecting this corrected position,[153] its assessment would need to be amended accordingly.

Scenario 2: Increase in the income of the income company

The taxable income/loss positions for ACo, BCo and CCo for the 2003 income year, prior to loss transfers, are shown in table 4.

Table 4: Taxable income/loss for the 2003 income year (before loss transfers)

Company	Taxable position	Amount
ACo	Loss	$300
BCo	Loss	$200
CCo	Income	$250

Under a valid loss transfer agreement, ACo transfers $250 of its 2003 tax loss to CCo.

Unused tax losses are transferred to HCo at the joining time, as shown in table 5.

Table 5: Transferred losses (initial position)

Loss bundle	Unused transferred losses	Sort
Bundle ACo	$50	Tax loss
Bundle BCo	$200	Tax loss

During the 2005 income year CCo asks the Commissioner to amend its 2003 assessment. The amendment would have the effect of increasing CCo's taxable income for the 2003 income year, prior to any further loss transfers, from nil to $100.

A request is made to enter into a further loss transfer agreement between ACo and CCo. The agreement specifies that $50 of ACo's 2003 tax loss be transferred to CCo.

[153] i.e. an amount thought to have been transferred from ACo or an amount exceeding the actual amount transferred from BCo.

A request is also made to enter into a late loss transfer agreement between BCo and CCo. The agreement specifies that $50 of BCo's 2003 tax loss be transferred to CCo.

These late loss transfer agreements would maintain CCo's taxable income at nil.

Provided the Commissioner's discretion is exercised to allow the further loss transfer agreement and the late loss transfer agreement, the corrected position is that a tax loss is transferred from BCo to HCo at the joining time. The transferred loss is shown in table 6.

Table 6: Transferred losses (corrected position)

Loss bundle	Unused transferred losses	Sort
Bundle BCo	$150	Tax loss

If HCo has lodged a 2004 income tax return and has utilised an amount of tax losses not reflecting this corrected position, its assessment would need to be amended accordingly.

Scenario 3: Increase in the loss of a loss company

The taxable income/loss positions for ACo, BCo and CCo for the 2003 income year, prior to loss transfers, are shown in table 7.

Table 7: Taxable income/loss for the 2003 income year (before loss transfers)

Company	Taxable position	Amount
ACo	Loss	$30
BCo	Loss	$200
CCo	Income	$250

Under valid loss transfer agreements, ACo and BCo each transfer their 2003 tax losses to CCo. CCo therefore has a taxable income of $20 for the 2003 income year.

As all losses have been utilised for an income year ending before the joining time, there are no losses transferred to HCo on 1 July 2003.

During the 2005 income year ACo asks the Commissioner to amend its 2003 assessment. The amendment results in ACo having its tax loss for the 2003 income year increased from $30 to $70.

A request is made to enter into a further loss transfer agreement between ACo and CCo. The agreement specifies that $20 of ACo's 2003 tax loss be transferred to CCo, with the effect that CCo's taxable income is reduced to nil.

Provided the Commissioner's discretion is exercised to allow the further loss transfer agreement, the corrected position is that a tax loss is transferred from ACo to HCo at the joining time. The transferred loss is shown in table 8.

Table 8: Transferred losses

Loss bundle	Unused transferred losses	Sort
Bundle ACo	$20	Tax

If HCo has lodged a 2004 income tax return prior to the discretion being exercised, and is able (and chooses) to utilise an amount of the transferred loss in the 2004 income year, its assessment would need to be amended accordingly.

References

Income Tax Assessment Act 1997, Subdivision 170-A; as in effect before amendments introduced by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002)

Income Tax Assessment Act 1997:

- paragraph 170-50(2)(d)
- subsection 170-65(1)
- section 701-30
- Subdivision 707-A
- subsections 707-140(1) and (2)
- section 975-500

Taxation Ruling TR 98/12

Revision history

Section C3-5-130 first published 27 January 2005.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Determining the reduction amount – subsection 707-325(3)

The available fraction is the core component of the rules for the utilisation of transferred losses by consolidated groups. It establishes the limit for the utilisation of transferred losses in a bundle for an income year. The rationale is that the rate of loss usage should be restricted to approximate the rate that would have been available to the entity from which the loss was transferred had it remained a single entity outside the consolidated group.

To maintain the integrity of the available fraction methodology, an integrity rule prevents the modified market value of an entity being inflated by certain events. Inflation of modified market value has the effect of increasing the available fraction and thereby potentially increasing the utilisation rate of losses in that bundle. The integrity rule is contained in subsections 707-325(2) to (5) of the *Income Tax Assessment Act 1997*.

If the integrity rule applies, a 'reduction amount' must be determined and the modified market value of the entity reduced by this amount.

Note

Worked examples

The *Consolidation reference manual* provides worked examples of how the reduction amount may be calculated in different situations:

- 'Determining the reduction amount – multiple events – determining the initial increase in market value', C3-6-110
- 'Determining the reduction amount – diminution in value up to the joining time', C3-6-120
- 'Determining the reduction amount – injection of capital that does not result in increased modified market value', C3-6-130
- 'Determining the reduction amount – compounding of value up to the joining time', C3-6-140
- 'Determining the reduction amount – injection of capital subsequently injected into a subsidiary', C3-6-150
- 'Determining the reduction amount – multiple events – market value reduced under some events', C3-6-160.

The worked examples show the procedure for applying the integrity rule. They are not intended to provide guidance on what constitutes an event or how valuations should be undertaken.

When is a reduction required?

The modified market value of an entity is reduced if:

- one or more of the events described in subsection 707-325(4) occurred in the four years[154] before the joining time, and
- the modified market value worked out under subsection 707-325(1) exceeds what it would have been had none of those events occurred (the 'excess').

The events described in subsection 707-325(4) are, broadly:

- an injection of capital[155] into the entity or an associate of the entity, and
- a non-arm's length transaction involving the entity or an associate of the entity.

Certain injections of capital, as described in subsection 707-325(5), are disregarded. Broadly, they are injections into a listed public company made through a dividend reinvestment scheme and injections under a qualifying employee share scheme.

The reduction amount

Once it is established that one or more events have resulted in an excess, the modified market value of the entity must be reduced by the amount worked out under subsection 707-325(3).

The amount of the reduction is the lesser of:

- the excess in the entity's modified market value at the joining time, and
- the total increase in the entity's market value resulting from summing each increase in market value that occurred immediately after each event because of the event (the 'initial increase').

This ensures no reduction is required if the event has not actually resulted in an inflated modified market value at the joining time. → 'Determining the reduction amount – injection of capital that does not result in increased modified market value', C3-6-130

Limiting the reduction amount to the initial increase in market value also ensures that the compounding effects of the events are not incorporated. For example, if additional profits (as reflected in the modified market value) are generated as a result of applying the initial increase, the reduction amount is only the amount of the initial increase. → 'Determining the reduction amount – compounding of value up to the joining time', C3-6-140

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[154] Events that take place before 9 December 2000 are disregarded → section 707-329, *Income Tax (Transitional Provisions) Act 1997*.

[155] Taxation Ruling TR 2004/9 provides the Tax Office view on the meaning of the expression 'injection of capital'.

Excess in entity's modified market value at the joining time

The excess in modified market value of an entity is the difference between the entity's modified market value at the joining time and what would have been its modified market value had the event(s) not occurred.

Two valuations are required to determine the excess. The first establishes the modified market value of the entity at the joining time, based on the assumptions in subsection 707-325(1)[156]. The second valuation establishes the 'hypothetical modified market value' of the entity – that is, what the modified market value would have been in the absence of the event(s). → 'Determining the reduction amount – diminution in value up to the joining time', C3-6-120

Initial increase in market value

A method of establishing the initial increase in market value is to obtain, in respect of an event, two valuations. The first would be undertaken as at the time just after the event occurs, to establish the market value of the entity immediately after the event – the 'initial market value' of the entity. The second valuation would be undertaken as at that time on the assumption the event did not occur. This valuation establishes what the market value of the entity would have been had the event not occurred – the 'hypothetical initial market value' of the entity. The difference between the actual and hypothetical market values establishes the initial increase in the entity's market value.

Using this approach, actual and hypothetical market valuations need to be undertaken for each event. Where there are multiple events, the total increase in market value is the sum of the initial increase in market value from all events.

→ 'Determining the reduction amount – multiple events – determining the initial increase in market value', C3-6-110
→ 'Determining the reduction amount – multiple events – market value reduced under some events', C3-6-160

Valuation assumptions and methodology

In verifying compliance with the integrity rule the Tax Office would expect a taxpayer to be able to clearly demonstrate how the valuation has been calculated, given the particular facts of each case. Assumptions made in arriving at a valuation should be documented to support the calculations made. Evidence to support valuations undertaken for the purposes of determining the reduction amount may include:

- valuation reports
- board minutes
- prospectus details, and
- records of discussions held with third parties, such as financiers, advisers and project partners.

The Tax Office has published guidelines on undertaking the valuations required by consolidation law. → 'Market valuation guidelines', C4-1

[156] The modified market value of an entity is, broadly, its market value, assuming it has no losses or franking credits and assuming it has no membership interest in any other group member.

Calculating the reduced modified market value

There are six steps to determine the modified market value of an entity in a situation where the integrity rule applies:

1 Determine the modified market value under subsection 707-325(1).

2 Determine the 'hypothetical modified market value' required by paragraph 707-325(2)(b). Hypothetical modified market value is calculated, under the assumptions in subsection 707-325(1), as though the prescribed event (or events) did not take place.

3 Reduce the step 1 amount by the step 2 amount. This is the paragraph 707-325(3)(a) amount.

4 Calculate the initial increase in market value that occurred after each event because of the event. The sum of these amounts is the paragraph 707-325(3)(b) amount.

5 The lesser of step 3 and step 4 is the 'reduction amount'.

6 Reduce the step 1 amount by the reduction amount.

Reduction amount short cut option

There may be substantial costs in obtaining the valuations required to accurately calculate the reduction amount. In recognition of these costs, the Commissioner of Taxation has provided a reduction amount short cut option that removes the need to obtain additional valuations in certain circumstances. The short cut option is provided under the Commissioner's general administrative powers[157].

The short cut option is only available where the event or events are cash injections. In this situation, the Tax Office will accept the actual dollar amount of the cash injected into the entity as the reduction amount and there is no need to follow the six step process to determine the reduced modified market value.

The short cut option is not available where an event is a non-cash transaction or a transaction that did not take place at arm's length. In these situations there is still a requirement to obtain the necessary valuations.

[157] Section 8 of the *Income Tax Assessment Act 1936*.

Example

Applying the reduction amount short cut option

The head company of a consolidated group transfers losses to itself when the group forms on 1 January 2005. The losses are contained in 'bundle HCo'.

During the four years prior to group formation the head company issued additional shares on the share market. The share subscription raised $3 million of additional share capital.

At formation time, the modified market value of the head company is determined to be $50 million. The adjusted market value of the consolidated group is $90 million.

Applying the reduction amount short cut option, the available fraction for bundle HCo is determined as follows:

$$\frac{\$50m - \$3m}{\$90m} = 0.522$$

Revision history

Section C3-6 first published 18 May 2005.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Determining the reduction amount – multiple events – determining the initial increase in market value

Description

This example shows that where there are two separate injections of capital[158], the total increase in an entity's market value is the sum of the initial increase in market value from each injection.

Note

More information:

→ 'Determining the reduction amount – subsection 707-325(3)', C3-6

Commentary

An integrity rule prevents the modified market value of an entity being inflated by certain events occurring prior to consolidation. → subsections 707-325(2) to (5), *Income Tax Assessment Act 1997*

The modified market value of an entity is reduced if:

- one or more of the events described in subsection 707-325(4) occurred in the four years[159] before the joining time – these events are, broadly:
  - an injection of capital into the entity or an associate of the entity, and
  - a non-arm's length transaction involving the entity or an associate of the entity, and
- the modified market value worked out under subsection 707-325(1) exceeds what it would have been had none of those events occurred.

The amount of the reduction is the lesser of:

- the difference between the entity's modified market value at the joining time and what would have been its modified market value if the events had not occurred (the 'excess'), and
- the total increase in the entity's market value resulting from summing each increase in market value that occurred immediately after each event because of the event (the 'initial increase').

Limiting the reduction amount to the initial increase in market value ensures that the compounding effects of the event are not incorporated. For example,

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[158] An injection of capital into the entity or an associate of the entity is an event described in paragraph 707-325(4)(a) of the *Income Tax Assessment Act 1997*. Taxation Ruling TR 2004/9 provides the Tax Office view on the meaning of the expression.

[159] Events that take place before 9 December 2000 are disregarded → section 707-329, *Income Tax (Transitional Provisions) Act 1997*.

if additional profits (as reflected in the modified market value) are generated as a result of applying the initial increase, the reduction amount is only the amount of the initial increase. → 'Determining the reduction amount – compounding of value up to the joining time', C3-6-140

Initial increase in market value

A method of establishing the initial increase in market value is to obtain, in respect of an event, two valuations. The first would be undertaken as at the time just after the event occurs, to establish the market value of the entity immediately after the event – the 'initial market value' of the entity. The second valuation would be undertaken as at that time on the assumption the event did not occur. This valuation establishes what the market value of the entity would have been had the event not occurred – the 'hypothetical initial market value' of the entity. The difference between the actual and hypothetical market values establishes the initial increase in the entity's market value.

Using this approach, actual and hypothetical market valuations need to be undertaken for each event. Where there are multiple events, the total increase in market value is the sum of the initial increase in market value from all events. → 'Determining the reduction amount – multiple events – market value reduced under some events', C3-6-160

Note

Valuation assumptions and methodology

This worked example highlights the steps to be undertaken when applying the integrity rule. Taxpayers should be able, when required, to provide evidence of the assumptions made and methodologies used in arriving at a particular value.

→ 'Determining the reduction amount – subsection 707-325(3)', C3-6
→ 'Market valuation guidelines', C4-1

Example

Facts

The Battletown Group, a consolidatable group consisting of HeadCo and SubCo, consolidates on 1 July 2006.

A tax loss incurred by SubCo is transferred to HeadCo at the joining time. An available fraction must be calculated to establish the rate at which the tax loss can be utilised by the Battletown Group.

During 2002, the board of directors of the Battletown Group decided to complete a placement of fully paid ordinary shares in the capital of the head company to Australian and foreign institutional investors. The capital raised was injected into SubCo, which used the funds to acquire assets for a new project. This was documented in the explanatory memorandum to the notice of general meeting:

> …the funds raised from the placement will be used to acquire mining assets for subsequent use in a new mining project.

On 1 December 2002 (the acceptance date of the share placement), HeadCo communicated acceptance of the offer to successful shareholders and injected the funds into SubCo. Both the capital raising by HeadCo and the subsequent injection of funds into SubCo are considered to be events for the purpose of the integrity rule.

The injected funds increased the working capital balance of SubCo. SubCo then acquired the new mining assets.

HeadCo decided to complete a second placement of fully paid ordinary shares in the capital of the company during 2004. The capital raised was intended to finance the continued operation of the mining project.

On 1 December 2004 (the acceptance date of share placement), HeadCo communicated acceptance of this offer to successful shareholders and injected the funds into SubCo. Both the capital raising by HeadCo and the subsequent injection of funds into SubCo are considered to be events for the purpose of the integrity rule.

Calculation

Valuations undertaken to determine the total increase in market value immediately after each event are shown in tables 1 and 2.

Table 1: Valuation data – HeadCo

Valuation	($ '000)	
1st share issue		
Initial market value of HeadCo immediately after acceptance	28,000	
Hypothetical* initial market value of HeadCo	20,000	
Initial increase in market value		8,000
2nd share issue		
Initial market value of HeadCo immediately after acceptance	38,000	
Hypothetical* initial market value of HeadCo	28,000	
Initial increase in market value		10,000
Total initial increase in market value		**18,000**

* As though the event (or events) had not occurred.

The sum of the increases in HeadCo's market value immediately after the events is $18,000,000. However, the integrity rule does not apply to HeadCo because the capital raised was immediately injected into SubCo. → 'Determining the reduction amount – injection of capital subsequently injected into a subsidiary', C3-6-150

Table 2: Valuation data – SubCo

Valuation	($ '000)	
1st share issue		
Initial market value of SubCo immediately after receiving injected funds	18,000	
Hypothetical* initial market value of SubCo	10,000	
Initial increase in market value		8,000
2nd share issue		
Initial market value of SubCo immediately after receiving injected funds	28,000	
Hypothetical* initial market value of SubCo	18,000	
Initial increase in market value		10,000
Total initial increase in market value		**18,000**

* As though the event (or events) had not occurred.

Conclusion

The sum of the increases in SubCo's market value immediately after the events is $18,000,000.

A reduction in the modified market value of SubCo may be required under subsection 707-325(2) of the ITAA 1997.

SubCo satisfies the criteria to be able to adopt the short cut option for establishing the reduction amount. SubCo is able to use the total amount injected in the period up to the joining time as the reduction amount.

→ 'Determining the reduction amount – subsection 707-325(3)', C3-6

References

Income Tax Assessment Act 1997, section 707-325.

Revision history

Section C3-6-110 first published 18 May 2005.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Determining the reduction amount – diminution in value up to the joining time

Description

This example shows how to determine a reduction to modified market value under subsection 707-325(2) of the *Income Tax Assessment Act 1997* (ITAA 1997). In this example, the initial increase in market value associated with a non-arm's length transaction diminishes in the period from the time of the event taking place to the joining time. In establishing the reduction amount, the diminution of value up to the joining time must be taken into consideration.

Note

More information:

→ 'Determining the reduction amount – subsection 707-325(3)', C3-6

Commentary

An integrity rule prevents the modified market value of an entity being inflated by certain events occurring prior to consolidation. → subsections 707-325(2) to (5), *Income Tax Assessment Act 1997*

The modified market value of an entity is reduced if:

- one or more of the events described in subsection 707-325(4) occurred in the four years[160] before the joining time – these events are, broadly:
  - – an injection of capital into the entity or an associate of the entity, and
  - – a non-arm's length transaction involving the entity or an associate of the entity, and
- the modified market value worked out under subsection 707-325(1) exceeds what it would have been had none of those events occurred.

The amount of the reduction is the lesser of:

- the difference between the entity's modified market value at the joining time and what would have been its modified market value if the events had not occurred (the 'excess'), and
- the total increase in the entity's market value resulting from summing each increase in market value that occurred immediately after each event because of the event (the 'initial increase').

This ensures no reduction is required if the event has not actually resulted in an increased modified market value at the joining time. → 'Determining the reduction amount – injection of capital that does not result in increased modified market value', C3-6-130

[160] Events that take place before 9 December 2000 are disregarded → section 707-329, *Income Tax (Transitional Provisions) Act 1997*.

Six step process to calculate reduced modified market value

There are six steps to determine the modified market value of an entity in a situation where the integrity rule applies:

1 Determine the modified market value under subsection 707-325(1).

2 Determine the 'hypothetical modified market value' required by paragraph 707-325(2)(b). Hypothetical modified market value is calculated, under the assumptions in subsection 707-325(1), as though the prescribed event (or events) did not take place.

3 Reduce the step 1 amount by the step 2 amount. This is the paragraph 707-325(3)(a) amount.

4 Calculate the initial increase in market value that occurred after each event because of the event. The sum of these amounts is the paragraph 707-325(3)(b) amount.

5 The lesser of step 3 and step 4 is the 'reduction amount'.

6 Reduce the step 1 amount by the reduction amount.

Note

Valuation assumptions and methodology

This worked example highlights the steps to be undertaken when applying the integrity rule. Taxpayers should be able, when required, to provide evidence of the assumptions made and methodologies used in arriving at a particular value.

→ 'Determining the reduction amount – subsection 707-325(3)', C3-6
→ 'Market valuation guidelines', C4-1

Example

Facts

The Cable Group, a consolidatable group consisting of HeadCo and SubCo, consolidates on 1 July 2005.

Carry-forward tax losses are transferred from SubCo at the joining time.

A restructure of the group occurred in 2002, resulting in SubCo being responsible for manufacturing and HeadCo taking on the group's retail function.

The restructure involved the transfer of plant and equipment used in the manufacturing of cables at its written down value. It was documented in board minutes:

> Due to a restructure of the Cable Group, all plant and equipment will be transferred to SubCo from HeadCo in an effort to centralise the manufacturing function of the group.

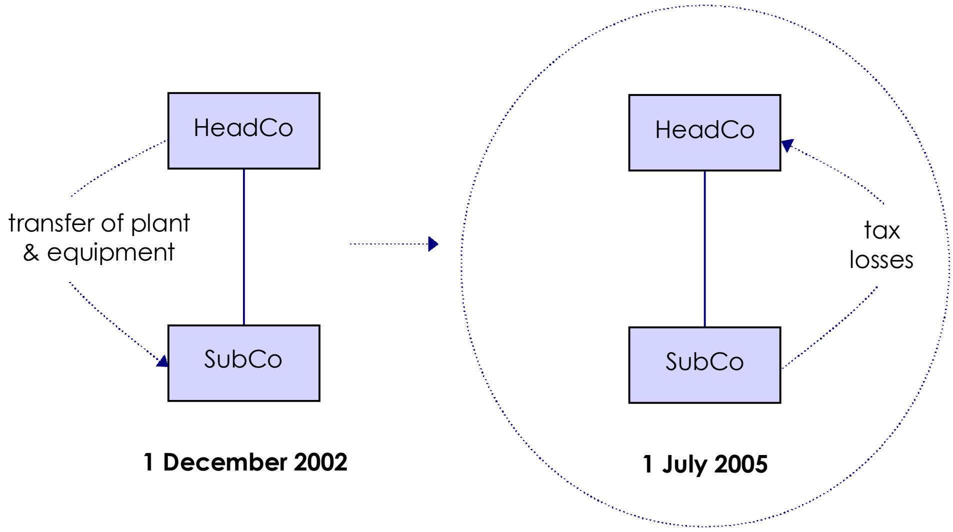
On 1 December 2002, HeadCo transferred the plant and equipment to SubCo for their book value of nil. Based on the output produced by the plant and equipment, the transfer had a positive impact on the market value of SubCo.

By 1 July 2005, production has reduced by half due to obsolescence. The positive impact on value attributable to the plant and equipment has diminished.

A reduction to the modified market value of SubCo may be required.

These facts are represented in figure 1.

Figure 1: Pre-consolidation non-arm's length transaction and subsequent consolidation



Calculation

Valuations undertaken to determine the reduction amount are shown in table 1.

Table 1: Valuation data – SubCo

Valuation	($ '000)
Modified market value of SubCo at the joining time	1,250
Hypothetical* modified market value of SubCo at the joining time	1,000
Excess in modified market value	**250**
Initial market value of SubCo immediately after the transfer	1,500
Hypothetical* initial market value of SubCo	1,000
Initial increase in market value	**500**

* As though the event (or events) had not occurred.

Applying the six step reduction method to SubCo

Table 2: Establishing the reduction amount – SubCo

Step	Explanation	$ ('000)
1	Modified market value	1,250
2	Hypothetical modified market value	1,000
3	Step 1 reduced by step 2	250
4	Initial increase in market value*	500
5	Reduction amount (lesser of step 3 and step 4)	250
6	Reduced modified market value	1,000

*[initial market value] – [hypothetical initial market value].

The modified market value of SubCo at 1 July 2005 that is to be used to determine the available fraction for the SubCo bundle is $1,000,000.

References

Income Tax Assessment Act 1997, section 707-325

Revision history

Section C3-6-120 first published 18 May 2005.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Determining the reduction amount – injection of capital that does not result in increased modified market value

Description

This example shows how to determine whether a reduction to modified market value is required under subsection 707-325(2) of the *Income Tax Assessment Act 1997* (ITAA 1997). In this example, capital introduced as a result of a share issue is directly invested in a new exploration project. The success or otherwise of the project (as reflected in the modified market value of the joining entity) as at the joining time must be considered when establishing the reduction amount.

Note

More information:

→ 'Determining the reduction amount – subsection 707-325(3)', C3-6

Commentary

An integrity rule prevents the modified market value of an entity being inflated by certain events occurring prior to consolidation. → subsections 707-325(2) to (5), *Income Tax Assessment Act 1997*

The modified market value of an entity is reduced if:

- one or more of the events described in subsection 707-325(4) occurred in the four years[161] before the joining time – these events are, broadly:
  - an injection of capital into the entity or an associate of the entity, and
  - a non-arm's length transaction involving the entity or an associate of the entity, and
- the modified market value worked out under subsection 707-325(1) exceeds what it would have been had none of those events occurred.

The amount of the reduction is the lesser of:

- the difference between the entity's modified market value at the joining time and what would have been its modified market value if the events had not occurred (the 'excess'), and
- the total increase in the entity's market value resulting from summing each increase in market value that occurred immediately after each event because of the event (the 'initial increase').

[161] Events that take place before 9 December 2000 are disregarded → section 707-329, *Income Tax (Transitional Provisions) Act 1997*.

Determining the excess in modified market value requires two valuations. The first establishes the modified market value of the entity at the joining time, based on the assumptions in subsection 707-325(1)[162]. The second valuation establishes the 'hypothetical modified market value' of the entity – that is, what the modified market value would have been in the absence of the event(s).

Six step process to calculate reduced modified market value

There are six steps to determine the modified market value of an entity in a situation where the integrity rule applies:

1 Determine the modified market value under subsection 707-325(1).

2 Determine the 'hypothetical modified market value' required by paragraph 707-325(2)(b). Hypothetical modified market value is calculated, under the assumptions in subsection 707-325(1), as though the prescribed event (or events) did not take place.

3 Reduce the step 1 amount by the step 2 amount. This is the paragraph 707-325(3)(a) amount.

4 Calculate the initial increase in market value that occurred after each event because of the event. The sum of these amounts is the paragraph 707-325(3)(b) amount.

5 The lesser of step 3 and step 4 is the 'reduction amount'.

6 Reduce the step 1 amount by the reduction amount.

If there is no excess at step 3 the integrity rule does not apply as the requirement in subsection 707-325(2)(b) is not satisfied, and consequently there is no need to obtain the valuations at step 4.

In such situations there is no reduction to the modified market value of the entity.

Note

Valuation assumptions and methodology

This worked example highlights the steps to be undertaken when applying the integrity rule. Taxpayers should be able, when required, to provide evidence of the assumptions made and methodologies used in arriving at a particular value.

→ 'Determining the reduction amount – subsection 707-325(3)', C3-6
→ 'Market valuation guidelines', C4-1

[162] The modified market value of an entity is, broadly, its market value, assuming it has no losses or franking credits and assuming it has no membership interest in any other group member.

Example

Facts

The Listed Group, a consolidatable group consisting of HeadCo and SubCo, consolidates on 1 July 2003.

A tax loss is transferred from HeadCo to itself at the joining time. HeadCo establishes its modified market value as at the joining time for the purposes of determining an available fraction for its bundle containing the transferred tax loss.

In April 2001 HeadCo advertised a renounceable rights issue to raise funds. Existing shareholders were offered one right to acquire shares in the Listed Group for every four shares owned, at a discount of 20c on the prevailing Australian Stock Exchange (ASX) share price.

A prospectus was sent to all shareholders detailing how the funds raised by the rights issue were to be invested. It stated in part:

> The funds are to be used for the development of additional oil fields in the Bluewater Basin. The exploration drilling program will commence in a largely unexplored but apparently viable reservoir.

The rights issue was fully subscribed and had a positive impact on the market value of the Listed Group. The share issue is an injection of capital event for the purposes of the integrity rule.

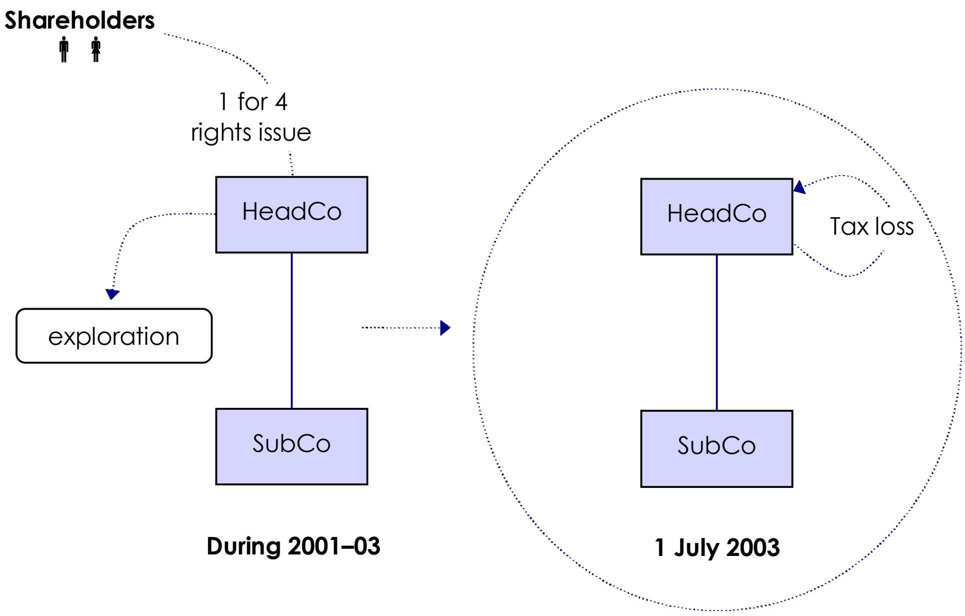
The project proceeded. However, in June 2003 the Listed Group issued a statement that:

- exploration activity for the Bluewater Basin project had been abandoned because of a lack of reserves, and
- all monies raised from the share issue and invested in the project were lost, as well as additional operating cash flows that were expended for that purpose.

The integrity rule may require a reduction to the modified market value of HeadCo.

These facts are represented in figure 1.

Figure 1: Pre-consolidation injection of capital and subsequent consolidation



Calculation

Valuations undertaken to determine the reduction amount are shown in table 1.

Table 1: Valuation data – HeadCo

Valuation	$ ('000)
Modified market value of HeadCo at the joining time	3,000
Hypothetical* modified market value of HeadCo at the joining time	3,600

* As though the event (or events) had not occurred.

The hypothetical modified market value of HeadCo is worked out on the assumption the losses incurred from the drilling activity would not have occurred in the absence of the rights issue.

Applying the six step reduction method to HeadCo

Table 2: Establishing the reduction amount – HeadCo

Step	Explanation	$ ('000)
1	Modified market value	3,000
2	Hypothetical modified market value	3,600
3	Step 1 reduced by step 2	nil*
4	Initial increase in market value	
5	Reduction amount (lesser of step 3 and step 4)	
6	Reduced modified market value	

* The step 3 amount cannot be reduced below nil.

As there was no excess at step 3 the modified market value of HeadCo is not reduced. The modified market value of HeadCo at 1 July 2003 that is used for the purpose of determining the available fraction for the HeadCo bundle is $3,000,000.

References

Income Tax Assessment Act 1997, section 707-325

Revision history

Section C3-6-130 first published 18 May 2005.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Determining the reduction amount – compounding of value up to the joining time

Description

This example shows how to determine a reduction to modified market value under subsection 707-325(2) of the *Income Tax Assessment Act 1997 (ITAA 1997)* in a situation where additional profits are generated as a result of investing the funds received through an injection of capital.

Note

More information:

→ 'Determining the reduction amount – subsection 707-325(3)', C3-6

Commentary

An integrity rule prevents the modified market value of an entity being inflated by certain events occurring prior to consolidation. → subsections 707-325(2) to (5), *Income Tax Assessment Act 1997*

The modified market value of an entity is reduced if:

- one or more of the events described in subsection 707-325(4) occurred in the four years[163] before the joining time – these events are, broadly:
  - an injection of capital into the entity or an associate of the entity, and
  - a non-arm's length transaction involving the entity or an associate of the entity, and
- the modified market value worked out under subsection 707-325(1) exceeds what it would have been had none of those events occurred.

The amount of the reduction is the lesser of:

- the difference between the entity's modified market value at the joining time and what would have been its modified market value if the events had not occurred (the 'excess'), and
- the total increase in the entity's market value resulting from summing each increase in market value that occurred immediately after each event because of the event (the 'initial increase').

Limiting the reduction amount to the initial increase in market value ensures that the compounding effects of the event are not incorporated. For example, if additional profits (as reflected in the modified market value) are generated as a result of applying the initial increase, the reduction amount is only the amount of the initial increase.

[163] Events that take place before 9 December 2000 are disregarded → section 707-329, *Income Tax (Transitional Provisions) Act 1997*.

Six step process to calculate reduced modified market value

There are six steps to determine the modified market value of an entity in a situation where the integrity rule applies:

1 Determine the modified market value under subsection 707-325(1).

2 Determine the 'hypothetical modified market value' required by paragraph 707-325(2)(b). Hypothetical modified market value is calculated, under the assumptions in subsection 707-325(1), as though the prescribed event (or events) did not take place.

3 Reduce the step 1 amount by the step 2 amount. This is the paragraph 707-325(3)(a) amount.

4 Calculate the initial increase in market value that occurred after each event because of the event. The sum of these amounts is the paragraph 707-325(3)(b) amount.

5 The lesser of step 3 and step 4 is the 'reduction amount'.

6 Reduce the step 1 amount by the reduction amount.

Note

Valuation assumptions and methodology

This worked example highlights the steps to be undertaken when applying the integrity rule. Taxpayers should be able, when required, to provide evidence of the assumptions made and methodologies used in arriving at a particular value.

→ 'Determining the reduction amount – subsection 707-325(3)', C3-6
→ 'Market valuation guidelines', C4-1

Example

Facts

The Medical Group, a consolidatable group consisting of HeadCo and SubCo, consolidates on 1 July 2003. The Medical Group is owned by five individual shareholders, who each hold an equal proportion of the share capital in HeadCo.

Carry-forward net capital losses are transferred from SubCo at the joining time. HeadCo is chosen to be a value donor[164] to SubCo for the purposes of determining an available fraction for the bundle containing the transferred net capital losses.

In March 2001, shareholders of the Medical Group subscribed for additional shares in HeadCo. It was documented in the board minutes that the share capital obtained from the existing shareholders would be used to fund further research into a discovery.

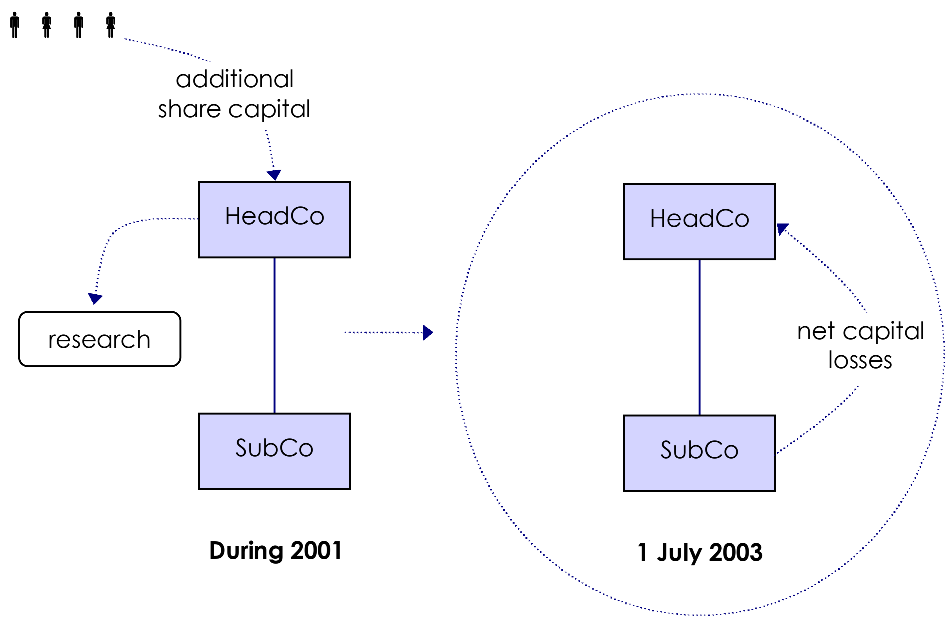
[164] The value donor concession is contained in Subdivision 707-C, *Income Tax (Transitional Provisions) Act 1997* → 'Adding to modified market value to reflect loss transferability', C3-4-210.

The research began and led to a medical breakthrough, which was commercially marketed and made a significant contribution to profits in the 2003 financial year.

A reduction to the modified market value of HeadCo may be required.

These facts are represented in figure 1.

Figure 1: Pre-consolidation injection of capital and subsequent consolidation



Calculation

Valuations undertaken to determine the reduction amount are shown in table 1.

Table 1: Valuation data – HeadCo

Valuation	$ ('000)
Modified market value of HeadCo at the joining time	6,000
Hypothetical* modified market value of HeadCo at the joining time	4,000
Excess in modified market value	**2,000**
Initial market value of HeadCo immediately after the injection of capital	5,200
Hypothetical* initial market value of HeadCo	5,000
Initial increase in market value	**200**

* As though the event (or events) had not occurred.

The data indicate that the use of the share capital considerably increased the value of HeadCo – its modified market value is much greater than it would have been had the share capital not been received. The hypothetical modified market value for HeadCo is determined on the basis that the profits and value generated from the discovery would not have occurred in the absence of the injection of capital.

Applying the six step reduction method to HeadCo

Table 2: Establishing the reduction amount – HeadCo

Step	Explanation	$ ('000)
1	Modified market value	6,000
2	Hypothetical modified market value	4,000
3	Step 1 reduced by step 2	2,000
4	Initial increase in market value*	200
5	Reduction amount (lesser of step 3 and step 4)	200
6	Reduced modified market value	5,800

* [initial market value] – [hypothetical initial market value].

The reduction amount is limited to the initial increase in market value that was attributable to the injection of capital ($200,000). The modified market value of HeadCo at 1 July 2003, that is to be donated to SubCo for the purpose of determining the available fraction for the SubCo bundle, is $5,800,000.

References

Income Tax Assessment Act 1997, section 707-325

Revision history

Section C3-6-140 first published 18 May 2005.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Determining the reduction amount – injection of capital subsequently injected into a subsidiary

Description

As shown in this example, there is only one reduction to modified market value under subsection 707-325(2) of the *Income Tax Assessment Act 1997* (ITAA 1997) where an injection of capital flows immediately to another entity within a wholly-owned group.

Note

More information:

→ 'Determining the reduction amount – subsection 707-325(3)', C3-6

Commentary

An integrity rule prevents the modified market value of an entity being inflated by certain events occurring prior to consolidation. → subsections 707-325(2) to (5), *Income Tax Assessment Act 1997*

The modified market value of an entity is reduced if:

- one or more of the events described in subsection 707-325(4) occurred in the four years[165] before the joining time – these events are, broadly:
  - an injection of capital into the entity or an associate of the entity, and
  - a non-arm's length transaction involving the entity or an associate of the entity, and
- the modified market value worked out under subsection 707-325(1) exceeds what it would have been had none of those events occurred.

The amount of the reduction is the lesser of:

- the difference between the entity's modified market value at the joining time and what would have been its modified market value if the events had not occurred (the 'excess'), and
- the total increase in the entity's market value resulting from summing each increase in market value that occurred immediately after each event because of the event (the 'initial increase').

Flow-through of injection of capital

It is a common commercial practice to raise funds by way of a share issue at the head or 'holding' company level of a corporate group. The funds raised are then injected in full into a wholly-owned subsidiary (either directly or through interposed entities), where they are invested in a business activity. In this

[165] Events that take place before 9 December 2000 are disregarded → section 707-329, *Income Tax (Transitional Provisions) Act 1997*.

scenario, assuming modified market values need to be determined for both entities, an event occurs when the holding company accepts the offer and when the wholly-owned subsidiary receives the injected capital.

However, the holding company is merely acting as a conduit to transfer the funds. Provided the funds pass immediately and in full to the wholly-owned subsidiary, there is no reduction to the holding company's modified market value. A reduction amount is calculated only for the wholly-owned subsidiary that ultimately receives the funds.

This is because the modified market value of the head company disregards all membership interests in other group members[166]. In the absence of any other events, the head company's modified market value equals what it would have been in the absence of the injection (its 'hypothetical modified market value'). There is, therefore, no excess as described in paragraph 707-325(2)(b).

Six step process to calculate reduced modified market value

There are six steps to determine the modified market value of an entity in a situation where the integrity rule applies:

1 Determine the modified market value under subsection 707-325(1).

2 Determine the 'hypothetical modified market value' required by paragraph 707-325(2)(b). Hypothetical modified market value is calculated, under the assumptions in subsection 707-325(1), as though the prescribed event (or events) did not take place.

3 Reduce the step 1 amount by the step 2 amount. This is the paragraph 707-325(3)(a) amount.

4 Calculate the initial increase in market value that occurred after each event because of the event. The sum of these amounts is the paragraph 707-325(3)(b) amount.

5 The lesser of step 3 and step 4 is the 'reduction amount'.

6 Reduce the step 1 amount by the reduction amount.

Note

Valuation assumptions and methodology

This worked example highlights the steps to be undertaken when applying the integrity rule. Taxpayers should be able, when required, to provide evidence of the assumptions made and methodologies used in arriving at a particular value.

→ 'Determining the reduction amount – subsection 707-325(3)', C3-6
→ 'Market valuation guidelines', C4-1

[166] Paragraph 707-325(1)(c), ITAA 1997.

Example

Facts

The Economic Group, a consolidatable group consisting of HeadCo and SubCo, consolidates on 1 January 2004. A net capital loss is transferred to HeadCo from SubCo at the joining time.

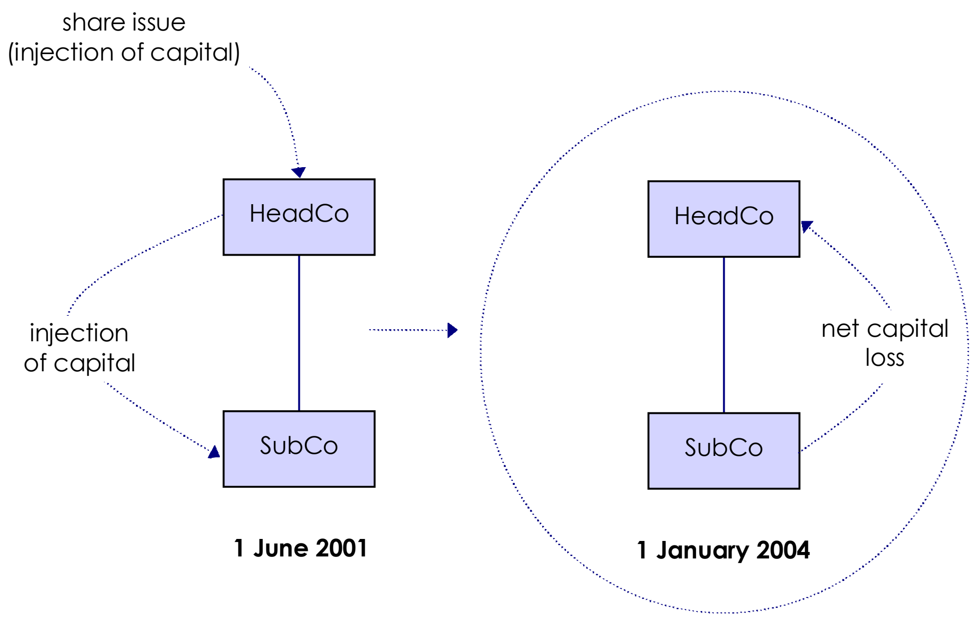
HeadCo is chosen to be a value donor[167] to SubCo for the purposes of determining an available fraction for the bundle containing the transferred net capital loss.

On 1 June 2001 HeadCo announced acceptance of an ordinary share issue, the purpose of which was to raise capital to fund the business activities of SubCo. On the same day the funds were received they were injected into SubCo, by way of HeadCo subscribing for additional shares in SubCo. The cash injection increased the working capital balance of SubCo.

Both the capital raising by HeadCo and the cash injection into SubCo are considered to be events for the purpose of the integrity rule. However, a reduction to modified market value may be required only for SubCo, even though there has also been an event in respect of HeadCo.

These facts are represented in figure 1.

Figure 1: Pre-consolidation injections of capital and subsequent consolidation



167 The value donor concession is contained in Subdivision 707-C, *Income Tax (Transitional Provisions) Act 1997*. → 'Adding to modified market value to reflect loss transferability', C3-4-210

Calculation

Valuations undertaken to determine the reduction amount are shown in tables 1 and 2.

Table 1: Valuation data – HeadCo

Valuation	$ ('000)
Modified market value of HeadCo at the joining time	200
Hypothetical* modified market value of HeadCo at the joining time	200

* As though the event had not occurred.

The value attributable to the membership interests HeadCo holds in SubCo (that would include the value attributable to the injected funds) is disregarded in determining the modified market value for HeadCo. The hypothetical modified market value for HeadCo equates to its modified market value as the capital generated by the share issue was subsequently injected in full into SubCo.

Table 2: Valuation data – SubCo

Valuation	$ ('000)
Modified market value of SubCo at the joining time	500
Hypothetical* modified market value of SubCo at the joining time	400
Excess in modified market value	**100**
Initial market value of SubCo immediately after the cash injection	500
Hypothetical* initial market value of SubCo	400
Initial increase in market value	**100**

* As though the event had not occurred.

Applying the six step reduction method to both HeadCo and SubCo

Table 3: Establishing the reduction amount – HeadCo

Step	Explanation	$ ('000)
1	Modified market value	200
2	Hypothetical modified market value	200
3	Step 1 reduced by step 2	nil
4	Initial increase in market value	
5	Reduction amount (lesser of step 3 and step 4)	
6	Reduced modified market value	

As there is no excess at step 3 the modified market value of HeadCo is not reduced. The modified market value of HeadCo at 1 July 2003, that is to be donated to SubCo for the purpose of determining the available fraction for the SubCo bundle, is $200,000.

Table 4: Establishing the reduction amount – SubCo

Step	Explanation	$ ('000)
1	Modified market value	500
2	Hypothetical modified market value	400
3	Step 1 reduced by step 2	100
4	Initial increase in market value*	100
5	Reduction amount (lesser of step 3 and step 4)	100
6	Reduced modified market value	400

* [initial market value] – [hypothetical initial market value].

The modified market value of SubCo at 1 July 2003, that is to be used to determine the available fraction for the SubCo bundle, is $400,000.

References

Income Tax Assessment Act 1997, section 707-325

Revision history

Section C3-6-150 first published 18 May 2005.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Determining the reduction amount – multiple events – market value reduced under some events

Description

As shown in this example, all events, including those that reduce the market value of an entity, are assumed not to have taken place in determining hypothetical modified market value.

Note

More information:

→ 'Determining the reduction amount – subsection 707-325(3)', C3-6

Commentary

An integrity rule prevents the modified market value of an entity being inflated by certain events occurring prior to consolidation. → subsections 707-325(2) to (5), *Income Tax Assessment Act 1997*

The modified market value of an entity is reduced if:

- one or more of the events described in subsection 707-325(4) occurred in the four years[168] before the joining time – these events are, broadly:
  - an injection of capital into the entity or an associate of the entity, and
  - a non-arm's length transaction involving the entity or an associate of the entity, and
- the modified market value worked out under subsection 707-325(1) exceeds what it would have been had none of those events occurred.

The amount of the reduction is the lesser of:

- the difference between the entity's modified market value at the joining time and what would have been its modified market value if the events had not occurred (the 'excess'), and
- the total increase in the entity's market value resulting from summing each increase in market value that occurred immediately after each event because of the event (the 'initial increase').

Six step process to calculate reduced modified market value

There are six steps to determine the modified market value of an entity in a situation where the integrity rule applies:

1 Determine the modified market value under subsection 707-325(1).

2 Determine the 'hypothetical modified market value' required by paragraph

[168] Events that take place before 9 December 2000 are disregarded → section 707-329, *Income Tax (Transitional Provisions) Act 1997*.

707-325(2)(b). Hypothetical modified market value is calculated, under the assumptions in subsection 707-325(1), as though the prescribed event (or events) did not take place.

3 Reduce the step 1 amount by the step 2 amount. This is the paragraph 707-325(3)(a) amount.

4 Calculate the initial increase in market value that occurred after each event because of the event. The sum of these amounts is the paragraph 707-325(3)(b) amount.

5 The lesser of step 3 and step 4 is the 'reduction amount'.

6 Reduce the step 1 amount by the reduction amount.

Reduction in market value after event

In determining the step 4 amount, only events that increase the initial market value of the entity are taken into account. This step does not provide for offsetting of increases and reductions in market value from different events.

However, all events described in subsection 707-325(4) must be disregarded in determining the hypothetical modified market value at step 2. Events that have a negative impact on market value, as well as events that have a positive impact on market value, are assumed not to have taken place.

Note

Valuation assumptions and methodology

This worked example highlights the steps to be undertaken when applying the integrity rule. Taxpayers should be able, when required, to provide evidence of the assumptions made and methodologies used in arriving at a particular value.

→ 'Determining the reduction amount – subsection 707-325(3)', C3-6

→ 'Market valuation guidelines', C4-1

Example

Facts

A consolidatable group consisting of HeadCo and SubCo consolidates on 1 July 2003. A tax loss is transferred to HeadCo from SubCo at the joining time.

HeadCo is chosen to be a value donor[169] to SubCo for the purposes of determining an available fraction for the bundle containing the transferred tax loss.

During June 2003, the following events took place:

- HeadCo obtained additional capital from a new share subscription.

[169] The value donor concession is contained in Subdivision 707-C, *Income Tax (Transitional Provisions) Act 1997*. → 'Adding to modified market value to reflect loss transferability', C3-4-210

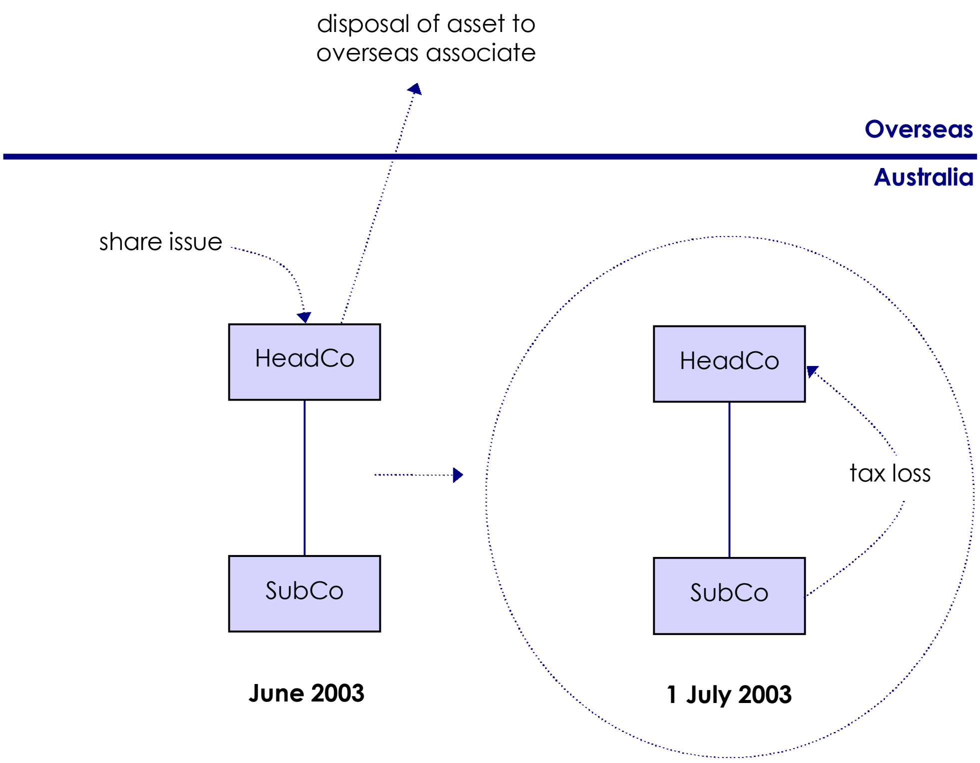
- HeadCo sold an asset to an associated company overseas at below market value. The sale had an immediate negative impact on the market value of HeadCo.

Both the capital raising and the disposal of the asset are considered to be events for the purpose of the integrity rule. The first event is an injection of capital and the second is a transaction that did not take place at arm's length.

A reduction to the modified market value of HeadCo may be required.

These facts are represented in figure 1.

Figure 1: Pre-consolidation events and subsequent consolidation



Calculation

Valuations undertaken to determine the reduction amount are shown in table 1.

Table 1: Valuation data – HeadCo

Valuation	$ ('000)
Modified market value of HeadCo at the joining time	700
Hypothetical modified market value* of HeadCo at the joining time	400
Excess in modified market value	**300**
Initial market value of HeadCo immediately after capital raising	1,500
Hypothetical initial market value** of HeadCo immediately after capital raising	1,000
Initial increase in market value	**500**

* As though the capital raising and disposal of asset had not occurred.
** As though the capital raising had not occurred.

Applying the six step reduction method to HeadCo

Table 2: Establishing the reduction amount – HeadCo

Step	Explanation	$ ('000)
1	Modified market value at joining time	700
2	Hypothetical modified market value	400
3	Step 1 reduced by step 2	300
4	Total initial increase in market value	500*
5	Reduction amount (lesser of step 3 and step 4)	300
6	Reduced modified market value	400

* There is no reduction in the initial increase in respect of the disposal of the asset.

The modified market value of HeadCo at 1 July 2003, that is to be donated to SubCo for the purpose of determining the available fraction for the SubCo bundle, is 400,000.

References

Income Tax Assessment Act 1997, section 707-325

Revision history

Section C3-6-160 first published 18 May 2005.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

C4: **Market valuation**

Market valuation

Status

Following the release of the revised version of *Market valuation for tax purposes*, which has been expanded to include the consolidation valuation short cut options, specific market valuation guidelines for consolidation are no longer required.

Consequently, the following action has been taken in relation to the material that previously made up section C4 of the *Consolidation Reference Manual* (CRM):

C4-1:	**Market valuation guidelines** – withdrawn
C4-1-110:	**Advanced market valuation agreement – proforma** – withdrawn
C4-2-110:	**Taxation Determination TD 2003/10** – withdrawn from the CRM but remains current and is available on ATO Law
C4-2-120:	**Taxation Determination TD 2003/11** – withdrawn from the CRM but remains current and is available on ATO Law

Market valuation for tax purposes can be found at **www.ato.gov.au**

Revision history

Section C4-1 first published (excluding drafts) on 2 December 2002 and updated 28 May 2003. Further revisions are described below.

Date	Amendment	Reason
3.12.03	New information on valuing goodwill.	More detailed interpretation.
	Clarification of ATO's potential request for information as part of a review and audit.	Clarification.
	Clarification relating to valuation short cuts and single large functioning units of integrated plant.	Clarification.
	New section on Advance Market Valuation Agreements (AMVAs).	AMVAs process introduced under Commissioner's administrative powers.
14.1.04	Further clarification relating to valuation short cuts and single large functioning units of integrated plant. Specifically, in relation to the requirement that such an item must have a value greater than 1% of the joining subsidiary's ACA to qualify for the exception, 'value' means *total adjustable* value (p. 20).	Clarification.
26.10.05	Reference to ATO's view on deductibility of valuation expenses, p. 11, and taxation rulings.	
	Major revision of 'Market valuing goodwill', p. 4, and following pages.	To reflect new taxation ruling and for clarification.
30.6.09	Reference to TD2007/1.	
6.5.11	Withdrawn and replaced by *Market valuation for tax purposes*.	

C5: **Franking credits**

Franking credits

About this section

The operation of franking accounts is briefly described in Part B of this Reference Manual → 'Transferring franking credits', B2-4.

This section (C5) provides more detail on the treatment of franking credits under consolidation, supported by an example showing the treatment of:

- any franking surplus or deficit on entry into consolidation
- members' franking accounts during consolidation
- distributions made by subsidiary members

Section contents

Treatment of franking credits

While a group is consolidated, the head company maintains a single franking account for the group as a whole, and the franking accounts of subsidiary members are inoperative.

When a subsidiary member joins a consolidated group, any surplus in its franking account is transferred to the head company's franking account. The franking credit resulting from the transferred surplus remains with the head company even if the subsidiary member subsequently leaves the group. If a subsidiary member's franking account is in deficit when it joins a consolidated group, the subsidiary is liable to pay franking deficit tax.

While a subsidiary is a member of a consolidated group, any franking credits or debits that would have arisen in its franking account if it were not a member of the group are attributed to the franking account of the head company.

For an example of how these rules operate in practice see → 'Franking accounts in consolidated groups', C5-2-110.

The special imputation rules that apply to consolidated groups are contained in Subdivision 709-A of the *Income Tax Assessment Act 1997* (ITAA 1997). They allow the franking of distributions made by a subsidiary member:

- on disregarded employee shareholdings
- on non-share equity interests
- whose membership interests are held by a non-resident.

A frankable distribution made by a subsidiary member in relation to such shares or interests will be treated as a frankable distribution by the head company for the purposes of the imputation rules.

Special rules apply in relation to multiple entry consolidated (MEC) groups and are contained in Subdivision 719-H of the ITAA 1997. They provide for:

- the transfer of the franking account balance from a provisional head company (PHC) that ceases to be the PHC of a group to a newly appointed PHC of the group
- frankable distributions made by eligible tier-1 companies to be taken to have been made by the provisional head company of the group, and
- frankable distributions made by a foreign held subsidiary member of a MEC group to an entity that is not a member of the MEC group, to be taken to have been made by the provisional head company of the group.

Existing anti-avoidance measures that counter franking credit trading have been extended to accommodate consolidated groups. → section 177EB, ITAA 1936 and Subdivision 709-B, ITAA 1997

References

Income Tax Assessment Act 1997, Subdivision 709-A; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Income Tax Assessment Act 1936, section 177EB; as amended by *New Business Tax System (Consolidations) Act (No.1) 2002* (No. 68 of 2002), Schedule 3, item 40

Income Tax Assessment Act 1997, Subdivision 719-H; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003 (No. 16 of 2003)*, Schedule 5, item 5

Income Tax Assessment Act 1997, section 709-90; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003 (No. 16 of 2003)*, Schedule 5, item 2

Income Tax Assessment Act 1997, Subdivision 709-B; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003 (No. 16 of 2003)*, Schedule 5, item 4

Income Tax Assessment Act 1997, Subdivisions 707-A and 709-B; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003 (No. 16 of 2003)*, Schedule 5, item 3

Income Tax Assessment Act 1936, section 177EB; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003 (No. 16 of 2003)*, Schedule 5, item 1

Revision history

Section C5-1 first published 2 December 2002 and updated 28 May 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

High-level worked example

Franking accounts in consolidated groups

Description

This high-level example illustrates the operation of the head company's single franking account in a consolidated group and the transactions in the subsidiary members' franking accounts on joining. For general information on the treatment of franking credits see → 'Treatment of franking credits', C5-1.

Commentary

While a group is consolidated, the head company maintains a single franking account for the group, and the franking accounts of subsidiary members are inoperative.

When a subsidiary member joins a consolidated group, any surplus in its franking account is transferred to the head company's franking account. If, on joining, a subsidiary member's franking account is in deficit the subsidiary will be liable to pay franking deficit tax.

While a subsidiary is a member of a consolidated group, any franking credits or debits that would have arisen if it were not a member are attributed to the franking account of the head company.

Example

Facts

- HCo (the head company) and ACo comprise a consolidated group that comes into existence on 1 July 2002.
- Just before that time, HCo had a $200 franking account surplus and ACo had a $300 franking surplus.
- On 1 August 2002, ACo acquires 100% of the shares in BCo which becomes a subsidiary member of the group.
- Just before that time, BCo had a $100 franking account deficit.

Treatment of franking surplus or deficit on entry into consolidation

HCo maintains a single franking account for the consolidated group. When the group forms, ACo's franking account surplus is transferred into HCo's franking account by way of a $300 franking credit to HCo's franking account and a $300 franking debit to ACo's franking account. The debit to ACo's franking account brings its balance to nil.

As BCo's franking account was in deficit just before it joined the consolidated group, it becomes liable to pay franking deficit tax. A corresponding credit arises in BCo's franking account at the joining time, which brings its balance to nil.

The resulting franking account entries are as follows (all entries being in terms of tax paid in accordance with the simplified imputation system):

Table 1: HCo – franking account

Date	Transaction details	Debit	Credit	Balance
1.7.02	Balance just before joining time			$200
1.7.02	Transfer surplus balance from ACo		$300	$500

Table 2: ACo – franking account

Date	Transaction details	Debit	Credit	Balance
1.7.02	Balance just before joining time			$300
1.7.02	Transfer surplus balance to HCo	$300		$0

Table 3: BCo – franking account

Date	Transaction details	Debit	Credit	Balance
1.8.02	Balance just before joining time			($100)
1.8.02	Liability for franking deficit tax		$100	$0

Additional facts

These income tax transactions occur in relation to the consolidated group:

- On 28 July 2002, ACo pays a $150 PAYG instalment for the quarter ended 30 June 2002.
- On 14 August 2002, ACo receives a $100 refund resulting from an amendment to its 2000–01 income tax assessment.
- On 28 October 2002, HCo pays a $350 PAYG instalment for the quarter ended 30 September 2002.
- On 1 December 2002, HCo pays $200 in relation to its 2001–02 income tax assessment.

Treatment of subsidiary's franking account during consolidation

While ACo and BCo remain subsidiary members of a consolidated group their franking accounts are inoperative. This means that neither credits nor debits can arise in their accounts, although the accounts still exist.

Treatment of head company's franking account during consolidation

The first two transactions above would, if ACo were not part of the consolidated group, result in entries arising in the franking account of ACo. However, given that ACo's franking account is inoperative, the entries arise in HCo's franking account. This is the case even though the transactions relate to the period before consolidation.

The remaining transactions relate to HCo. They give rise to entries in HCo's franking account in the same way that other credits or debits arise in the ordinary course of its activities as a taxpayer and a franking entity.

The franking account entries resulting from these transactions are as follows.

Table 4: HCo – franking account

Date	Transaction details	Debit	Credit	Balance
1.7.02	Balance brought forward			$500
28.7.02	Payment of fourth 2001–02 PAYG instalment – ACo		$150	$650
14.8.02	Refund on 2000–01 income tax assessment – ACo	$100		$550
28.10.02	Payment of first 2002–03 PAYG instalment – HCo		$350	$900
1.12.02	Payment of 2001–02 income tax assessment – HCo		$200	$1,100

Additional facts

ACo pays dividends to its shareholders on 15 December 2002. It pays $7,000 to HCo and $70 in relation to employee shares that have been disregarded for consolidation membership purposes.

Treatment of distributions made by a subsidiary during consolidation

The $7,000 payment made by ACo to HCo is an intragroup dividend which, as a consequence of the single entity rule, is not subject to the franking regime. As far as the $70 dividend is concerned, the general rule in consolidated groups is that a subsidiary member cannot frank distributions to entities outside the group. However, frankable distributions made by a subsidiary member in regard to the employee shares are treated as a frankable distribution by the head company for the purposes of the imputation rules.

On the basis that a $30 franking credit can be allocated to the $70 dividend paid on the employee shares, the following franking account entries result:

Table 5: HCo – franking account

Date	Transaction details	Debit	Credit	Balance
1.12.02	Balance			$1,100
15.12.02	Franking credit allocated in relation to dividend paid to ACo employee shareholders	$30		$1,070

References

Income Tax Assessment Act 1997, Subdivision 709-A; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (68 of 2002), Schedule 1

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraph 2.18 and chapter 10

New Business Tax System (Imputation) Act 2002 (48 of 2002), Division 205

Explanatory Memorandum to the New Business Tax System (Imputation) Bill 2002, chapter 4

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Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

C6: **International**

International

About this section

Section C6 provides technical detail on the consolidation rules for:

- the treatment of foreign income tax offsets
- transferring and using excess foreign tax credits
- transferring attribution surpluses relating to controlled foreign companies, foreign investment funds and foreign life assurance policies
- the treatment of conduit foreign income
- transferring foreign dividend account balances, and
- inheriting irrevocable elections or choices in relation to interests in CFCs, FIFs or FLPs.

This section has an overall explanation of these rules and detailed worked examples showing the processes and calculations involved.

For a brief description of the above rules see Part B (→ 'Treatment of foreign income tax offsets, excess foreign tax credits, attribution surpluses, conduit foreign income and irrevocable elections', B2-5).

Section contents

Overall explanation:

Worked examples:

Treatment of foreign income tax offsets, attribution surpluses and conduit foreign income

Foreign income tax offset rules

The foreign income tax offset rules (in Division 770 of the *Income Tax Assessment Act 1997* – ITAA 1997) replace the foreign tax credit (FTC) rules and apply to income years starting on or after 1 July 2008. The application of the foreign income tax offset rules to consolidated and multiple entry consolidated (MEC) groups is dealt with in Subdivision 717-A of the ITAA 1997 (which replaces the previous provisions on FTCs and tax consolidation).

Transitional rules provide for the utilisation of an entity's excess FTCs, with specific rules for consolidated groups and MEC groups in Subdivision 770-E of the *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A 1997).

The application of the FTC rules to consolidated groups is dealt with in this section from p. 4.

Entitlement to a foreign income tax offset

The foreign income tax offset rules provide a non-refundable tax offset for foreign income tax paid on an amount included in an entity's assessable income (a 'double-taxed amount'). The entity becomes entitled to a tax offset in the income year the amount is included in its assessable income, and the offset is determined on a whole-of-income basis, not on a class-of-income basis.

A head company's entitlement to foreign income tax offset is determined in accordance with the general foreign income tax offset rules in Division 770 of the ITAA 1997. The head company can only claim a foreign income tax offset for the income year in which the relevant amount is included in its assessable income, which may be different from the income year in which the foreign income tax on that amount is paid. If foreign income tax is paid after the year in which the relevant income amount is included in assessable income, the head company will need to lodge an amended return for that year to claim the foreign income tax offset.

Under the single entity rule, each subsidiary member of a consolidated or MEC group is treated as being part of the head company for income tax purposes. Therefore, amounts, including amounts on which foreign income tax has been paid, received by a subsidiary member of a consolidated or MEC group will be taken to be received by the head company and will be included in the head company's assessable income.

Where a subsidiary member pays foreign income tax on an amount included in the head company's assessable income, the head company rather than the subsidiary member is treated as having paid the tax. → section 717-10, ITAA 1997

Foreign income tax deemed to be paid

Foreign income tax is deemed to have been paid by an entity on an amount included in its assessable income where the tax has effectively been paid by another entity in certain circumstances, such as payments by a partnership or trust.

Under subsections 770-130(1) and (2) of the ITAA 1997 and the single entity rule, the head company is treated as having paid foreign income tax on an amount included in its assessable income where the tax has been paid by another entity under an arrangement or under the law relating to the tax.

For example, where a subsidiary member of a consolidated or MEC group is a partner in a partnership that is not a member of the group, and the partnership pays foreign income tax, on behalf of the subsidiary member under an arrangement with it, on an amount part of which is included in the head company's assessable income, the head company will be deemed to have paid the tax. The application of the deeming rule and the single entity rule allows the head company to claim a foreign income tax offset.

An entity is also deemed to have paid foreign income tax where it is presently entitled to a share of trust income that is attributable to income received by the trust on which foreign income tax has already been paid → Subsections 770-130(1) & (3), ITAA 1997. This rule applies in conjunction with section 6B of the ITAA 1936, which ensures that the character and source of income that flows through a trust is retained when received by a beneficiary. When applied together with the single entity rule, these rules ensure the head company is deemed to have paid the foreign income tax on an amount included in its assessable income where a subsidiary member is a beneficiary of a trust and the trust is not part of the consolidated or MEC group.

→ 'Calculating the foreign income tax offset', C6-2-130

Using pre-commencement excess foreign income tax

Excess FTCs from the five income years before the commencement of the foreign income tax offset rules are converted to pre-commencement excess foreign income tax.

At the commencement of the new foreign income tax offset rules, the head company of a consolidated or MEC group amalgamates and converts existing excess FTCs from the previous five income years into a classless bundle of pre-commencement excess foreign income tax. There is no requirement to maintain the four classes of assessable foreign income, as required under the previous FTC rules.

Subject to the transitional rules (→ p. 3 of this section), pre-commencement excess foreign income tax can be used for up to five years from the commencement of the new regime to top up the amount of foreign income tax paid if there is a foreign income tax shortfall (that is, where the foreign income tax paid is less than the foreign income tax offset limit). → section 770-230, IT(TP)A 1997

The foreign income tax offset limit is calculated as the amount of Australian tax payable on the double-taxed amounts and other assessable income that does not have an Australian source. Alternatively, the taxpayer can elect to use

$1,000 (the *de minimis* rule) as the foreign tax offset limit. → section 770-75, ITAA 1997

Where a head company has a foreign income tax shortfall, it can increase the foreign income tax paid up to the foreign income tax offset limit by using any pre-commencement excess foreign income tax it has or that has been transferred to it from a joining entity, subject to the transitional rules. → section 770-230, IT(TP)A 1997

Where the foreign income tax paid exceeds the foreign income tax offset limit, the excess foreign income tax cannot be carried forward to a subsequent year or transferred.

→ Subdivision 770-D, IT(TP)A 1997

Transitional rules

Transitional rules (in Subdivision 770-E of the IT(TP) Act 1997) allow a joining entity to transfer pre-commencement excess foreign income tax to the head company at the joining time. The rules apply in the same way to MEC groups and consolidated groups. → Subdivision 770-E, IT(TP) Act 1997

These transitional rules substantially replicate the previous FTC rules on the transfer of excess FTCs to the head company at the joining time (previously in Subdivision 717-A of the ITAA 1997).

Once an entity joins a consolidated or MEC group, the entity's pre-commencement excess foreign income tax is effectively transferred to the head company. The pre-commencement excess foreign income tax transferred from the joining entity is pooled with any other pre-commencement excess foreign income tax of the head company and any other subsidiary members. → section 770-290, IT(TP)A 1997

There is a five year limit on the utilisation of pre-commencement excess foreign income tax by the head company, and the pre-commencement excess foreign tax in the pool must be separately identified according to the income years in which it arose. The head company can apply pre-commencement excess foreign income tax transferred from a joining entity in an income year starting on or after joining time.

The worked example 'Foreign income tax offset – transitional rules' (→ C6-2-120) shows how the pre-commencement excess foreign income tax is transferred to the head company of the group and subsequently used.

Joining a consolidated group

An entity that joins a consolidated or MEC group part way through an income year is entitled to a foreign income tax offset for foreign income tax paid on an amount included in its assessable income for the non-membership period before it joined the group.

A joining entity can use its pre-commencement excess foreign income tax where it has a foreign income tax shortfall in the non-membership period. It can also transfer unutilised pre-commencement excess foreign income tax to the head company at the joining time.

If the foreign income tax paid by the joining entity exceeds the foreign tax offset limit in the non-membership period, the excess foreign income tax paid cannot be transferred to the head company.

Leaving a consolidated group

An entity that leaves a consolidated group is not entitled to any pre-commencement excess foreign income tax it had before joining the group, or that arose in the group while it was a subsidiary member.

→ section 770-305, IT(TP)A 1997

The head company is entitled to an offset for foreign income tax paid by a leaving entity after it leaves the group on an amount included in the head company's assessable income.

Period to lodge amendments extended

To ensure an entity can claim an offset for foreign income tax paid after the year in which the amount on which the tax has been paid is included in its assessable income, section 770-190 of the ITAA 1997 modifies the usual amendment period to allow an amendment to be lodged within four years of the time the foreign income tax is paid. The amendment to claim the offset is made to the assessment for the income year in which the double-taxed amount was included in assessable income.

Foreign tax credit rules (pre 1 July 2008)

The FTC rules were replaced by the foreign income tax offset rules from 1 July 2008, subject to the transitional provisions.

Under the single entity rule, the head company of a consolidated group is assessed on the foreign income of all members of the group. Previously, the head company could claim an FTC against Australian tax payable on this income – using its own FTCs, FTCs of subsidiary members and excess FTCs transferred into the group from joining entities.

On consolidation, the excess FTCs of entities joining or forming a consolidated group were transferred to the head company. The excess FTCs were then pooled by the head company according to class of income and the income year in which they arose.

The head company generally could not use the excess FTCs of a subsidiary member until the end of the head company's income year following the one in which the member joined the group, unless the joining time was at the start of the head company's income year.

There were special rules for the transfer of excess FTCs where the income year of the joining entity ended before that of the head company – that is, where the joining entity was an early balancer relative to the head company.

The worked example 'Pooling of excess foreign tax credits' (→ C6-2-110) shows how the excess FTCs of a joining entity were transferred to and used by the head company.

Claiming FTCs

Section 160AF of the ITAA 1936 allowed an FTC to be claimed only by the entity that paid and was personally liable for the foreign tax. To ensure a head company could claim an FTC against Australian tax payable on a consolidated group's foreign income, the head company was deemed to have paid and been personally liable for the foreign tax on that foreign income rather than the subsidiary member. This also applied to foreign tax on certain overseas film income under Part III, Division 18A of the ITAA 1936 and certain shipping income under Division 18B.

Where the head company was assessed on foreign income, it could use its own FTCs, FTCs of subsidiary members and excess FTCs transferred into the group from joining entities. This applied even if the entity that paid the foreign tax was no longer a member of the group or if the foreign tax was paid by an entity after it left the group. However, if an entity was assessed on foreign income before joining the group but paid the foreign tax afterwards, the entity was still entitled to the FTC to offset the Australian tax payable by it on the foreign income.

Once transferred, FTCs were effectively pooled according to class of income and the year in which the credits arose. Any excess FTCs held by or arising for the head company (through subsidiary members in the consolidated group) remained with the head company when entities left the group. This was because the head company is the only entity recognised as having paid and been personally liable for the foreign tax that gives rise to the FTCs.

Transfer and carry-forward of FTCs

The rules for the carry-forward of excess FTCs were contained in section 160AFE of the ITAA 1936. Before its amendment[170] this section (the old section 160AFE) allowed:

- the carry-forward of excess foreign tax paid over the Australian tax payable on foreign income for up to five years (excess FTCs from the earliest year must be used first), and
- the transfer of excess FTCs between companies that have been members of the same wholly-owned group for the whole of an income year, subject to certain conditions.

The amended section 160AFE (the new section 160AFE) continued to allow all taxpayers to carry-forward excess FTCs for five years, but removed the provisions allowing transfer of excess FTCs between companies in a wholly-owned group.

Subject to certain variations and exceptions to its application in the transitional period, the new section 160AFE applied to any income years and any non-membership periods starting after 30 June 2003. This basic rule applied to an entity whether or not it was a member of a consolidated or MEC group, either as a head company or as a subsidiary member, and irrespective of whether the

[170] Section 160AFE was amended by Schedule 10 of the *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002).

entity had a substituted accounting period (SAP). The old section 160AFE continued to operate until 30 June 2003 or until the time the new section 160AFE applied.

Where an entity with excess FTCs became a subsidiary member of a consolidated group, the excess FTCs were effectively transferred to the head company of that group. This was done by deeming the head company to have held the excess FTCs (referred to as transfer credits) rather than the subsidiary member. Once transferred, the excess FTCs remained with the head company.

The head company could not use the excess FTCs of a subsidiary entity until the end of the head company's income year following the one in which the entity joined the group, unless the transitional rule applied. This was the case whether or not the entity was still a member of the group at that time.

Where an entity was not currently a member of a consolidated group, it was entitled to any excess FTCs that arose under section 160AFE during that time. However, where the excess FTCs had been transferred to the head company of a consolidated group because the entity had joined the group, the entity relinquished any future entitlement to those excess FTCs in later non-membership periods or when it joined another group.

Joining part-way through an income year

If an entity is a subsidiary member of a consolidated group for part but not all of an income year, and there are one or more periods in that year where it is not a member of any consolidated group, each period is referred to as a non-membership period. This period is treated as if it were an income year.

→ former section 701-30, IT(TP)A 1997

Where a joining entity had a non-membership period and foreign income was included in its assessable income for that period, the entity could claim an FTC on any foreign tax it paid on that foreign income (even if it paid the tax after joining the group). The entity could also use any excess FTCs to which it was entitled (that is, FTCs that were not previously transferred to a head company), subject to the rules in section 160AFE. Any remaining excess FTCs were then transferred to the head company of the group it joined.

If an entity left a consolidated group part-way through an income year and foreign income was included in its assessable income, the leaving entity was entitled to claim an FTC only for the foreign tax paid on that foreign income. It could not claim a credit for excess FTCs of earlier income years or non-membership periods because those FTCs remained with the head company of the group the entity was leaving. → section 717-30, ITAA 1997

Attribution surpluses

Changes to attributed tax accounts

As part of the changes made under the foreign income tax offset rules, attribution tax accounts are no longer required to track underlying foreign tax paid. Under the foreign income tax offset rules, a resident taxpayer that receives non-assessable non-exempt income, under either section 23AI or 23AK of the ITAA 1936, may be entitled to a foreign income tax offset for the foreign income tax paid on the distribution. A taxpayer with previously attributed income will no longer be entitled to claim a credit for underlying foreign taxes paid on a distribution, and therefore attributed tax accounts are no longer necessary.

The legislative provisions dealing with the attributed tax accounts were repealed on 24 September 2007.

Attribution accounts

The foreign investment fund (FIF) rules were repealed with effect from the 2010-11 income year. Companies with interests in a FIF or foreign life policy (FLP) are no longer subject to the requirements of the attribution rules. Consequently, insofar as this section refers to FIFs and FLPs, it only applies in relation to income years before 2010-11. For the treatment of FIFs and FLPs in later years, see → 'FIF income (2010-11 onwards)', p. 12.

In keeping with the single entity principle, in a consolidated group only the head company is able to operate attribution accounts for the purposes of the controlled foreign company (CFC) and FIF provisions. The pre-consolidation surpluses of such accounts are transferred to the head company.

This section explains the rules for:

- dealing with attribution accounts at entry and exit, and
- calculating the appropriate amount of FIF income that should be assessed to an entity that joins or leaves a consolidated group with an interest in a FIF in order to determine the surplus to be transferred.

The worked example 'Transfer of attribution surpluses' (→ C6-2-210) shows how attribution account surpluses relating to interests in CFCs, FIFs and FLPs are transferred from a joining company to a head company at the joining time and from a head company to a leaving company at the leaving time.

Transfer of surpluses

These rules apply to surpluses in attribution accounts, attributed tax accounts, FIF attribution accounts and FIF attributed tax accounts – collectively referred to here as 'attribution accounts'.

At entry

A company that becomes a subsidiary member of a consolidated group may hold interests in a CFC, FIF or FLP. If the balance of any relevant attribution account kept by that company is in surplus immediately before the joining time, the surplus is transferred to the head company of that group.

This ensures that distributions from CFCs, FIFs and FLPs are not taxed to the head company where the joining company has already been taxed on the attributed income.

A surplus is transferred from the joining company to the head company in the following way:

1. The balance of the joining company's attribution account is calculated immediately before the joining time to determine the amount of the surplus to be transferred (if any).
2. At the joining time an attribution account credit equal to the amount of that surplus arises in the attribution account of the head company.
3. At the same time, a corresponding and equal attribution account debit arises in the attribution account of the joining company.

After the transfer of surpluses, the attribution accounts of the joining company become inoperative. Any attribution account debits or credits that would have arisen in the attribution accounts kept by the joining company during the time it is a member of the consolidated group will now arise in the attribution accounts kept by the head company.

At exit

When a company leaves a consolidated group it may take with it interests in a CFC, FIF or FLP. Where this happens, the head company transfers to the leaving company a proportion of the attribution account surplus that the head company has in relation to these interests.

The underlying rationale for transferring the surplus on exit is the same as that for transferring attribution account surpluses on entry, and the procedure is effectively a reversal of steps 1 to 3 above. The principal difference, however, is in the amount transferred.

Only a proportion of the head company's attribution account surplus, as it relates to the relevant CFC, FIF or FLP interests, is transferred. The proportion is calculated at the leaving time using the following formula:

$$\frac{\text{Leaving company's attribution account percentage}^{1}\text{ in relation to the attribution account entity}^{2}\text{ at the leaving time}}{\text{Head company's attribution account percentage in relation to the attribution account entity just before the leaving time}} \times \text{Attribution surplus for the attribution account entity in relation to the head company just before leaving time}$$

Notes:

1 The term 'attribution account percentage' is defined in the ITAA 1936 – section 364 for CFCs and section 602 for FIFs.

2 An 'attribution account entity' is defined in the ITAA 1936 – section 363 for CFCs and section 601 for FIFs.

Calculation of FIF income before the joining or leaving time

Special rules are required to ensure that the correct amount of FIF income is assessed to the correct taxpayer where a company joins or leaves a consolidated group during the notional accounting period of a FIF. To achieve this, where the FIF's notional accounting period does not actually end at the joining time or leaving time, it is taken to end immediately before the joining or leaving time. These rules are not required for interests held in CFCs (see note).

Note

Calculation of CFC income

Under the CFC rules, an attributable taxpayer includes its share of the CFC income for the whole statutory accounting period of the CFC when the statutory accounting period ends in the income year of the taxpayer. If the CFC's statutory accounting period ends in a non-membership period of a company that joins or leaves a group, that company is assessed on its attribution percentage of the whole of the CFC's attributable income for the CFC's statutory accounting period that ended in the company's income year. If the CFC's statutory accounting period ends while the company is a member of a group, the head company is assessed instead on the attributable income for the whole statutory accounting period.

At entry

If a joining company holds an interest in a FIF at a time immediately before the joining time and the notional accounting period of the FIF actually ends at the joining time, the joining company will calculate the FIF income according to the rules in Part XI of the ITAA 1936. If this is not the case, the notional accounting period of the FIF is taken to end immediately before the joining time and the joining company will need to calculate the FIF income relating to the shortened notional accounting period that ended at that time.

If the FIF income calculation results in an amount being assessable, a credit arises in the joining company's FIF attribution account. If the calculation results in a FIF loss and the FIF attribution account is in surplus, so much of the FIF loss as does not exceed that surplus is allowable as a deduction against the joining company's assessable income for that period. A debit will arise in the joining company's FIF attribution account to the extent of the allowable deduction. Any remaining FIF loss will be inherited by the head company under the entry history rule.

Thus, all possible credits and debits to the FIF attribution account and FIF attributed tax account are made before the surplus (calculated immediately before the joining time) is transferred to the head company.

The head company will have FIF income included in its assessable income from the joining time onwards in accordance with the FIF provisions. This is achieved by the head company being deemed to have acquired the FIF interests at the joining time. The deemed acquisition at the joining time means that the head company will only include in its assessable income an amount of FIF income relating to the period from the joining time until the end of the notional accounting period of the FIF.

At exit

When a company leaves a consolidated group taking FIF interests with it, the principles for calculating FIF income are effectively the same as those outlined above but in reverse.

Where the notional accounting period of the FIF is taken to end at the leaving time, the head company determines the FIF income and the FIF attribution and attributed tax account surpluses immediately before the leaving time as though the FIF interest held by the leaving company was held by the head company at the end of its income year. As in the entry case, this calculation is made to determine the FIF income where the notional accounting period of the FIF does not ordinarily end at the leaving time.

The head company will continue to determine the FIF income in relation to the interests in the FIF remaining in the group, from the leaving time until the actual end of that FIF's notional accounting period.

The leaving company will have FIF income included in its assessable income from the leaving time onwards in accordance with the FIF provisions. This is achieved by the leaving company being deemed to have acquired the FIF interests at the leaving time. The deemed acquisition at the leaving time means that the leaving company will only include in its assessable income an amount of FIF income relating to the period from the leaving time until the end of the notional accounting period of the FIF.

Deferred attribution credits

An attributable taxpayer joining a consolidated group may have elected to defer the timing of an attribution credit that relates to the attribution of an unrealised gain on assets (a notional gain) where a CFC changes residence from an unlisted country to a listed country. At the joining time, the joining company's deferred attribution credit is made available for the head company to use when the CFC pays a dividend from a gain derived from the actual disposal of an asset. → section 717-227 Schedule 8, *New Business Tax System (Consolidation and Other Measures) Act 2003*

A company that leaves a consolidated group with an interest in a CFC is able to take a proportion of the deferred attribution credit that relates to the attribution account percentage of the attribution account entity. The amount of the deferred attribution credit – referred to as the 'original credit' – is worked out using the following formula:

$$\frac{\text{Leaving company's attribution account percentage in relation to the attribution account entity at the leaving time}}{\text{Head company's attribution account percentage in relation to the attribution account entity just before the leaving time}} \times \text{Original credit}$$

The proportion taken by the leaving company reduces the amount of the attribution credit available for the head company to use when the CFC pays a dividend from gains derived from the actual disposal of an asset.

→ section 717-262 Schedule 8, *New Business Tax System (Consolidation and Other Measures) Act 2003*

Elections relating to CFCs, FIFs and FLPs

An entity can make irrevocable elections in relation to calculating the attributable income of CFCs, or FIF income in relation to FIFs or FLPs. If a subsidiary member makes irrevocable elections prior to the joining time, those elections are not taken to have been made by the head company for the head company core purposes. The head company is also not prevented from applying the calculation method to determine FIF income if an entity that became a subsidiary member would have been prevented from using the calculation method had it not joined the consolidated group.

However, any irrevocable elections made by a head company prior to consolidation continue to apply to interests in CFCs, FIFs and FLPs that the head company holds under the single entity principle. Also, if a head company is prevented from using the calculation method to determine FIF income, it continues to be bound by that restriction. → Subdivision 717-F Schedule 8, *New Business Tax System (Consolidation and Other Measures) Act 2003*

An entity that leaves a consolidated group is not bound by any elections made by the head company prior to the leaving time. After the leaving time, the leaving entity can make its own elections under Parts X and XI in calculating attributable income or FIF income. → Subdivision 717-G Schedule 8, *New Business Tax System (Consolidation and Other Measures) Act 2003*

A special rule ensures the entry history rule does not affect the time limit in which the head company can elect to value at market value FIF interests brought to the group by a joining entity that are treated as trading stock. → section 717-292

Example: election for FIF interests that are trading stock

In July 2001, Company A holds an interest in a FIF that is trading stock. It does not make an election under section 70-70 to value its FIF interest at market value.

Company A becomes a subsidiary member of a consolidated group on 1 July 2003. Prior to the joining time, the head company had not held any interests in FIFs that were trading stock.

If the entry history rule were to apply, the head company would not be able to satisfy the time limits imposed by subsection 70-70(3) and therefore would not be able to elect to value the FIF interests brought to the group by Company A at market value.

Section 717-292 overrides the application of the entry history rule for the purposes of satisfying the time limit requirement in subsection 70-70(3) for the head company. The head company can therefore elect to value the FIF interest at market value.

If Company A left the group with FIF interests as trading stock, Company A would not inherit the election made by the head company under subsection 70-70(2) by virtue of section 717-310. Further, Company A would not be able to make the election after it left the group because it would still fail to satisfy the time limits required by subsection 70-70(3).

Had Company A made the election to value its FIF interests that were trading stock at market value before the joining time, it would be required to continue to value its FIF interests at market value after it left the group.

FIF income (2010-11 onwards)

From the 2010-11 income year onwards, any FIF attribution surpluses that previously arose for the head company of a consolidated group, including those transferred to it and those of its own, will become part of its post-FIF abolition surplus.

When a company becomes a subsidiary member of a consolidated group and it has a post-FIF abolition surplus, the surplus is transferred to the head company of that group. → section 717-220, ITAA 1997

When a company leaves a consolidated group and takes with it interests in a FIF or FLP, the head company transfers to the leaving company a proportion of the post-FIF abolition surplus that it has in relation to those interests. The proportion is based on the percentage of the group's interest in the FIF or FLP held by the leaving company. → section 717-255, ITAA 1997

Under section 23AK of the ITAA 1936, when the head company or the leaving company receives a distribution paid out of previously attributed FIF income, it will continue to be exempt from tax.

Under section 23B of the ITAA 1936 (which was introduced to preserve the effect of former section 613 of the ITAA 1936), when the head company or the leaving company disposes of an interest in a FIF or FLP where the FIF income has been attributed but not distributed before disposal, the head company or the leaving company may reduce its capital proceeds. The capital proceeds may be reduced by so much of the post-FIF abolition surplus that it has in relation to those interests, not exceeding the capital proceeds.

Therefore, on disposal of an interest in a FIF or FLP, the head company or the leaving company can continue to take advantage of the section 23AK exemption or the former section 613 reduction of capital proceeds.

From the 2010-11 income year onwards, taxpayers with interests in FIFs or FLPs are no longer subject to the attribution rules and are not required to make any elections in relation to calculating FIF income. Consequently, section 715-660 of the ITAA 1997 (about certain resettable elections) was amended to remove these elections from the list of elections that a head company can reset.

Conduit foreign income

The conduit foreign income rules replace the foreign dividend account rules with effect from an entity's first income year commencing on or after 1 July 2005. The specific application of the conduit foreign income rules to consolidated groups is contained in Subdivision 715-U. These rules have the same effect in relation to MEC groups.

Under the conduit foreign income rules, Australian corporate tax entities calculate their conduit foreign income at a particular time (the 'relevant time'), usually before the time such entities declare a dividend or make a distribution, rather than keeping a rolling balance of conduit foreign income → section 802-25, ITAA 1997. Amounts that are included or excluded from the calculation of conduit foreign income at this relevant time are set out in sections 802-30 to 802-55 of the ITAA 1997.

For consolidated and MEC groups, the single entity rule means that conduit foreign income derived by subsidiary members of the consolidated or MEC group is taken to be derived by the head company or provisional head company respectively. → section 715-875, ITAA 1997

The head company of a consolidated group and the provisional head company of a MEC group are Australian corporate tax entities that, at the relevant time, calculate the conduit foreign income of the group. Subsidiary members of a consolidated or MEC group do not calculate their own amounts of conduit foreign income while they are members of the group.

To determine the basic conduit foreign income amount, it is the head company or provisional head company that is treated as a foreign resident when working out if an amount is included in the first step of the conduit foreign income calculation. However, the requirement that this amount is or will be included in an income statement does not mean the amount must be included in an income statement of the head company or provisional head company. The amount may be included in the income statement of the subsidiary member that received the amount. An income statement is broadly a statement prepared in accordance with Australian Accounting Standards.

→ subsection 802-30(1), ITAA 1997

Distributions between Australian corporate tax entities

The conduit foreign income rules allow conduit foreign income to be distributed through another Australian corporate tax entity under certain conditions. The provisions that deal with distributions between Australian corporate tax entities have no application where the distributions in question are made between members of the same consolidated or MEC group.

→ Explanatory Memorandum to Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Bill 2005, paragraph 5.104

If declared conduit foreign income is distributed to a member of a consolidated or MEC group from an Australian corporate tax entity or entities outside the group, the receiving entity for the purposes of subsection 802-20(1) of the ITAA 1997 is the head company or provisional head company respectively. The declared conduit foreign income amount will be non-assessable, non-exempt income of the head company of the consolidated or MEC group provided the conduit foreign income is on-paid within the period commencing at the start of the income year and ending before the due date for lodging the head company's income tax return for that income year.

→ subsection 802-20(1), ITAA 1997

Joining a consolidated group part way through an income year

The entry history rule applies to treat any amounts of conduit foreign income received by an entity before it joins a consolidated or MEC group as amounts the head company can treat as conduit foreign income. → subsection 715-875(1), ITAA 1997

Leaving a consolidated group

If an entity leaves a consolidated or MEC group it cannot take an amount of conduit foreign income with it → section 715-880, ITAA 1997. Amounts of conduit foreign income received by the entity either before it joined the group or while it was a member of the group will remain with the head company.

→ 'Treatment of conduit foreign income', C6-2-410

Foreign dividend accounts

Repeal of foreign dividend account provisions

The provisions dealing with the foreign dividend account regime were repealed on 14 December 2005, subject to the transitional rules. Specifically, in relation to consolidated groups and MEC groups, Subdivisions 717-J and 719-X of the ITAA 1997 have no application after that date.

Previous foreign dividend accounts

Under the foreign dividend account measure which operated before the introduction of the conduit foreign income rules, a head company of a consolidated group operated a single foreign dividend account (FDA) by pooling any FDA surpluses or deficits transferred to it at the joining time. The head company was also able to aggregate the foreign investments of all its subsidiary members. The aggregation of the foreign investments held by the members enabled the head company to, for instance, credit the FDA for the total non-portfolio dividends received and debit the account for the FDA declaration amounts that relate to all dividends paid on a particular day.

The worked example 'Transfer of foreign dividend account balance' (→ C6-2-310) shows the transfer of a joining company's FDA balance to the head company of a consolidated group. It also shows how the head company uses the FDA surplus to pay non-resident shareholders unfranked dividends exempt from dividend withholding tax.

FDA surplus

An FDA surplus is an excess of FDA credits over FDA debits.

If a subsidiary member had an FDA surplus at the balance time (that is, a time just before the joining time), the FDA surplus was transferred to the head company by:

- entering an FDA debit in the subsidiary member's account equal to the FDA surplus at the balance time, and
- entering an FDA credit in the head company's account equal to the FDA surplus at the joining time.

FDA deficit

An FDA deficit is an excess of FDA debits over FDA credits.

If a subsidiary member had an FDA deficit at the balance time, the FDA deficit was transferred to the head company by:

- entering an FDA credit in the subsidiary member's account equal to the FDA deficit at the balance time, and
- entering an FDA debit in the head company's account equal to the FDA deficit at the joining time.

→ Section 717-510, ITAA 1997 (repealed)

The FDA of a subsidiary member was inoperative following the transfer of its FDA balances – no credit or debit entries were made to the subsidiary member's FDA while it was a member of a consolidated group.

Joining part-way through an income year

If a company joined a consolidated group part-way through its income year, and an FDA debit for an Australian taxable dividend amount would have arisen for that company had it not joined the consolidated group, an FDA debit was made to the account immediately before the balance time. The FDA debit amount for the Australian taxable dividend amount was calculated according to the formula in subsection 128TB(2) of the ITAA 1936 (repealed).

Leaving a consolidated group

When a company ceased to be a subsidiary member of a group it could not take an FDA balance with it on exit.

FDA declarations

During consolidation, the head company could utilise a pooled FDA surplus to pay non-resident shareholders unfranked dividends, free from dividend withholding tax. The head company was taken to make the FDA declarations for dividends paid to its shareholders and to the shareholders of its subsidiary members. If the head company made more than one FDA declaration on a particular day, the sum of the FDA declaration amounts must not have exceeded the FDA surplus at the beginning of the day.

If the total of the FDA declaration amounts exceeded the FDA surplus, the FDA declaration percentages specified by the head company were proportionally reduced so that the FDA declaration amounts did not exceed the FDA surplus available to the head company. The proportional reduction of the FDA declaration percentages, which in turn reduced the FDA declaration amounts, did not affect the dividend amount paid to non-resident shareholders. → sections 717-520 and 717-525, ITAA 1997 (repealed)

Repeal of the FDA grouping provision

The FDA grouping provision, which allowed resident companies of a wholly-owned group to transfer a proportion of the FDA surplus with the payment of unfranked dividends, generally ceased to apply from 1 July 2003.

MEC groups

The FDA rules that applied for a consolidated group also applied to MEC groups. In a MEC group, the provisional head company operated the FDA and made FDA declarations for dividends paid to its shareholders and shareholders of its subsidiary members.

The provisional head company was also taken to have paid foreign tax where that tax is actually paid by a subsidiary member of the group. This deemed payment of foreign tax enabled the provisional head company to claim an FDA credit under paragraph 128TA(1)(b) of the ITAA 1936.

Where a provisional head company is replaced by a new provisional head company, the FDA balance was transferred from the old provisional head company to the new one. → section 719-905, ITAA 1997 (repealed)

Where the provisional head company was paid a dividend at a particular time, and that entity was not the head company of the group for the income year, section 128TB of the ITAA 1936 operated in relation to the Australian-taxable dividend amount as if the dividend had been paid to the head company.

Offshore banking units

If a member of a consolidated group is a gazetted offshore banking unit (OBU), the consolidation rules deem the head company of the consolidated group to be an OBU for the period in which the subsidiary member has this status.

The OBU provisions in Division 9A of Part III of the ITAA 1936 will apply to the head company to ensure that the income arising from offshore banking activities of members of the group are effectively taxed at 10%. Division 9A will also apply in this way where the head company itself is an OBU. → Section 717-710 Schedule 10, *New Business Tax System (Consolidation and Other Measures) Act 2003*

However, the head company will not be taken to be an OBU for the purposes of determining whether a non-resident lender to the group is entitled to withholding tax exemptions under Division 11A of Part III of the ITAA 1936. This is because the withholding tax regime is not covered by the core purposes and therefore not subject to the single entity rule. In other words, for the exemptions under Division 11A to apply to an interest payment to a non-resident, the member of the group paying the interest must in itself be a gazetted OBU.

References

Income Tax Assessment Act 1936, sections 128TB, 128TC; Division 9A of Part III, Division 11A of Part III

Income Tax Assessment Act 1936, sections 160AF and 160AFE, Part III, Divisions 18A and 18B; as amended by:

- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 10
- *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 15

Income Tax Assessment Act 1997, section 701-5

Income Tax Assessment Act 1997, Division 717, Subdivision 717-A; as amended by:

- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 6
- *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 7
- *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedules 8, 9 and 10

Income Tax (Transitional Provisions) Act 1997, former section 701-30; as amended by *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 7

Income Tax (Transitional Provisions) Act 1997, Division 717; as amended by *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 9

Income Tax Assessment Act 1997, Division 717; as amended by *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (No. 83 of 2004), Schedule 2

Explanatory Memorandum to New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, Chapter 3

Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill 2002, Chapter 9

Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 7

Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006 (No. 101 of 2006), which repealed section 701-30 of the *Income Tax (Transitional Provisions) Act 1997*

Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Act 2005, which repealed Subdivisions 717-J and 719-X and inserted Subdivisions 715-U and 802-A in the *Income Tax Assessment Act 1997*

Explanatory Memorandum to Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Bill 2005, Chapter 5

Tax Laws Amendment (2007 Measures No. 4) Act 2007 which repealed Divisions 18, 18A and 19 and sections 79D, 79DA, 424 and 430 of the *Income Tax Assessment Act 1936*

Explanatory Memorandum to Tax Laws Amendment (2007 Measures No. 4) Bill 2007, Chapter 1

Revision history

Section C6-1 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on recent changes to consolidation rules.	Legislative amendments.
3.11.04	Clarify timing of use of transferred FTCs. Example on election for FIF interests that are trading stock – an irrevocable election. Explain effects of repeal of FDA grouping provision in relation to FDA surplus. Clarify effects of FDA rules for MEC groups.	Reflect changes in *Taxation Laws Amendment (2004 Measures No. 2) Act 2004* (83 of 2004).
	Remove 14.7.04 note on recent changes to consolidation rules.	Text amended to reflect the changed rules.
15.11.06	Updated references to inoperative provisions.	Legislative amendment.
30.6.09	Extensively revised to take account of new rules for foreign income tax offsets, conduit foreign income and attributed tax accounts.	Amendments in *Tax Laws Amendment (2007 Measures No. 4) Act 2007* and *Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Act 2005.*
6.5.11	Revised to take into account the repeal of Part XI of the ITAA 1936 in relation to the FIF and FLP rules.	Legislative amendments.

Thin capitalisation and consolidated groups

Note

MEC groups and the thin capitalisation rules

The thin capitalisation rules for consolidated groups also apply to multiple entry consolidated (MEC) groups. For the purposes of this section, 'consolidated groups' includes MEC groups.

Repeal of thin capitalisation grouping rules

The thin capitalisation grouping rules generally cease to operate for a company from the time it becomes a member of a consolidated group or from 1 July 2003, whichever is earlier. However, these rules continue to operate until the consolidation day (joining time) for companies that become members of a consolidated group that forms on the first day of the head company's income year beginning before 1 July 2004. The day on which the thin capitalisation rules cease to operate is referred to as the 'cut-off day'[171].

The thin capitalisation grouping rules are effectively replaced by the consolidation rules. The consolidation rules determine which entities form part of the head company's group for income tax purposes; the thin capitalisation provisions then apply to the head company of a consolidated group in accordance with the single entity principle. This means the head company, together with the subsidiary members of the group, are treated as a single entity for the purposes of applying the thin capitalisation provisions. The thin capitalisation rules also permit a foreign bank branch – that is, a permanent establishment in Australia of a foreign bank – to be part of a head company for thin capitalisation purposes.

In determining the thin capitalisation position of the group, the values to be used for relevant assets, debts etc. are those required under the thin capitalisation rules.

Note that certain thin capitalisation rules regarding the revaluation of assets have been modified by *Taxation Laws Amendment Act (No. 5) 2003.*[172]

Classification

For the purposes of thin capitalisation, a head company can be classified as:

- an outward investing entity that is not an authorised deposit-taking institution (non-ADI) – general or financial
- an inward investing entity (non-ADI) – general or financial
- an outward investing entity (ADI), or
- an inward investing entity (ADI).

[171] For more information about thin capitalisation groups and the 'cut-off day', see the *Guide to thin capitalisation* at **www.ato.gov.au** or refer to sections 820-455 to 820-457 of the ITAA 1997.

[172] Subsection 820-680(2), section 820-985, ITAA 1997; subsection 262A(3), ITAA 1936.

The classification of the head company of the group is determined for thin capitalisation purposes by the nature of the members of the group. This in turn determines which thin capitalisation rules apply to the head company in a period within the head company's income year. For instance, if there has been a change in the head company's classification during its income year, the thin capitalisation rules that apply in the period before the change are different to those that apply in the period after the change. This can result in the head company having to determine the group's thin capitalisation position more than once in its income year.

Outward investing entity (non-ADI)

The head company is classified as an outward investor (general) in a period if, within that period, one or more members of the group:

- is the Australian controller of an Australian controlled foreign entity, and/or
- carries on business at or through an overseas permanent establishment, or
- is the associate entity (by definition) of an outward investing entity (non-ADI).

  → subsection 820-85, ITAA 1997

For example, the head company is classified as an outward investor (general) if one or more members of the group holds an interest in a controlled foreign company.

In addition, there must not be a member of the group that is a financial entity or an ADI by definition.

If at least one member of the group is a financial entity and no member is an ADI the head company is classified as outward investor (financial). In accordance with the single entity principle, the special thin capitalisation rules that apply to on-lent amounts and zero-capital amounts will therefore apply to all such assets in the group.

In these cases Subdivision 820-B of the thin capitalisation provisions applies to the head company. → subsections 820-583(1) to (3), ITAA 1997

Inward investing entity (non-ADI)

The head company is classified as an inward investment vehicle (general) if it is a foreign controlled Australian company by definition → section 820-785, ITAA 1997. This essentially means the head company must either be actually or effectively controlled by five or fewer foreign entities or be controlled by a single foreign entity that holds a thin capitalisation control interest of at least 40%. For example, the head company of a MEC group would automatically be classified as an inward investing entity (unless it could be classified as an outward investing entity) because of the requirements to form a MEC group.

Again, there must not be a member of the group that is a financial entity or an ADI by definition.

If at least one member of the group is a financial entity and no member is an ADI, the head company is classified as an inward investment vehicle (financial). As before, the special thin capitalisation rules for on-lent amounts and zero-capital amounts will apply.

In these cases Subdivision 820-C of the thin capitalisation rules applies to the head company. → subsections 820-583(4) to (6), ITAA 1997

A head company is excluded from this classification in a period if it can be classified as an outward investing entity (non-ADI) in that period.

Outward investing entity (ADI)

The head company is classified as an outward investing entity (ADI) in a period if it is classified as an outward investing entity and at least one member of the group is an ADI. → subsection 820-583(7), ITAA 1997

In addition, under certain conditions the head company of a MEC group that is not classified as an outward investing entity (ADI) – for example, if it is classified as an inward investing entity – will be treated as if it were classified as an outward investing entity (ADI). This occurs if one member of the MEC group is a foreign controlled Australian ADI by definition and at least one eligible tier-1 company is neither an ADI nor the owner of a wholly-owned subsidiary that is an ADI. → section 820-587, ITAA 1997

With one exception, a choice by a head company to treat an Australian permanent establishment of a foreign bank (a 'foreign bank branch') as part of itself for thin capitalisation purposes results in the head company being classified as an outward investing entity (ADI). This rule applies even where a head company that in itself is an ADI was held to be exempt from the thin capitalisation rules (see below), or where a head company of a MEC group was treated as if it were an outward investing entity (ADI) as described above.

The exception is where the head company is classified as an inward investing entity (non-ADI). The inclusion of the foreign bank branch effectively reclassifies the head company as an inward investing entity (ADI).

The new classification resulting from the inclusion of the foreign bank branch takes precedence over any other classification resulting from Division 820.
→ section 820-609, ITAA 1997

Subdivision 820-D of the thin capitalisation rules applies to a head company that is given this classification.

Modification of adjusted average equity capital calculation

Where a head company is classified as an outward investing entity (ADI), the definition of adjusted average equity capital in Subdivision 820-D is modified to account for non-ADI members of the group (if any), that is, members not supervised by the Australian Prudential Regulation Authority (APRA). The modification requires the inclusion of:

- (consolidated) paid-up share capital (other than debt interests)
- capital of other entities (other than debt interests)
- retained earnings

- general reserves
- asset revaluation reserves, and
- interest-free debt of non-ADI group members.

These amounts are then added to the tier-1 capital (net of included debt capital) of members that are ADIs or wholly-owned subsidiaries of ADIs.

The above equity capital is determined net of any amounts attributable to overseas permanent establishments of the group members. Any controlled foreign equity (net of amounts attributable to overseas permanent establishments) of the members of the group must also be excluded.

A further modification is made where the head company chooses to treat a foreign bank branch as part of itself for thin capitalisation purposes. → 'Foreign bank branches and consolidated groups', C6-1-210

Amounts for this calculation are to be worked out as far as practicable from a set of consolidated accounts that have been prepared in accordance with the accounting standards at the measurement time. These consolidated accounts should cover only the members of the group.

These modifications to the definition of adjusted average equity capital only have effect for the period 1 July 2002 to 30 June 2003. The affected section 820-589 has been repealed effective from 1 July 2003 and is replaced by a new section 820-90 because of the amendments to the definition of equity capital that came into effect on that date.

→ 'Consequences of amendments to the definition of equity capital', p. 5

Modified determination of safe harbour capital amount

The modification to the determination of the safe harbour capital amount results in the risk-weighted assets being reduced by the amount on-lent when the following conditions are satisfied:

- a subsidiary member of a consolidated group is both an ADI and a wholly-owned foreign subsidiary of a foreign bank, and
- the subsidiary member has on-lent amounts, raised from the issue of debentures covered by section 128F of the ITAA 1936, to an Australian permanent establishment of the foreign bank, and
- the Australian permanent establishment has not been chosen to be part of the head company for thin capitalisation purposes.

This modification will be available only until the end of the head company's 2006 income year. → section 820-591, ITAA 1997

Inward investing entity (ADI)

A head company is classified as an inward investing entity (ADI) only where it has chosen to include a foreign bank branch as a member of the group for thin capitalisation purposes → 'Foreign bank branches and consolidated groups', C6-1-210. However, a head company will be excluded from this classification in a period if it can be classified as an outward investing entity in that period.

Subdivision 820-E of the thin capitalisation rules applies, subject to certain modifications, to a head company that has been classified as an inward investing entity (ADI) under the above circumstances. It is noted that the definition of average equity capital in Subdivision 820-E is to be changed as a result of the change to the definition of equity capital effective from 1 July 2003). → section 820-615, ITAA 1997

Amendments

Consequences of amendments to the definition of 'equity capital'

The current definition of equity capital has been repealed and replaced by a generic definition that applies to both ADIs and non-ADIs. In addition, a new concept, 'ADI equity capital', has been introduced. Both changes are effective from 1 July 2003. As a consequence, a number of the provisions that modified the definition of adjusted average equity capital and average equity capital for consolidated groups have also been repealed and replaced. The replacement provisions[173] provide the following:

- For the purposes of applying Subdivision 820-D to a head company of a MEC group, the replacement section 820-589 ensures the inclusion of the ADI equity capital (as defined) of eligible tier-1 companies in a MEC group in the calculation of the adjusted average equity capital of the head company of that group. The definition of adjusted average equity capital no longer requires modification in relation to the head company of a consolidated group except in the circumstances below.
- If a foreign bank branch has been treated as part of a head company to which Subdivision 820-D applies, the replacement subsections 820-613(2) and (3) now include the ADI equity capital (as defined) of the foreign bank that is attributable to the foreign bank branch and any interest-free loans provided by the foreign bank to its Australian branch.
- For the purposes of applying Subdivision 820-E to a head company, the definition of average equity capital as amended by the replacement subsection 820-615(2) includes the ADI equity capital (as defined) of the head company for the test period plus the ADI equity capital of the foreign bank that is attributable to the foreign bank branch and any interest-free loans provided by the foreign bank to its Australian branch.

[173] *Taxation Laws Amendment Act (No. 5) 2003*, Schedule 3 Part 1.

Choice by a financial entity to be treated as an ADI

Rules have been introduced to enable a financial entity to choose to be treated as an ADI where it satisfies conditions referred to as the '80% rule'. This choice can be made only once. → sections 820-430 and 820-435, ITAA 1997

If a head company of a consolidated group has at least one member that is a financial entity and the group satisfies the 80% rule, the head company can choose to be treated as an ADI instead of a financial entity for thin capitalisation purposes → subsections 820-435(2) and (3). Making this choice results in the head company being classified as an outward investing entity (ADI) → subsection 820-430 (1), ITAA 1997.

However, the fact that a member of the group that is a financial entity has itself made a choice to be treated as an ADI will not result in the head company of the group being classified as an ADI. Only a choice by the head company when the above conditions are satisfied can do this.

Example

A financial entity that was a subsidiary member of a consolidatable group (that was not a thin capitalisation group) satisfies the 80% rule. It therefore chooses to be treated as an ADI for thin capitalisation purposes.

Upon consolidation, the head company is prohibited from making the choice to be treated as an ADI because the group does not satisfy the 80% rule. The choice by the subsidiary member of the group therefore ceases to have effect.

This would be the case even if the head company had been able to make the choice but had not done so.

In addition, the choice by a head company to treat a foreign bank branch as part of itself in a period, thereby resulting in the head company being classified as an inward or outward investing entity (ADI), takes precedence over any choice by the head company to be treated as an ADI instead of a financial entity for classification purposes. → former section 820-445, ITAA 1997

The choice by a head company to be treated as an ADI ceases to have effect if it fails to meet the requirements of the 80% rule (the test time being at the end of every third income year) or if the Commissioner provides written approval of a revocation of the choice (which is effective from the date written approval is given or the date revocation is requested if earlier). Once the choice ceases to have effect it cannot be made again. → subsections 820-430(6) and (7) and section 820-440, ITAA 1997

Example

The head company of a consolidated group was classified as an inward investment vehicle (financial) to which Subdivision 820-C applied. The group satisfied the 80% rule so the head company chose to be treated as an ADI. It had not made this choice before. Consequently, the head company was classified as an outward investing entity (ADI) to which Subdivision 820-D applied.

At the beginning of the following income year it chose to treat the foreign bank branch of its parent (a foreign bank) as part of itself. This resulted in the head company being classified as an inward investing entity (ADI) to which Subdivision 820-E applied.

At the beginning of its third income year it did not choose to treat the foreign bank branch as part of itself and so reverted to the classification of outward investing entity (ADI).

If the head company had not satisfied the 80% rule at the end of its third income year, the choice to be treated as an ADI would have ceased to have effect and it would have reverted to the classification of inward investment vehicle (financial) for that income year.

However, choosing to be treated as an ADI does not affect the calculation of an associate entity's associate entity debt, and, subject to certain limitations, the calculation of an associate entity's associate entity capital. → subsection 820-430(4); and Explanatory Memorandum to Taxation Laws Amendment Bill (No. 5) 2003, paragraph 1.30

Exclusion of insolvency remote special purpose entities

For income years beginning on or after 1 July 2001, certain special purpose entities are excluded from the thin capitalisation rules during periods that they meet certain conditions. Such an entity is excluded from the rules in all or part of an income year that it satisfies the following conditions:

- the entity is established for the purposes of managing some or all of the economic risk associated with assets, liabilities or investments (whether the entity assumes the risk from another entity or creates the risk itself), and
- at least 50% of the entity's assets are funded by debt interests, and
- the entity is an insolvency remote special purpose entity according to the criteria of an internationally recognised rating agency applicable to the entity's circumstances.

Where a special purpose entity that satisfies these conditions is a member of a consolidated group or MEC group, that entity will be disregarded for the purposes of determining the group's thin capitalisation position in the income year (or part of the income year) in which the conditions are satisfied. Further, if two or more members of the group together satisfy the requisite conditions and, had they been notionally taken to be divisions of a notional entity, that notional entity would be considered to have satisfied the requisite conditions of the 80% rule, each of those members is disregarded for the purposes of determining the group's thin capitalisation position.

→ sections 820-39 and 820-584, ITAA 1997

Exclusion of head company from thin capitalisation rules

Debt deductions of the head company of a consolidated group will not be disallowed under the thin capitalisation rules where it meets the requirements of either the $250,000 threshold test or the Australian assets threshold test (the de minimis tests). → sections 820-35 and 820-37, ITAA 1997

In addition, debt deductions of the head company of a consolidated group will not be disallowed under the thin capitalisation rules where it cannot be classified as an outward investing entity, and is either:

- a foreign controlled Australian entity and an ADI in its own right, e.g. a foreign controlled bank, or
- a holding company with no debt capital whose only asset is all the membership interests in a foreign controlled Australian entity that is an ADI, e.g. a 'pure' bank holding company. → section 820-585, ITAA 1997

Note

Recent changes to consolidation rules

Recent changes to the *Financial Corporations (Transfer of Assets and Liabilities) Act 1993* ensure that the income tax relief provided by that Act applies appropriately to financial corporations that are members of consolidated groups – see *Taxation Laws Amendment (2004 Measures No. 2) Act 2004* (83 of 2004), Schedule 2, Part 12, 'Financial corporations (Transfer of Assets and Liabilities) Act 1993'.

References

Income Tax Assessment Act 1997, Subdivisions 820-A to E, FA and FB of Division 820

Income Tax Assessment Act 1997; as amended by *Taxation Laws Amendment Act (No. 5) 2003* (No. 142 of 2003), Schedules 1 to 3:

- sections 820-39, 820-430, 820-435, 820-440
- former section 820-445
- sections 820-584, 820-589
- subsections 820-613(2) and (3)
- section 820-615
- subsection 820-680(2)

Income Tax Assessment Act 1936; as amended by *Taxation Laws Amendment Act (No. 5) 2003* (No. 142 of 2003), Schedule 1: subsection 262A

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, Chapter 6

Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 5) 2003, Chapter 1

Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006 (No. 101 of 2006), which repealed section 820-445 of the *Income Tax Assessment Act 1997*

Revision history

Section C6-1-110 first published 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
12.5.04	Confirm that information previously based on proposed law accurately reflects the law as enacted – in particular, amendments to the definition of equity capital to cover both ADIs and non-ADIs.	Enactment of *Taxation Laws Amendment Act (No. 5) 2003* (No. 142 of 2003)
14.7.04	Note on recent changes to consolidation rules, p. 8.	Legislative amendments.
15.11.06	Updated references to inoperative provisions.	Legislative amendment.
26.6.07	Change to reference.	To correct error.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Foreign bank branches and consolidated groups

Note

MEC groups and foreign bank branches

The rules for foreign bank branches and consolidated groups also apply to multiple entry consolidated (MEC) groups. For the purposes of this section, 'consolidated groups' includes MEC groups.

Grouping of foreign bank branches

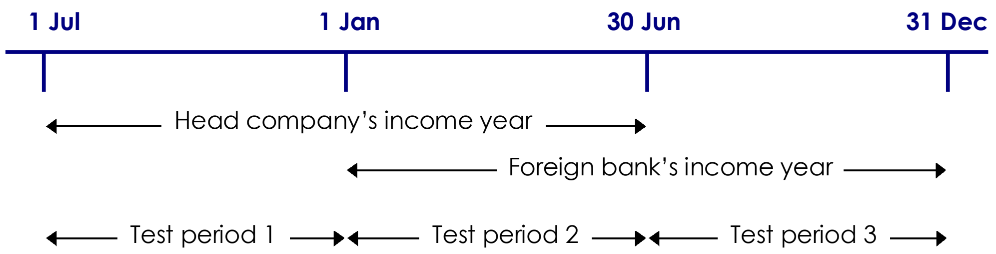
From 1 July 2002, a head company of a consolidated group can make a choice each income year to have the Australian permanent establishment of a foreign bank (a 'foreign bank branch') treated as part of the head company for the purposes of applying the thin capitalisation provisions in that income year. This can occur when a head company of a consolidated group and a foreign bank are members of the same wholly-owned group and the foreign bank carries on its business through a foreign bank branch. The period in the head company's income year in which the above conditions are met is the 'grouping period'. The period for which the choice is made cannot be shorter than the grouping period within an income year. → section 820-597, ITAA 1997

Subdivision 820-FB applies to the head company where this choice is made.

Where the head company's income year differs from that of the foreign bank, and hence the foreign bank branch, separate thin capitalisation calculations must be made for each period that relates to different income years for the respective taxpayers – that is, there may be more than one test period within a grouping period.

Example

The head company of a consolidated group and a foreign bank are members of the same wholly-owned group. The head company and the foreign bank have income years ending 30 June and 31 December respectively. The head company chooses to treat the foreign bank's Australian branch as part of itself for thin capitalisation purposes. The test periods for which thin capitalisation calculations must be made are shown in the figure below.



The combined calculations for test periods 1 and 2 determine any disallowed deductions for the head company and the combined calculations for test periods 2 and 3 determine any disallowed deductions for the foreign bank.

Where the head company makes the choice for a grouping period for an income year, it is binding on both the head company and the foreign bank and cannot be revoked. Once the choice is made the foreign bank branch is treated as a subsidiary of the consolidated group, for thin capitalisation purposes, rather than a part of the foreign bank. As such, any assets, liabilities and incurred debt deductions attributable to the foreign bank branch are treated as separate to those of the foreign bank. The foreign bank, however, is still required to keep records in relation to the foreign bank branch in accordance with Subdivision 820-L. → section 820-603, ITAA 1997

Subdivision 820-L has been amended[174] to allow inward investors carrying on business in Australia at or through a permanent establishment to satisfy the record keeping requirements where financial statements have been prepared using certain international accounting standards.

Foreign bank branches can also group with a single resident company that is not a member of a consolidated group[175].

Modifications to Subdivision 820-D

Where a head company that has chosen to treat a foreign bank branch as part of itself for thin capitalisation purposes is classified as an outward investing entity (ADI), the following additional modifications to the rules in Subdivision 820-D, as they apply to a head company, are required:

- the definition of adjusted average equity capital is further modified to include certain equity capital of the foreign bank branch and any interest-free loans made by the foreign bank to the branch, and
- the risk-weighted assets of the head company will also include certain risk-weighted assets of the foreign bank attributable to the foreign bank branch (excluding those allocated to offshore banking activities).

Note

Definition of 'equity capital'

Because of the change to the definition of 'equity capital' (effective from 1 July 2003), the modification to the adjusted average equity capital definition only has effect for the period 1 July 2002 to 30 June 2003. As a consequence subsections 820-613(2) and (3) have been repealed and replaced.

→ 'Thin capitalisation and consolidated groups', C6-1-110

[174] *Taxation Laws Amendment Act No. 5 2003* (No. 142 of 2003), Schedule 2 Part 2.

[175] For more information see the *Guide to thin capitalisation for ADIs (E)* at **www.ato.gov.au**

Modifications to Subdivision 820-E

Where a head company has chosen to treat a foreign bank branch as part of itself for thin capitalisation purposes – resulting in the head company being classified as an inward investing entity (ADI) – the following additional modifications to the rules in Subdivision 820-E, as they apply to a head company, are required:

- The definition of average equity capital in Subdivision 820-E is modified to include:
  - (consolidated) paid-up share capital (less debt interest amounts)
  - capital of other entities (other than debt interests)
  - retained earnings
  - general reserves
  - asset revaluation reserves
  - interest-free debt of group members
  - equity capital of the foreign bank attributable to the foreign bank branch (excluding amounts allocated to offshore banking activities), and
  - interest-free debt of the foreign bank branch in relation to loans from the foreign bank.
- For the purpose of determining the safe harbour capital amount of the head company, the risk-weighted assets include certain risk-weighted assets of the foreign bank attributable to the foreign bank branch (excluding those allocated to offshore banking activities). The total risk-weighted assets is then multiplied by 4% to give the safe harbour capital amount.

Note

Definition of 'equity capital'

Because of the change to the definition of 'equity capital' (effective from 1 July 2003), the definition of average equity capital is also changed. This is discussed in the section above on consequences of the change to the definition of equity capital.

→ 'Thin capitalisation and consolidated groups', C6-1-110

→ section 820-615, ITAA 1997

Determining thin capitalisation values and amounts

Values and amounts used for thin capitalisation purposes are determined in accordance with the single entity principle, that is, intragroup transactions are ignored. These values and amounts are to be worked out as far as practicable from a set of consolidated accounts that have been prepared in accordance with the accounting standards at the measurement time. These consolidated accounts should cover only the members of the group. → section 820-611, ITAA 1997

Effect on foreign bank if certain debt deductions disallowed

A foreign bank may incur a debt deduction that is attributable to a foreign bank branch that has been treated as part of a head company under Subdivision 820-FB. Because the foreign bank branch is treated as part of the head company for thin capitalisation purposes, the debt deduction is also treated as a deduction of the head company for those purposes. Where all or part of the relevant debt deduction has been disallowed due to the operation of the thin capitalisation provisions to the head company, the whole or part of the deduction is disallowed to the foreign bank.

Example

The head company of a consolidated group and a foreign bank are both members of the same wholly-owned group. The foreign bank has an Australian permanent establishment (the foreign bank branch).

The head company incurs and is treated as having incurred $500,000 of debt deductions, of which $100,000 relates to the foreign bank branch that the head company has chosen to treat as a part of itself. Neither debt deduction arises because of a debt arrangement between the head company and the foreign bank via its branch, i.e. it all relates to external debt.

The head company fails the thin capitalisation test and $200,000 of the total debt deduction is disallowed. As a result, the head company is disallowed a deduction to the extent of $160,000 against the assessable income of the consolidated group and the foreign bank is disallowed a deduction to the extent of $40,000 against the assessable income of the foreign bank branch.

There is an exception to this provision where the cost of the debt deduction attributable to the foreign bank branch, and incurred during the grouping period, gives rise to an amount paid or owed to the head company as representative of the consolidated group. This type of effective intragroup debt deduction is disregarded for thin capitalisation purposes. The same result arises where a head company incurs a debt deduction the cost of which is paid or owed to the foreign bank branch that is being treated as part of the head company under Subdivision 820-FB.

Example

The head company of a consolidated group and a foreign bank are both members of the same wholly-owned group. The foreign bank has an Australian permanent establishment (the foreign bank branch).

The head company borrows funds from the foreign bank via its foreign bank branch, upon which it incurs a $2,000,000 debt deduction. The head company also borrows funds from a third party, upon which it incurs a $3,000,000 debt deduction. The head company treats the foreign bank branch as a part of itself for thin capitalisation purposes. The $2,000,000 debt deduction is treated as if it arose from an intragroup loan arrangement and is therefore disregarded for the purposes of thin capitalisation. Consequently, the full $2,000,000 is available to the head company as an allowable deduction against the consolidated group's assessable income. → section 820-605, ITAA 1997

References

Income Tax Assessment Act 1997, Subdivisions 820-D, E and FB of Division 820

Income Tax Assessment Act 1997 – as amended by *Taxation Laws Amendment Act (No. 5) 2003* (No. 142 of 2003), Schedules 2 and 3:

- sections 820-613, 820-615, 820-960

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, Chapter 6

Revision history

Section C6-1-210 first published 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
12.5.04	Confirm that information previously based on proposed law accurately reflects the law as enacted – in particular, amendments to the definition of equity capital and treatment of inward investors.	Enactment of *Taxation Laws Amendment Act (No. 5) 2003* (No. 142 of 2003)

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Pooling of excess foreign tax credits

Description

This example shows how the excess foreign tax credits (FTCs) of a joining entity are transferred to the head company of the group and may subsequently be used by the head company.

Commentary

A resident entity is entitled to a foreign tax credit where its assessable income for an income year includes foreign income on which it has paid foreign tax and for which it was personally liable → section 160AF, *Income Tax Assessment Act 1936*. If the foreign tax paid on a particular class of foreign income exceeds the Australian tax payable on the relevant foreign income, the excess FTCs can be carried forward for up to five years to be offset against Australian tax payable on foreign income of that class → section 160AFE, *Income Tax Assessment Act 1936*. After this time the excess FTCs are lost.

Under the single entity principle, the head company is assessed on foreign income derived by the group. Consequently it must have access to all FTCs of members of the group. To achieve this, all excess FTCs of members joining or forming the group are transferred to the head company and any foreign tax paid by a member of the consolidated group is held to have been paid by the head company.

The transferred FTCs are pooled with other excess FTCs of the group according to the class of foreign income and the income year in which they arose. They remain with the head company if the transferor leaves the group. Excess FTCs transferred from a joining entity cannot be used by the head company until the income year following that in which the entity became a member of the group, unless the joining time is at the start of the head company's income year.

Note

Transitional provision for using transferred excess FTCs

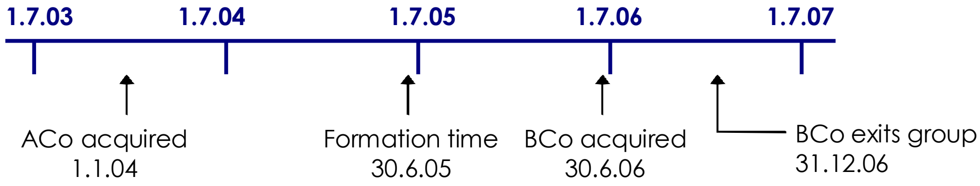
Transitional provisions operating from 1 July 2002 to 30 June 2004 enable wholly-owned groups to use excess FTCs of group members at the end of the income year in which the consolidated group is formed, rather than in the following year as under the general rules, subject to certain conditions.
→ 'Treatment of foreign tax credits and attribution surpluses', C6-1

Example

Facts

As shown in figure 1, HCo (the head company) acquires all the membership interests in ACo on 1 January 2004. It chooses to form a consolidated group on 30 June 2005. On 30 June 2006, HCo acquires all the membership interests in BCo, which immediately becomes part of the consolidated group. HCo disposes of all its interests in BCo on 31 December 2006, at which time BCo leaves the group. All three companies have an income year ending 30 June.

Figure 1: Timeline of events



The excess FTCs of HCo and ACo immediately before the group's formation time of 30 June 2005 are shown in tables 1 and 2 respectively.

The excess FTCs held by BCo immediately before the joining time are shown in table 3.

Table 1: Excess FTC balances of HCo

	Year excess credits arose				
	2001	**2002**	**2003**	**2004**	**2005**
Passive income		$36		$53	
Other income					

Table 2: Excess FTC balances of ACo

	Year excess credits arose				
	2001	**2002**	**2003**	**2004**	**2005**
Passive income	$75	$24		$19	$88
Other income			$217		$101

Table 3: Excess FTC balances of BCo

	Year excess credits arose					
	2001	**2002**	**2003**	**2004**	**2005**	**2006**
Passive income		$32		$57	$48	$33
Other income	$80	$4	$62		$50	$97

Assume that the excess FTCs are not used by HCo to offset the Australian tax payable on foreign income of the group derived after consolidation.

Calculation

ACo becomes a member of HCo's consolidated group before the start of HCo's 2006 income year. The five-year limit for carrying forward excess FTCs has not been exceeded. This means all ACo's excess FTCs (transfer credits) are available to HCo to be used to offset the Australian tax payable on foreign income of the group assessable at the end of the 2006 income year.

BCo has not become a member of the consolidated group before the start of HCo's 2006 income year. This means the only excess FTCs available to be used by HCo at the end of its 2006 income year are its own and those transferred by ACo – that is, the balances shown in table 4.

Table 4: Pooled excess FTCs of HCo (available at 30 June 2006)

		Year excess credits arose				
		2001	2002	2003	2004	2005
Passive income	HCo		$36		$53	
	ACo	$75	$24		$19	$88
	Total	**$75**	**$60**		**$72**	**$88**
Other income	HCo					
	ACo			$217		$101
	Total			**$217**		**$101**

However, BCo becomes a member of the consolidated group before the start of HCo's 2007 income year. This means the excess FTCs transferred from BCo that arise in the 2002 to 2006 income years are now available to be used by HCo at the end of its 2007 income year. They are available despite the fact that BCo leaves the group before the end of that income year. The excess FTCs that arise in the 2001 income year that have not been or are unavailable to be used by HCo at the end of its 2006 income year exceed the five-year carry-forward limit for excess FTCs and are lost.

Therefore, the excess FTCs available to HCo at the end of its 2007 income year are as shown in table 5.

Table 5: Pooled excess FTC balances of HCo (available at 30 June 2007)

		Year excess credits arose				
		2002	2003	2004	2005	2006
Passive income	HCo	$36		$53		
	ACo	$24		$19	$88	
	BCo	$32		$57	$48	$33
	Total	**$92**		**$129**	**$136**	**$33**
Other income	HCo					
	ACo		$217		$101	
	BCo	$4	$62		$50	$97
	Total	**$4**	**$279**		**$151**	**$97**

References

Income Tax Assessment Act 1936, sections 160AF and 160AFE – as amended by:

- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 10
- *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 15

Income Tax Assessment Act 1997, Division 717, Subdivision 717-A; as amended by *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 6

Income Tax Assessment Act 1997, Division 717; as amended by *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (No. 83 of 2004), Schedule 2

Income Tax (Transitional Provisions) Act 1997, Division 717; as amended by *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 9

Explanatory Memorandum to the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, Chapter 3

Revision history

Section C6-2-110 first published (excluding drafts) 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Recent changes to consolidation rules.	Legislative amendments.
3.11.04	Clarify timing of use of transferred FTCs.	Reflect amendments in *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (83 of 2004).
	Remove 14.7.04 note on recent changes to consolidation rules.	Text amended to reflect the changed rules.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Foreign income tax offsets – transitional rules

Description

This example provides guidance on the operation of the transitional rules for the foreign income tax offset provisions that came into effect for the income year starting on and after 1 July 2008. This example shows how:

1. excess foreign tax credits are converted to pre-commencement excess foreign income tax
2. pre-commencement excess foreign income tax is transferred from the joining entity to the head company, and
3. pre-commencement excess foreign income tax is utilised to increase the foreign income tax offset.

Commentary

The foreign income tax offset rules replace the foreign tax credit rules from the first income year starting on or after 1 July 2008. When the foreign income tax offset rules take effect, the head company of a consolidated or MEC group will convert any existing excess foreign tax credits from the previous five income years to pre-commencement excess foreign income tax.

Transitional rules for consolidated and MEC groups allow the joining entity to transfer to the head company excess foreign tax credits that have been converted to pre-commencement excess foreign income tax. These transitional rules reflect the previous foreign tax credit rules on the transfer of excess foreign tax credits to the head company at the joining time.

The pre-commencement excess foreign income tax transferred from the joining entity is pooled with any other pre-commencement excess foreign income tax of the head company and any other subsidiary members. There is no longer any requirement to categorise or quarantine foreign income tax into various classes of income. However, it is necessary to track the year in which the excess foreign tax credits arose due to the five year limit on utilisation.

Pre-commencement excess foreign income tax can be used to increase the foreign income tax offset if there is a foreign income tax shortfall, subject to the five year time limit. A foreign income tax shortfall occurs where the foreign income tax paid is less than the foreign income tax offset limit as calculated under section 770-75 of the ITAA 1997.

Where an entity joins a consolidated or MEC group part way through an income year, the head company cannot apply the pre-commencement excess foreign tax transferred from the joining entity until the following income year.

Example

Facts

On 30 June 2005, HCo becomes the head company of a consolidated group with one subsidiary member, ACo. On 30 June 2006, BCo is acquired by HCo and becomes a subsidiary member of the consolidated group for six months until HCo disposes of all its interests in BCo on 31 December 2006, at which time BCo leaves the group.

At 30 June 2008, HCo has the following excess foreign tax credits available (including amounts transferred to the group when BCo joins on 30 June 2006).

Table 1: Pooled excess foreign tax credit balances of HCo (available at 30 June 2008)

		Excess foreign tax credits arising in …					
		03-04	**04-05**	**05-06**	**06-07**	**07-08**	**Total**
Passive income	HCo	$53			$200		
	ACo	$19	$88			$100	
	BCo	$57	$48	$33			
	Total	**$129**	**$136**	**$33**	**$200**	**$100**	**$598**
Other income	HCo					$150	
	ACo		$101			$70	
	BCo		$50	$97			
	Total		**$151**	**$97**		**$220**	**$468**

On 1 January 2009, HCo acquires all the membership interests in CCo (which has the same income year as HCo). CCo had converted its excess foreign tax credits to pre-commencement excess foreign income tax when the foreign income tax offset rules commenced on 1 July 2008. The pre-commencement excess foreign income tax of CCo immediately before the joining time is as follows:

Table 2: Pre-commencement excess foreign income tax of CCo at 31 December 2008

	Pre-commencement excess foreign income tax arising in…				
	03-04	**04-05**	**05-06**	**06-07**	**07-08**
As at 31 Dec. 2008	$350	$500	–	$600	$400

CCo pays foreign income tax of $2,500 on income derived in its non-membership period from 1 July 2008 to 31 December 2008.

For the 2008-09 income year, HCo pays $4,000 in foreign income tax on amounts included in its assessable income.

For the 2009-10 income year, HCo pays foreign income tax of $7,000 on amounts included in its assessable income.

Calculation

2008-09 income year

From 1 July 2008, the foreign income tax offset rules apply to HCo, which converts its excess foreign tax credits to pre-commencement excess foreign income tax.

Table 3: Pre-commencement excess foreign income tax of HCo at 1 July 2008

	Pre-commencement excess foreign income tax arising in …				
	03-04	**04-05**	**05-06**	**06-07**	**07-08**
Pool	$129	$287	$130	$200	$320

CCo joins the group on 1 January 2009. In the non-membership period from 1 July 2008 to 31 December 2008, CCo pays foreign income tax of $2,500 on an amount included in its assessable income in this period.

CCo is eligible for a foreign income tax offset for the foreign income tax it has paid subject to the foreign income tax offset limit. CCo can calculate the foreign income tax offset limit as the lesser of the foreign income tax paid or the Australian tax payable on the double-taxed amounts, or choose to use the $1,000 de minimis cap. CCo calculates its foreign tax offset limit as $2,200.

CCo is able to offset $2,200 of the foreign income tax it has paid to reduce tax payable for the non-membership period. The foreign income tax of $300 not utilised cannot be transferred to HCo, as it relates to income included in CCo's assessable income and it is not pre-commencement excess foreign tax.

CCo transfers its pre-commencement excess foreign income tax to HCo at the joining time to be pooled with HCo's pre-commencement excess foreign income tax, as follows:

Table 4: Pre-commencement excess foreign income tax of HCo at 1 Jan 2009

	Pre-commencement excess foreign income tax arising in …				
	03-04	**04-05**	**05-06**	**06-07**	**07-08**
Previous pool	$129	$287	$130	$200	$320
Transferred from CCo	$350	$500	–	$600	$400

For the 2008-09 income year, HCo calculates its foreign tax offset limit at $4,250. As HCo paid foreign income tax of $4,000, there is a foreign income tax shortfall because the tax offset amount is less than the foreign tax offset limit.

HCo can utilise its pre-commencement excess foreign income tax to increase the tax offset amount. It uses a first-in, first-out basis for utilising pre-commencement excess foreign income tax from the pool. HCo increases the foreign income tax offset amount by $250 by using pooled pre-commencement excess foreign income tax amounts (reducing the 2003-04 amount by $129 and 2004-05 by $121).

HCo cannot use any excess foreign income tax transferred by CCo because CCo had not joined the consolidated group before the start of HCo's 2008-09 income year. The first income year in which HCo can use the transferred excess foreign income tax from CCo is 2009-10.

Table 5: Pre-commencement excess foreign income tax of HCo at 30 June 2009

	Pre-commencement excess foreign income tax arising in …				
	03-04	**04-05**	**05-06**	**06-07**	**07-08**
Previous pool	$129	$287	$130	$200	$320
Transferred from CCo	$350	$500	–	$600	$400
Utilised 30 June 2009	($129)	($121)			
Balance	$350	$666	$130	$800	$720

2009-10 income year

For the 2009-10 income year, HCo calculates its foreign income tax offset limit as $8,500. Having paid foreign income tax of $7,000, HCo is left with a foreign income tax shortfall of $1,500. HCo can utilise its pre-commencement excess foreign income tax and add $1,500 to the tax offset for the income year.

The five year time limit prevents HCo from using pre-commencement excess foreign income tax from the 2003-04 income year because these amounts arose outside the five years preceding 2009-10. The pre-commencement excess foreign income tax from the 2004-05 and following income years is available for HCo to use. HCo uses a first-in, first out basis for utilising the pre-commencement excess foreign income tax from the pool.

The balance of the pool after utilising pre-commencement excess foreign income tax is calculated as follows:

Table 6: Pre-commencement excess foreign income tax available for HCo at 30 June 2010

	Pre-commencement excess foreign income tax arising in …				
	04-05	**05-06**	**06-07**	**07-08**	**Total**
Pool	$666	$130	$800	$720	$2,316
Utilised 30 June 2010	($666)	($130)	($704)		($1500)
Balance			$96	$720	$816

References

Income Tax Assessment Act 1997, Subdivision 717-A and Division 770, as amended by *Tax Laws Amendment (2007 Measures No. 4) Act 2007*

Income Tax (Transitional Provisions) Act 1997, Subdivisions 770-D and 770-E, as amended by *Tax Laws Amendment (2007 Measures No. 4) Act 2007*

Explanatory Memorandum to Tax Laws Amendment (2007 Measures No. 4) Bill 2007, Chapter 1

Revision history

Section C6-2-120 first published 30 June 2009.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Calculating the foreign income tax offset

Description

This example shows how a head company determines its entitlement to a foreign income tax offset and calculates the amount of the offset.

Commentary

The foreign income tax offset rules allow a non-refundable tax offset for foreign income tax paid on an amount included in assessable income. The taxpayer is entitled to a tax offset in the income year in which the amount is included in its assessable income.

The foreign income tax offset rules replace the foreign tax credit rules from the first income year starting on or after 1 July 2008. From the commencement year, transitional rules apply to the transfer and utilisation of pre-commencement excess foreign income tax → worked example 'Foreign income tax offset – transitional rules', C6-2-120.

Under the single entity rule, the head company of a consolidated or MEC group is assessed on foreign income derived by it and subsidiary members of the group. Where a subsidiary member pays foreign income tax on an amount included in the head company's assessable income, the head company is treated as having paid the foreign income tax, and only it is entitled to the corresponding foreign income tax offset.

An entity that joins a consolidated or MEC group part way through an income year is entitled to a foreign income tax offset for foreign income tax paid on an amount included in its assessable income for the non-membership period before it joined the group.

The head company is deemed to have paid foreign income tax on an amount included in its assessable income where the foreign income tax has been paid by another entity under an arrangement or under the law relating to the foreign income tax, such as payments by a partnership or trust. The deeming rules cannot apply to a subsidiary member while it is a member of the consolidated or MEC group because the subsidiary member does not include the amount on which the foreign income tax has been paid in its assessable income.

Deeming rules extend the flow-through of a tax offset entitlement to ensure that a beneficiary of a trust can be deemed to have paid any foreign income tax on its share of trust income that is attributable to income flowing through a trust (or chain of trusts) on which foreign income tax is paid by another entity. Where income beneficially derived by a subsidiary member is attributable to income received by a trust on which foreign income tax has already been paid, the head company is treated as having paid the foreign income tax where the income is included in its assessable income due to the operation of the single entity rule.

Example

Facts

HCo is the head company of a consolidated group, which has two subsidiary members, ACo and BCo, at the start of the 2009-10 income year.

ACo holds a 50% interest in a partnership that earns foreign income.

BCo is one of two beneficiaries of a trust that has shares in a foreign company, FCo. Both beneficiaries have equal entitlement to income and capital of the trust but the other beneficiary is not a subsidiary member of the HCo consolidated group.

In the income year beginning 1 July 2009, the following transactions occur:

- The partnership in which ACo is a partner earns $1,000 of net partnership income on which it pays $200 foreign income tax.
- FCo pays a dividend of $6,000 to the trust and deducts $900 withholding tax, leaving a net distribution of $5,100. The trust distributes $2,550 to BCo.

On 1 January 2010, HCo acquires all the membership interests in CCo (which has the same income year as HCo).

CCo derives $10,000 of foreign income in the non-membership period from 1 July 2009 to 31 December 2009. In May 2010, CCo pays foreign income tax of $2,500 on this amount of foreign income.

Neither HCo nor CCo has any pre-commencement excess foreign income tax from previous income years.

Calculation

Under the single entity rule, HCo includes the income of the subsidiary members in its assessable income. Under the foreign income tax offset rules, the amount included in assessable income is the grossed-up amount: that is, the amount before the payment of foreign income tax.

For the year ending 30 June 2010, HCo's assessable income will include:

ACo's share of the partnership's income:	$500 (grossed-up amount)
BCo's distribution from the trust:	$3,000 (grossed-up amount)

CCo joined the group part way through the income year and treats the non-membership period from 1 July 2009 to 31 December 2009 as an income year. CCo's assessable income includes $10,000 of foreign income.

These grossed-up amounts are the double-taxed amounts for the purposes of determining the foreign income tax offset entitlement.

Foreign income tax offset entitlement

HCo will be deemed to have paid the foreign income tax paid by the partnership on the income included in HCo's assessable income: that is, $100 (being a 50% share of tax paid by the partnership).

The amount distributed to BCo by the trust and included in HCo's assessable income is ultimately attributable to the dividend paid by the foreign company, FCo. HCo will be treated as having paid the withholding tax deducted from the dividend paid by FCo ($450).

HCo will be eligible for a foreign income tax offset for foreign tax paid on:

- income received from the partnership, and
- the dividend paid by FCo to the trust.

The amount of the foreign income tax offset is determined in accordance with the foreign income tax offset limit.

HCo can calculate the foreign income tax offset limit as the lesser of the foreign income tax paid or the Australian tax payable on the double taxed amounts, or choose to use the $1,000 de minimis cap. HCo opts for the cap because its total foreign income tax paid is less than $1,000. HCo is entitled to a foreign income tax offset of $550 (that is, $100 + $450).

CCo is entitled to a foreign income tax offset for the foreign income tax it paid after joining the group because it relates to an amount included in CCo's assessable income for the non-membership period.

CCo calculates the Australian tax payable on its foreign income of $10,000 as $3,000. However, as the foreign income tax paid by CCo is less than its foreign income tax offset limit, CCo's foreign income tax offset is limited to the amount of foreign income tax paid: that is, $2,500.

References

Income Tax Assessment Act 1997, Subdivision 717-A and Division 770, as amended by *Tax Laws Amendment (2007 Measures No. 4) Act 2007*

Income Tax (Transitional Provisions) Act 1997, Subdivisions 770-D and 770-E, as amended by *Tax Laws Amendment (2007 Measures No. 4) Act 2007*

Explanatory Memorandum to Tax Laws Amendment (2007 Measures No. 4) Bill 2007, Chapter 1

Revision history

Section C6-2-130 first published 30 June 2009.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Transfer of attribution surpluses

Description

This example shows how attribution account surpluses relating to interests in controlled foreign companies (CFCs), foreign investment funds (FIFs) and foreign life assurance policies (FLPs) are transferred from a joining company to a head company at the joining time and from a head company to a leaving company at the leaving time.

Commentary

CFC income (and FIF income up to 2009-10)

The FIF rules were repealed with effect from the 2010-11 income year. Companies with interests in a FIF or foreign life policy (FLP) are no longer subject to the attribution rules. Consequently, insofar as the examples here refer to FIFs and FLPs, they only apply in relation to income years before 2010-11. For later years, see → 'FIF income (2010-11 onwards)' below.

The transfer of attribution account surpluses from a joining company to a head company ensures that distributions from CFCs, FIFs and FLPs are not taxed to the head company where the joining company has already been taxed on the attributed income. The same rationale applies when a company leaves a group.

Where a company that holds interests in a CFC, FIF or FLP becomes a subsidiary member of a consolidated group, any surplus in the relevant attribution account at the joining time is transferred to the head company. This applies with respect to surpluses in attribution accounts, attributed tax accounts, FIF attribution accounts and FIF attributed tax accounts.

If the company leaves the consolidated group and takes interests in a CFC, FIF or FLP with it, the head company transfers to the leaving company at the leaving time a proportion of the surplus in the relevant attribution account kept by the head company.

FIF income (2010-11 onwards

From the 2010-11 income year onwards, any FIF attribution surpluses that previously arose for the head company of a consolidated group, including those transferred to it and those of its own, will become part of its post-FIF abolition surplus.

When a company becomes a subsidiary member of a consolidated group and it has a post-FIF abolition surplus, the surplus is transferred to the head company of that group. → section 717-220, ITAA 1997

When a company leaves a consolidated group and takes with it interests in a FIF or FLP, the head company transfers to the leaving company a proportion of the post-FIF abolition surplus that it has in relation to those interests. The proportion is based on the percentage of the group's interest in the FIF or FLP held by the leaving company. → section 717-255, ITAA 1997

Under section 23AK of the ITAA 1936, when the head company or the leaving company receives a distribution paid out of previously attributed FIF income, it will continue to be exempt from tax.

Under section 23B of the ITAA 1936 (which was introduced to preserve the effect of former section 613 of the ITAA 1936), when the head company or the leaving company disposes of an interest in a FIF or FLP where the FIF income has been attributed but not distributed before disposal, the head company or the leaving company may reduce its capital proceeds. The capital proceeds may be reduced by so much of the post-FIF abolition surplus that it has in relation to those interests not exceeding the capital proceeds.

Therefore, on disposal of an interest in a FIF or FLP, the head company or the leaving company can continue to take advantage of the section 23AK exemption or the former section 613 reduction of capital proceeds.

→ 'Treatment of foreign income tax offsets, attribution surpluses and conduit foreign income', C6-1

From the 2010-11 income year onwards, taxpayers with interests in FIFs or FLPs are no longer subject to the attribution rules and are not required to make any elections in relation to calculating FIF income. Consequently, section 715-660 of the ITAA 1997 (about certain resettable elections) was amended to remove these elections from the list of elections that a head company can reset.

Example: joining company

Facts

HCo is the head company of a consolidated group. On 1 January 2006 HCo acquires all the shares in another company, ACo. Both companies have an income year of 1 July to 30 June.

At the joining time HCo has FIF interests in FIF1, which has a notional accounting period of 1 July to 30 June. At that time the FIF attribution account for FIF1 has a surplus of $50.

Table 1: ACo's FIF interests at the joining time

	Notional accounting period	Attribution account balance as at 30.06.05
FIF1	1 July to 30 June	$75 surplus
FIF2	1 January to 31 December*	$100 surplus
FIF3	1 January to 31 December*	$150 surplus

* ACo made an election under subsection 486(3) of the *Income Tax Assessment Act 1936* (ITAA 1936) that the notional accounting period for FIF2 and FIF3 is the period for which the FIFs' accounts are prepared.

ACo has held these interests for the two years prior to the joining time, neither acquiring nor disposing of any interests during that period. ACo used the market value method to calculate the FIF income accruing to the FIF interests.

Section 529 in Part XI of the ITAA 1936 requires a taxpayer that holds an interest in a FIF at the end of the taxpayer's income year to include in their assessable income any FIF income that accrues to that FIF interest for the notional accounting period of the FIF that ends in the taxpayer's income year.

A non-membership period is treated as if it were an income year → former section 701-30, *Income Tax (Transitional Provisions) Act 1997*. This means ACo must determine the FIF income or loss that accrued in relation to its FIF interests for the non-membership period 1 July 2005 to 31 December 2005.

Calculation

For the purpose of calculating the FIF income assessable to ACo, FIF1's notional accounting period is taken to end earlier than it actually does. Ending the notional accounting period of FIF1 immediately before the joining time ensures that ACo is assessed on the FIF income that accrues to its FIF1 interest for the non-membership period before the joining time, and that HCo is assessed on any FIF income that accrues to its FIF1 interests (which include ACo's interests) during the period of consolidation. HCo determines the FIF income as if it has acquired the FIF interests at the joining time. If HCo chooses to use the market value method, the consideration taken to be given at the joining time is the market value of those interests immediately before the joining time.

The notional accounting periods of FIF2 and FIF3 both end at the joining time. Therefore, for the purpose of calculating its assessable income in the non-membership period, ACo must determine in relation to each FIF the FIF income or loss that accrued for the whole of the notional accounting period.

The FIF income/loss for each of ACo's FIF interests determined for the purposes of ACo's assessable income for the non-membership period before the joining time is shown in table 2.

Table 2: FIF income/loss of ACo FIF interests for non-membership period

	Period in which FIF income accrued	FIF income
FIF1	1 July 2005 to 31 December 2005	$200
FIF2	1 January 2005 to 31 December 2005	($100)
FIF3	1 January 2005 to 31 December 2005	$300

The FIF loss in relation to FIF2 can be claimed as a deduction against ACo's other assessable income → section 532, ITAA 1936. ACo can claim the deduction only to the extent of the surplus in the attribution account of FIF2. The deduction gives rise to an attribution account debit to the extent of the loss or the surplus, whichever is less. ACo includes the FIF income for FIF3 for the whole of the notional accounting period in its assessable income.

The FIF income included in ACo's assessable income gives rise to an attribution account credit immediately before the joining time.

The attribution account surplus transferred by ACo for each of the three FIFs is shown in table 3.

Table 3: Attribution account surplus transferred by ACo

	FIF1		FIF2		FIF3	
	Credit	Debit	Credit	Debit	Credit	Debit
Balance brought forward as at 1.7.05	$75		$100		$150	
Credit/debit as at 31.12.05	$200			$100	$300	
Balance as at 31.12.05	**$275**		**NIL**		**$450**	

Had the FIF loss in relation to ACo's interest in FIF2 exceeded the attribution account surplus, that excess would not have been allowable as a deduction. Instead the entry history rule would make the remaining FIF loss available to HCo to offset against FIF income accruing in later income years for interests in FIF2 held by the group.

The attribution account surpluses transferred by ACo are pooled with those of HCo as head company of the group. As HCo also held interests in FIF1 and had a surplus of $50 in the attribution account that it kept for its interest in FIF1, the attribution accounts kept by HCo immediately following the joining time are as shown in table 4.

Table 4: HCo's attribution accounts immediately following joining time

	FIF1		FIF2		FIF3	
	Credit	Debit	Credit	Debit	Credit	Debit
Balance at joining time	$50		N/A	N/A	N/A	N/A
Surplus from ACo	$275		NIL		$450	
Balance post joining time	**$325**		**NIL**		**$450**	

Example: leaving company

Facts

On 1 July 2006 HCo sells all its shares in ACo to a company outside the group. ACo takes 50% of the group's interests in FIF1 with it. FIF1's attribution account was in surplus to the extent of $350.

The proportion of the attribution account surplus to be transferred to ACo is determined using the following formula:

$$\frac{\text{Leaving company's attribution account percentage in relation to the attribution account entity at the leaving time}}{\text{Head company's attribution account percentage in relation to the attribution account entity just before the leaving time}} \times \text{Attribution surplus for the attribution account entity in relation to the head company just before the leaving time}$$

Calculation

ACo's attribution account percentage in FIF1 at the leaving time is 50% of HCo's attribution account percentage in FIF1 just before the leaving time. The proportion of the attribution account surplus transferred to ACo at the leaving time will therefore be $175, i.e. 50/100 x $350.

The attribution account surplus taken by ACo ensures that it will not be assessed on distributions it receives from FIF1 in relation to the interests it holds to the extent of the surplus.

References

Income Tax Assessment Act 1936, sections 532 and 529 and subsection 486(3)

Income Tax Assessment Act 1997, Division 717, Subdivisions 717-D and 717-E; as amended by *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 6

Income Tax (Transitional Provisions) Act 1997, former section 701-30; as amended by *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 7

Explanatory Memorandum to New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, Chapter 2

Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006 (No. 101 of 2006), which repealed section 701-30 of the *Income Tax (Transitional Provisions) Act 1997*

Revision history

Section C6-2-210 first published (excluding drafts) 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
15.11.06	Updated references to inoperative provisions.	Legislative amendment.
6.5.11	Revised to take into account the repeal of Part XI of the ITAA 1936 in relation to the FIF and FLP rules.	Legislative amendments.

Worked example

Transfer of foreign dividend account balance

Description

This example shows the transfer of a joining company's foreign dividend account (FDA) balance to the head company of a consolidated group. It also shows how the head company uses the FDA surplus to pay non-resident shareholders unfranked dividends exempt from dividend withholding tax.

Commentary

The FDA balance of a company that becomes a subsidiary member of a consolidated group is transferred to the head company of the group. The FDA surplus in the head company's account enables that company to pay unfranked dividends to the non-resident shareholders of the group, free from dividend withholding tax.

Where a company leaves a consolidated group, the leaving company is not entitled to take any FDA balances with it on exit. If the leaving company operates an FDA after the leaving time, the rules in Subdivision B of Division 11A of the ITAA 1936 apply.

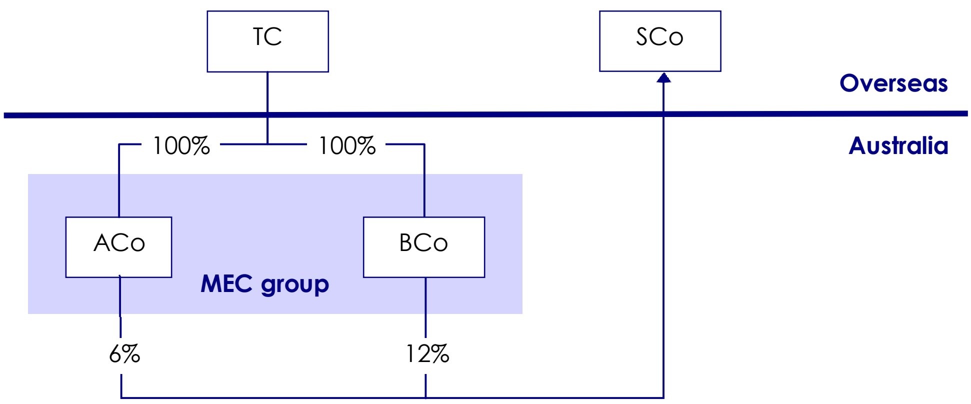
Example

Facts

ACo and BCo are wholly-owned subsidiaries of TC – the top company. ACo and BCo are both eligible tier-1 companies. On 1 July 2004 they form a MEC group, jointly nominating ACo to be the provisional head company of the MEC group. ACo is the provisional head company at the end of the MEC group's income year and so is taken to be the head company of the group for the whole of its income year.

At the formation time, ACo holds a 6% foreign investment in SCo but does not operate an FDA as the dividends paid by SCo are not non-portfolio dividends. BCo holds a 12% foreign investment in SCo and has an FDA surplus of $5,000. No further foreign investments are made by ACo or BCo.

Figure 1: Foreign investments of MEC group



On 1 September 2004, SCo pays a dividend of $4,400 to ACo and $6,600 to BCo. ACo incurs an expense of $2,000 on 1 October 2004 that relates to the dividends paid by SCo. No further credit or debit entries are made to ACo's FDA.

On 31 December, ACo and BCo both pay a dividend to TC. ACo pays a dividend of $12,000 and BCo pays one of $10,000. The FDA declaration percentage specified by ACo is 75%, while BCo specifies 60%.

Calculation

The FDA surplus of $5,000 is transferred to ACo by debiting BCo's FDA for $5,000 at the balance time (that is, the time just before the joining time) and crediting ACo's FDA for $5,000 at the joining time. At the joining time ACo is also able to aggregate the total foreign investment holding and operate a single FDA based on the group's 18% foreign investment.

The dividends received by ACo give rise to an FDA credit of $11,000 in ACo's account on 1 September 2004. The $2,000 expense incurred by ACo in relation to the dividends received gives rise to an FDA debit in ACo's account on 1 October 2004. The balance in ACo's FDA is $14,000.

When ACo pays an unfranked dividend to TC on 31 December, the FDA surplus at the beginning of that day is $14,000. To pay TC unfranked dividends free from dividend withholding tax, ACo needs to ensure the FDA declarations do not exceed the FDA surplus available at the beginning of the day.

The dividend payment of $12,000 with an FDA declaration percentage of 75% would have an FDA declaration amount of $9,000. The dividend payment of $10,000 with an FDA declaration of 60% would have an FDA declaration amount of $6,000. The sum of the declaration amounts is $15,000, which exceeds ACo's FDA surplus of $14,000 at the beginning of the day.

ACo needs to proportionally reduce the FDA declaration percentage for each FDA declaration made. The proportional reduction is achieved by applying the following formula (→ subsection 717-525(3)):

$$\text{FDA declaration percentage actually specified in the declaration} \times \frac{\text{That FDA surplus}}{\text{That sum}}$$

The FDA declaration percentage that ACo is taken to have declared, and the corresponding FDA declaration amounts, are shown in table 1.

Table 1: Proportional reduction of declaration percentages and amounts

	Spec. %	x	FDA surplus / Sum	=	Reduced %	x	Dividend amount	=	Declaration amount
Dividend paid by ACo	75%	x	$14,000 / $15,000	=	70%	x	$12,000	=	$8,400
Dividend paid by BCo	60%	x	$14,000 / $15,000	=	56%	x	$10,000	=	$5,600
Total									**$14,000**

The FDA declarations made give rise to an FDA debit of $14,000 in ACo's account on 31 December 2004.

References

Income Tax Assessment Act 1997, Division 717 – as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003)

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 7

Revision history

Section C6-2-310 first published 28 May 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Treatment of conduit foreign income

Description

This example shows how the conduit foreign income of an entity that joins a consolidated or MEC group is treated as conduit foreign income of the head company. It also shows how the head company can use the conduit foreign income to pay non-resident shareholders unfranked dividends that are exempt from dividend withholding tax, including on-paying conduit foreign income received from another Australian corporate tax entity outside the consolidated or MEC group.

Commentary

The conduit foreign income of an entity that joins a consolidated or MEC group becomes conduit foreign income of the group's head company. Any conduit foreign income derived by subsidiary members is treated as being derived by the head company. The head company calculates the amount of conduit foreign income that is available to pay unfranked dividends to the non-resident shareholders of the group, free from dividend withholding tax. The head company is also able to on-pay a declared conduit foreign income amount that is received as a distribution from another Australian corporate tax entity outside the group.

Example

Facts

ACo and BCo are wholly-owned subsidiaries of TC, the top company. ACo and BCo are both eligible tier-1 companies. On 1 July 2008 they form a MEC group, jointly nominating ACo to be the provisional head company. ACo is the provisional head company at the end of the group's income year and so is taken to be the head company of the MEC group for the whole of its income year.

The head company's income year is 1 July to 30 June.

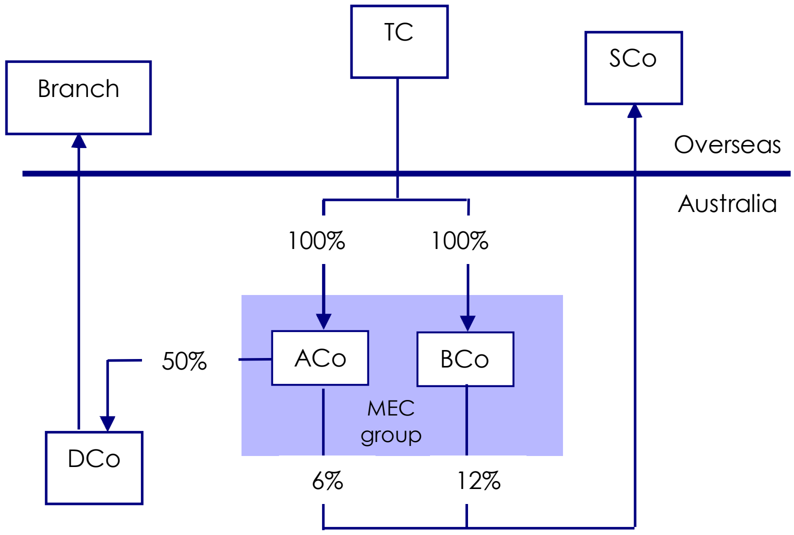
At the formation time, ACo holds a 6% foreign investment in SCo, so the dividends paid by SCo to ACo are not non-portfolio dividends. On 30 May 2008, ACo receives $2,500 in dividends from SCo.

ACo also owns 50% of DCo, an Australian corporate tax entity. DCo carries on business overseas through a branch (that is, a permanent establishment) and receives foreign branch income that is non-assessable, non-exempt income under section 23AH of the ITAA 1936. ACo has declared and distributed all the conduit foreign income it received from DCo before forming the MEC group on 1 July 2008.

BCo holds a 12% foreign investment (that is non-portfolio) in SCo, and on 30 May 2008 receives $5,000 in non-portfolio dividends from SCo. At 30 June 2008, BCo calculates its conduit foreign income to be $5,000.

No further foreign investments are made by ACo or BCo.

Figure 1: Foreign investments of MEC group



On 1 September 2008, SCo pays dividends of $4,400 to ACo and $8,800 to BCo. BCo incurs an expense of $2,000 on 1 October 2008 that relates to the dividends paid by SCo.

On 1 October 2008, DCo pays ACo an unfranked dividend of $20,000, of which $10,000 is a declared conduit foreign income amount.

On 31 December 2008, ACo and BCo both make distributions to TC. ACo pays a dividend of $12,000 and BCo pays one of $10,000. ACo, as the provisional head company, will be taken to have paid BCo's dividend to TC and will be required to provide the distribution statement to TC.

Calculation

Conduit foreign income of $5,000 received by BCo before joining the MEC group is treated as conduit foreign income of ACo as the provisional head company of the MEC group. At the joining time, ACo is also able to aggregate the total foreign investment holding and calculate conduit foreign income based on the group's 18% foreign investment in SCo. Therefore, all dividends received from SCo after the joining time will be treated as non-portfolio dividends.

Before making the distribution to TC, ACo (the provisional head company) calculates the conduit foreign income for the group at 31 December 2008 as follows:

- ACo has a balance of conduit foreign income received from BCo of $5,000 at the joining time.
- The dividends SCo paid to ACo and BCo totalling $13,200 are treated as being derived by ACo and added to the conduit foreign income amount.
- The $2,000 expense incurred by BCo in relation to the dividends received from SCo reduces the conduit foreign income amount.

- ACo adds to its conduit foreign income amount the received conduit foreign income amount of $10,000 included in the unfranked dividends received from DCo.

ACo has $26,200 of conduit foreign income available for distribution on 31 December 2008.

The unfranked dividend of $22,000 paid to TC on 31 December 2008 is declared to be 100% conduit foreign income.

ACo, as provisional head company, provides a distribution statement indicating the amount of the unfranked distributions that is declared to be conduit foreign income. TC will receive this amount free of withholding tax.

As ACo on-paid within the required timeframe the full amount of declared conduit foreign income it received as part of the unfranked distribution from DCo, this portion of the DCo dividend is treated is non-assessable, non-exempt income of ACo.

References

Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Act 2005, which repealed Subdivisions 717-J and 719-X and inserted Subdivisions 715-U and 802-A of the ITAA 1997

Explanatory Memorandum to the Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Bill 2005, Chapter 5

Revision history

Section C6-2-410 first published 30 June 2009.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

C7: Making a choice in writing – and notifying

Making a choice in writing – and notifying

About this section

To consolidate, a head company of a consolidatable group must make a choice in writing that it is forming a consolidated group from a certain date. The head company must also notify the ATO of its choice to form a consolidated group.

The ATO must also be notified when members join or leave the group or the group ceases to exist.

This section provides information on how to make a choice in writing and the notification requirements.

Multiple entry consolidated (MEC) groups use different notification forms.
→ 'MEC groups – notices to be given to the Commissioner', C10-1-110

Section contents

General information

Notification forms for consolidated groups

The notification forms with instructions for their completion can be found at ato.gov.au/consolidation

Choice in writing

Key points

Effective from 1 July 2002, the following choices must be made in writing:

- the choice to form a consolidated group
- the choice to form a multiple entry consolidated (MEC) group
- the choice to create a MEC group from a consolidated group (special conversion event)
- the choice for a new eligible tier-1 company to become a member of a MEC group, and
- the choice to appoint a new provisional head company.

There is no requirement to give the written choice to the Commissioner but it must be kept for record keeping purposes. The relevant information about the choice must be notified to the Commissioner in the approved form.

Background

Legislative amendments to the provisions covering how a choice is made to form a consolidated group or MEC group (and certain other choices relevant to these groups) were enacted on 3 June 2010, with effect from 1 July 2002.

Before the amendments were enacted, to be effective a choice had to be made in the approved form and given to the Commissioner. The amendments require the choice to be made in writing but there is no requirement for the written choice to be given to the Commissioner. However, the relevant information about the choice must be notified to the Commissioner in the approved form.

→ 'Consolidated groups – notices to be given to the Commissioner', C7-1-120;
'MEC groups – notices to be given to the Commissioner', C10-1-110

Option to apply changes from 10 Feb. 2010

The amendments apply from 1 July 2002 unless a separate choice is made by the head company or provisional head company of a group to apply the changes from 10 February 2010. This choice must be made in writing on or before 30 June 2014 or within such further time allowed by the Commissioner.

Note

Where an effective choice has been made before the enactment of the amendments, no further information needs to be given to the Commissioner.

Choices must be in writing

There are five choices that must be made in writing:

1. Choice to form a consolidated group → subsection 703-50(1), *Income Tax Assessment Act 1997* (ITAA 1997)
2. Choice to form a MEC group → subsection 719-50(1), ITAA 1997
3. Choice that a special conversion event takes place to create a MEC group from a consolidated group → subsection 719-40(1), ITAA 1997
4. Choice that a new eligible tier-1 company becomes a member of a MEC group → subsection 719-5(4), ITAA 1997
5. Choice to appoint a new provisional head company (PHC) following a cessation event happening to the former PHC → subsection 719-60(3), ITAA 1997

Valid choice in writing

For a choice in writing to be valid there needs to be a written document stating:

- the choice being made
- the entities making the choice
- the date the choice was made, and
- any other particulars specifically required by the choice provisions.

The specific particulars required for making a valid choice in writing for each type of choice are listed in table 1.

Each choice provision specifies which entity or entities can make the choice, and this information must be evident in the choice documents. For example, the choice to form a MEC group or to appoint a new PHC after formation must be made in writing jointly by all the eligible tier-1 companies of the group at the relevant time.

It is necessary that the choice in writing document is signed and dated by the public officer of each entity required to make the choice as specified in the relevant choice provisions.

The head company must keep the written choice to meet the statutory record-keeping requirements. → 'Record keeping guidelines and checklist', C9-2

Time period for making and notifying a choice

The choice must be made within the time period specified in the relevant choice provision. Note that the Commissioner does *not* have any discretion to extend the time period for making a choice in writing.

The choice to form a consolidated or MEC group or create a MEC group from a consolidated group may be made up to the day the head company lodges the income tax return for the income year in which the day specified in the choice occurs – or, if a return is not required for that income year, the date it would have otherwise been due. The choice must be notified to the Commissioner within the same time period.

Similarly, the choice for a new eligible tier-1 company to become a member of a MEC group may be made up to the day the head company lodges the income tax return for the income year in which the company becomes an eligible tier-1 company of the top company – or, if a return is not required for that income year, the date it would have otherwise been due. The choice must be notified within the same time period.

The time period for making a choice to appoint a new PHC of a MEC group depends on when the cessation event occurs, that is when the former PHC became ineligible. If the cessation event occurs more than 28 days before the notice of formation has been lodged with the ATO, the choice must be made and notified by the time the formation notice is given. Otherwise, the choice must be made and notified within 28 days of the cessation event.

Specific requirements

Table 1 summarises the specific requirements for each type of choice.

Table 1: Requirements for a valid choice in writing

Type of choice	Who can make choice	Particulars required in written choice	Time period for making the choice
1. Choice to form a consolidated group → subsection 703-50(1)	Head company	A statement that the consolidated group has formed, including: • date of consolidation • name of head company • date the choice was made The statement must be signed by the public officer of the head company	Up to the day the head company lodges the income tax return for the income year in which the day specified in the choice occurs – or, if a return is not required for that income year, the date it would have otherwise been due. → subsection 703-50(3)
2. Choice to form a MEC group → subsection 719-50(1); subsection 719-60(1)	Eligible tier-1 companies of the potential MEC group	A statement that a MEC group has formed, including: • date of consolidation • names and details of eligible tier-1 companies who jointly made the choice to consolidate the potential MEC group • name of the PHC appointed at formation • date the choice was made The statement must be signed by the public officer of each eligible tier-1 company	As above → subsection 719-50(3)
3. Choice that a special conversion event takes place to create a MEC group from a consolidated group → subsection 719-40(1)	Head company of consolidated group	A statement that the MEC group came into existence at the time the specified companies became eligible tier-1 companies of the top company including: • name of head company of the consolidated group • names and details of the companies who became eligible tier-1 companies of the top company at that time • date the choice was made The statement must be signed by the public officer of the head company of the consolidated group	As above → subsection 719-40(2)
4. Choice that a new eligible tier-1 company becomes a member of the MEC group → subsection 719-5(4)	Provisional head company	A statement that a new eligible tier-1 company became a member of the MEC group at the time it became an eligible tier-1 company of the top company including: • name of the new eligible tier-1 company • where the new eligible tier-1 company was a member of another MEC group and all the eligible tier-1 companies of the other MEC group become eligible tier-1 companies of the top company at that time, the name of each eligible tier-1 company of the other MEC group that became an eligible tier-1 member of the MEC group • name of the PHC • date the choice was made The statement must be signed by the public officer of the PHC	Up to the day the head company lodges the income tax return for the income year in which the company became an eligible tier-1 company of the top company – or, if a return is not required for that income year, the day it would have otherwise been due → subsection 719-5(6)
5. Choice to appoint a new provisional head company after formation of a group → subsection 719-60(3)	Eligible tier-1 members of the MEC group immediately after the cessation event	A statement that a new PHC has been appointed jointly by the eligible tier-1 members with effect from immediately after the cessation event, including: • names of eligible tier-1 companies who jointly appointed the new PHC • name of the new PHC • date of the choice The statement must be signed by the public officer of each eligible tier-1 company	Within 28 days of the cessation event – or, if the cessation event occurs more than 28 days before the notification of the MEC group's formation is lodged, by the time the formation notice is lodged

References

Income Tax Assessment Act 1997: subsections 703-50(1) , 703-50(3),719-5(4), 719-5(6), 719-40(1), 719-40(2), 719-50(1), 719-50(3) 719-60(1) and 719-60(3); as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 18

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.369 to 5.427

Revision history

Section C7-1-110 first published 6 May 2011.

Consolidated groups – notices to be given to the Commissioner

Key point

The Commissioner must be notified in the approved form where a choice in writing is made to form a consolidated group or where there is a change in the membership of the group or the group ceases to exist.

Choice in writing to be notified

Where a choice in writing is made to form a consolidated group, the head company must give the Commissioner a notice in the approved form with the relevant information. The choice in writing must be kept by the head company for record keeping purposes, but there is no requirement to give the written choice to the Commissioner. → 'Choice in writing', C 7-1-110

Changes to a consolidated group

The head company must also notify the Commissioner in the approved form of any of the following changes to a consolidated group:

- an entity becomes a member of the group
- an entity ceases to be a member of the group
- the consolidated group ceases to exist.

Where an entity joins or leaves a group before the choice to form a consolidated group is notified, the relevant information about the change in membership must be included on the choice notice and no additional notification is necessary.

Interposed head company

The Commissioner should also be notified where an interposed shelf company becomes the head company of a consolidated group because it makes a choice, under section 124-380 of the *Income Tax Assessment Act 1997*, for the consolidated group to continue to exist. This information is required so the ATO can update its income tax, PAYG instalments and franking account details for the group.

Notices

The approved notification forms for consolidated groups are listed in table 1.

Note

MEC groups

A different set of notices must be given to the Commissioner when a multiple entry consolidated (MEC) group forms or changes. → 'MEC groups – notices to be given to the Commissioner',C10-1-110

Table 1: Notices to be given to the Commissioner

What must be notified	Notification deadline and form (→ forms available at **www.ato.gov.au/consolidation**)	Who must give notice
1. A choice in writing is made to form a consolidated group under section 703-50 Notice required by section 703-58	The notice must be lodged by no later than: • the date of lodgement of the group's income tax return for the income year in which the day specified in the choice occurs, or • if a return is not required for that income year, the date it would have otherwise been due. Notify using *Notification of formation of an income tax consolidated group* (NAT 6781)	Head company
2. An entity becomes a member of a consolidated group Notice required by section 703-60	Within 28 days of the entity joining the group Notify using *Notification of members joining and/or leaving an income tax consolidated group* (NAT 6782) If the entity joins the group before the notification of formation of a consolidated group has been lodged, the required information must be included in *Notification of formation of an income tax consolidated group* (NAT 6781)	Head company
3. An entity ceases to be a member of a consolidated group Notice required by section 703-60	Within 28 days of the entity leaving the group Notify using *Notification of members joining and/or leaving an income tax consolidated group* (NAT 6782) If the entity leaves the group before the notification of formation of a consolidated group has been lodged, the required information must be included in *Notification of formation of an income tax consolidated group* (NAT 6781)	Head company, or the public officer just before the head company ceased to exist
4. The consolidated group ceases to exist Notice required by section 703-60	Within 28 days of the group ceasing to exist Notify using *Notification of head company no longer eligible: income tax consolidated group ceases to exist* (NAT 6783) If the group ceases to exist before the notification of formation of a consolidated group has been lodged, this notice must be given by the time the income tax return is lodged for the year in which the choice to form the group is made, or, if a return is not required, the date it would have otherwise been due	The company that was the head company of the group, or the public officer of the company that was the head company just before it ceased to exist
5. An interposed shelf company becomes a head company as a result of a choice made under subsection 124-380(5) Notification required for administrative purposes	Within 28 days of the share exchange being completed Notify using *Notification of the continuation of a consolidated group with a new interposed head company* (NAT 71275)	New interposed head company of the group

References

Income Tax Assessment Act 1997, subsection 124-380(5)

Income Tax Assessment Act 1997, sections 703-50 and 703-60; as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5

Income Tax Assessment Act 1997, section 703-58; as inserted by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.369 to 5.381

Revision history

Section C7-1-120 first published 6 May 2011.

Impact of liquidation and deregistration

Key points

The liquidation and deregistration of a company will affect its membership of a consolidated group.

- However, the *appointment* of a liquidator to a subsidiary company does not affect its membership.
- A company that has been *deregistered* ceases to be a member of a consolidated group at the time of deregistration.

A liquidator has obligations to the creditors and contributories (shareholders) of the company being liquidated and to the ATO and the Australian Securities and Investments Commission (ASIC).

- The consolidation core rules do not affect the duties and obligations of the liquidator under the *Corporations Act 2001*.

A liquidator is appointed

The appointment of a liquidator to a company does not of itself affect a company's membership of a consolidated group or the membership of its wholly-owned subsidiaries. Deregistration at the end of the winding up process is the event that will terminate a company's membership of a consolidated group.

Nor does the appointment of a liquidator to the head company cause the deconsolidation of the group – that occurs when the head company is deregistered at the end of the liquidation process.

A liquidator may be appointed by the court or appointed as part of a voluntary process initiated by the company.

A liquidator's duties under the *Corporations Act 2001* include realising any assets, satisfying the company's creditors and returning any remaining capital and funds to the shareholders. A liquidator may satisfy these requirements by transferring assets, rather than realising them, in some circumstances, for example, where there are no creditors, only shareholders (contributories) who require a return of their investment.

Impact of the single entity rule

The single entity rule applies to transfers of funds or assets within a consolidated group. For example, the payment of capital profits from subsidiary B (in liquidation), to its shareholder, subsidiary A (a member of the same consolidated group), is ignored for the purposes of calculating the head company's income tax liability. Similarly, the transfer of an asset as part of the return of capital from the liquidating subsidiary to its shareholder (also part of the same consolidated group) is ignored for the purposes of calculating the head company's income tax liability.

The single entity rule does *not* directly affect:

- the duties and obligations of the liquidator under the *Corporations Act 2001*
- the accounts of the members of the consolidated group (this is determined according to accounting standards and practice), or
- the head company's shareholders (their tax liability is separate and distinct from the head company's tax liability).

For tax purposes, the single entity rule has the following effects:

- Liquidators cannot distribute assets or pay dividends to anyone but the creditors and the direct shareholders of the company (in other words, they cannot make a direct payment to an ultimate shareholder unless they are liquidating the head company of a consolidated group). Distributions within the group are ignored for the purposes of determining the tax liability of the head company.
- Accounts must be kept by each company in a group in accordance with accounting standards and practices, reflecting the nature and amount of distributions they receive from a liquidator, or dividends from their subsidiaries, where those subsidiaries are not being liquidated.
- The head company's shareholder is outside of the consolidated group, with the consequence that the tax liability of the shareholder will be determined according to the nature of the accounts and distributions made to them by the liquidator of the head company.

A liquidator's taxation responsibilities

Subdivision 260-B of the *Taxation Administration Act 1953* (TAA 1953) outlines liquidators' income tax responsibilities (which are separate from, and in addition to, their responsibilities under the *Corporations Act 2001* and other taxing Acts).

Liquidators must:

- notify the Commissioner of their appointment within 14 days of the appointment (preferably by way of the electronic form *Appointment of a representative of an incapacitated entity*, NAT 9504, available at **www.ato.gov.au**)
- after paying secured and priority creditors, retain the remaining company assets until they have received the Commissioner's section 260-45 notice of the amount sufficient to discharge the company's outstanding tax-related liabilities at the time the Commissioner gives his notice (which will include details of the company's income tax, PAYG instalment and franking deficit tax liabilities)
- after receiving the Commissioner's notice, set aside an amount in relation to the outstanding tax-related liabilities worked out using the formula in subsection 260-45 (6) of the TAA 1953 (the amount set aside must come out of the assets available for paying the ordinary unsecured debts of the company), and
- discharge the outstanding tax-related liabilities to the extent of the value of the assets required to be set aside.

Liquidators have a number of reporting requirements under the *Corporations Act 2001*, including lodging returns and providing information as to how the assets and funds of the company have been disposed of. The company's outstanding and settled tax liabilities are included in this accounting.

Deregistering without a liquidator

In the following circumstances, a company, or a director or member of a company, can apply directly to ASIC to deregister the company without appointing a liquidator to wind it up → Part 5A.1 of the *Corporations Act 2001*:

- all the members of the company agree to the deregistration
- the company is not carrying on a business
- the company's assets are worth less than $1,000
- the company has paid all fees and penalties levied under the *Corporations Act 2001*
- the company has no outstanding liabilities (including taxation liabilities), and
- the company is not a party to any legal proceedings.

Before a company can be deregistered without a formal winding up process, the head company's due date (for the relevant period) must have been reached, and the income tax liability paid. The income tax liabilities that must be satisfied before the application is made include both those that have arisen while the head company was outside a consolidated group and those that have arisen while it was in a consolidated group (ensuring that the company will not become jointly and severally liable, or liable under a tax sharing agreement, for any default of the head company). Consequently, the provisions contained in Subdivisions 260-B, 260-C and 260-E of the TAA 1953 are not relevant to these situations.

The deregistration process (application, notification and mandatory waiting periods) does not affect the company's membership of the consolidated group, nor does it affect its ownership of any assets it holds at any time during the process. (Generally, all assets will be disposed of by the end of the process, and capital will have been distributed – but any assets held by the company at the time of its deregistration will vest in ASIC.) The single entity rule will operate normally until the company is deregistered. Intra-group distributions from the subsidiary to its shareholder will be ignored for the purposes of calculating the head company's income tax liability.

ASIC initiated deregistration

Section 601AB of the *Corporations Act 2001* allows ASIC to initiate deregistration in the following circumstances:

- ASIC has no reason to believe the company is carrying on a business, and:
  - the response to a return of particulars given to the company is at least six months late, and
  - the company has not lodged any other documents under the *Corporations Act 2001* in the 18 months before the date of the decision to deregister a company

- the company has not paid its review fees within 12 months of the due date for payment
- the company is being wound up and ASIC has reason to believe the company's affairs have been fully wound up and the liquidator's return is at least 6 months late
- the company is being wound up and ASIC has reason to believe the liquidator is no longer acting, or
- the company is being wound up and ASIC has reason to believe the company's affairs have been fully wound up under Part 5.4 of the *Corporations Act 2001* and there is not enough property to cover the costs of obtaining a court order for the company's deregistration.

Once ASIC decides to deregister a company, it gives notice of the proposed deregistration:

- to the company
- to the company's liquidator (if any)
- to the company's directors
- on the ASIC database, and
- in the *Gazette*.

ASIC may deregister the company when two months have elapsed from the date of the *Gazette* notice. ASIC must give notice of the deregistration to everyone it notified of its proposal to deregister the company.

Deregistration occurs

Once deregistration occurs (whether or not as part of the liquidation process), the company is no longer eligible to be a member of a consolidated group, as it ceases to exist → section 601AD, *Corporations Act 2001*. The company ceases to be a member of the consolidated group at the time of deregistration as it is no longer a company and can no longer satisfy the conditions of eligibility.

The head company will need to determine the capital gains tax consequences of the deregistered company ceasing to be a member of the consolidated group. This will require the cost base of the membership interests of the leaving company to be determined under Division 711 of the *Income Tax Assessment Act 1997* (ITAA 1997). The head company will also need to determine if the cancellation of the shares or a declaration by a liquidator that the shares are worthless will give rise to a capital gain or loss under the CGT provisions → CGT event, section 104-25, and CGT event G3, section 104-145, ITAA 1997.

Notifying the ATO

The Commissioner must be notified that a subsidiary member ceased to be a member of the group within 28 days of the subsidiary member's deregistration → table item 2 in subsection 703-60(1), ITAA 1997. However, where the deregistration occurs before the choice to consolidate is notified, the information about the deregistered company no longer being a member must be provided on the choice notification.

If the head company is deregistered, the group will deconsolidate at the time of deregistration. In this situation, the person who was the public officer of the head company is required to notify the ATO of the cessation of the group within 28 days of the head company's deregistration → table item 3 in subsection 703-60(1). Where the consolidated group ceases to exist before the choice to consolidate is notified, the notification of the cessation of the group must be given by the time the income tax return is lodged for the year in which the choice is made (or if a return is not required, the date it would have otherwise been due).

For information on the notification forms, see → 'Consolidated groups – notices to be given to the Commissioner', C7-1-120.

MEC groups

If the provisional head company (PHC) of a multiple entry consolidated (MEC) group is deregistered, the Commissioner must be notified within 28 days that the PHC is no longer eligible. Where the PHC is deregistered before the choice to consolidate the MEC group has been notified, the notification that the PHC is no longer eligible must be given by the time the income tax return is lodged for the income year in which the deregistration occurs (or if a return is not required, the date it would have otherwise been due).

The MEC group does not, however, deconsolidate when the PHC is deregistered if:

- a choice in writing is made to appoint a replacement PHC, and
- the Commissioner is notified within the prescribed time.

If no replacement PHC is appointed, the MEC group will cease to exist.

For information on the MEC notification forms, see → 'MEC groups – notices to be given to the Commissioner', C10-1-110.

Other issues

Non-consolidation debts

A company that is being liquidated will continue to be solely liable for any income tax liabilities that have accrued to it while it is outside a consolidated group. These liabilities do not become the responsibility of the head company. The Commissioner will include these liabilities when determining the amount that the liquidator will need to set aside in order to satisfy the company's tax liabilities.

Other taxes, such as GST, PAYG withholding and fringe benefits tax, are not covered by consolidation. Accordingly, the company that is being liquidated will still be responsible for its liabilities in respect of other taxes.

Tax sharing agreements – effect on other parties

Once a company is deregistered, it generally cannot be the subject of further debt recovery action.

Where the Commissioner's ability to recover the liquidating company's potential share of any outstanding liability is compromised, the Commissioner may not be prepared to issue a section 260-45 notice until after the head company's debt has been established and it has been paid by the head company – or the contributories under a tax sharing agreement (TSA).

The head company is expected to pay the group liabilities by the due date. Initially, the ATO will seek to recover any outstanding amounts from the head company. If this is unsuccessful, or unlikely to be successful, the ATO may seek recovery from the subsidiary members of the group, which may include the company being wound up.

Where no TSA exists (and no members of the group are excluded from joint and several liability), the Commissioner may pursue the debt from the subsidiary members (which may include a company being wound up).

A TSA, or an exclusion from joint and several liability, may limit the liability of a particular member of the group with respect to their share of the group liability in the case of a defaulting head company. A TSA is subject to the specific provisions in Division 721 of the ITAA 1997.

The ATO recommends that TSAs contain provisions covering the entry and exit of members of the consolidated group, including where the exit is a result of deregistration. Regard should be had to the continuity of the agreement in the event that one or more parties cease to exist.

It may be in the interests of the liquidator to approach the head company for a copy of any existing TSA, in order to determine the extent of the liquidating company's potential tax liability.

Effect of 'retrospective' decision to consolidate

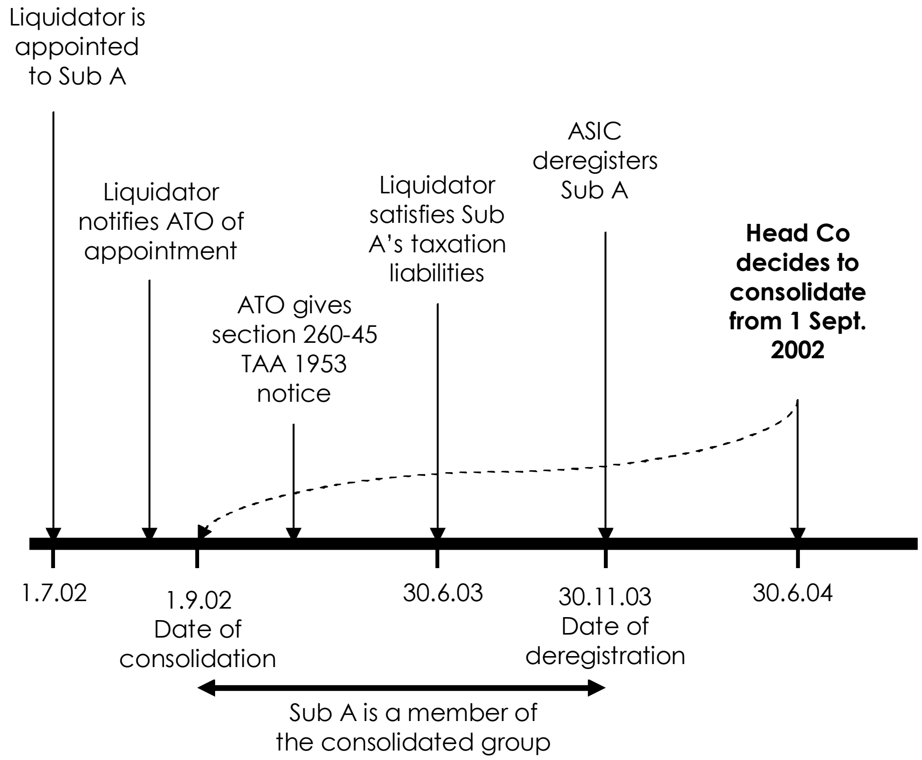
Part 3-90 requires the head company to make a choice in writing to consolidate on a specific date and to manage the group's tax affairs on that basis from that date. However, the head company isn't required to notify the ATO of that choice until the date of lodgment of its first consolidated income tax return (or, if a return is not required, the date it would have otherwise been due).

Where the ATO has been notified, the liquidator of a company, on seeking information from the ATO about the consolidatable group's status, would be advised that the company is a member of a consolidated group and would then be in a position to act on that information.

However, during the transitional period, the situation may arise where a head company of a consolidatable group makes the decision to consolidate after a member of the group has been deregistered but with the date of effect of consolidation prior to the date of deregistration. → figure 1

The deregistered member of the consolidatable group will be a member of the consolidated group from the date of effect of consolidation until the date of deregistration. The fact that the deregistered entity was no longer in existence when the consolidation decision was made has no effect on its membership eligibility. The test is whether it would have satisfied the membership tests on the date chosen by the head company to form a consolidated group.

Figure 1: 'Retrospective' decision to consolidate



In this example, Sub A will be a member of the consolidated group from the date of consolidation, 1 September 2002, until it is deregistered, on 30 November 2003.

Where the liquidating company is a member of a *consolidatable* group, the liquidator should advise the ATO of this when applying for the section 260-45 notice. This will enable the ATO to ensure that the correct taxpayer (which may in fact be the head company, not the liquidating subsidiary) is identified and its income tax liability correctly calculated. Consolidation will affect which company is treated as the taxpayer, and may also have an effect on that taxpayer's income tax liability.

In some rare cases during the transitional period, the liquidator may be unaware that the company they are liquidating is a member of a consolidatable group at the time the liquidation is being carried out. In those instances the liquidator may have paid income tax liabilities which they believed were liabilities of the liquidated company, but which were in fact liabilities of the head company (for example, as the result of a retrospective decision to consolidate).

The head company is nonetheless required to lodge an income tax return that includes income, deductions, gains, losses, credits and offsets from the activities of the liquidated company during the period in which it was a member of the consolidated group. The head company's income tax liability will be determined according to its income and deductions from *all* its subsidiaries, including the liquidated company.

The liquidated company's income tax liability will be adjusted so that it reflects only the period of time it was not a member of the consolidated group (for example, the periods before the choice to consolidate became effective, and any other periods in which it was outside the consolidated group). Any excess payment will be:

- **where deregistration *has not* yet occurred**: refunded to the liquidator, who may then make further distributions to the creditors and contributories, or
- **where deregistration *has* occurred**: refunded to ASIC, as all property rights of the company now vest in ASIC.

The head company will be liable to the full extent of its income tax liability, which includes any liability that arises as a result of the activities of the deregistered subsidiary. The head company's remedy (for the mistake made by the liquidated subsidiary member of the group) is to ask ASIC to reinstate the company → section 601AH of the *Corporations Act 2001*. ASIC will refund amounts held on behalf of that company to the company's liquidator or the directors of the company on its behalf (where the company was not liquidated). The amount returned to the company will be distributed among the creditors of the company (of which the head company may be one if there is a tax funding agreement in place) or contributories, where no unsatisfied creditors are left.

Thus, it is in the interests of the potential head company to carefully consider all taxation consequences of the appointment of a liquidator to one of its wholly-owned subsidiaries in advance of the decision to consolidate.

Revision history

Section C7-1-220 first published 11 March 2005.

Further revisions are described below.

Date	Amendment	Reason
6.5.11	Revisions to reflect changes to the choice and notification provisions.	Legislative amendments.

C8: **PAYG instalments**

PAYG instalments

About this section

When the head company lodges the first consolidated income tax return, the Tax Office calculates an instalment rate for the head company using information on the return. The head company then pays PAYG instalments on a consolidated basis, using a new *Consolidated activity statement*.

This section has a detailed explanation of the treatment of PAYG instalments for consolidated groups, instructions for completing the *Consolidated activity statement*, and a sample of the activity statement.

For a brief description of PAYG instalments for consolidated groups → 'Paying PAYG instalments', B3-2

Section contents

Treatment of PAYG instalments

After a head company lodges a group's first consolidated income tax return, the ATO calculates a consolidated instalment rate for the group based on the head company's return. The arrangements for pay as you go (PAYG) instalments differ for the periods before and after this occurs.

During the 'formation period', member entities continue to pay PAYG instalments as if they were not consolidated. The formation period extends from:

- the date of effect of consolidation – that is, the date the group forms

  until

- the date of effect of the consolidated instalment rate[176] – that is, the beginning of the instalment quarter in which the head company receives its consolidated instalment rate.

After this, the group is a 'mature group' and the head company pays PAYG instalments for the group as if it were one entity.

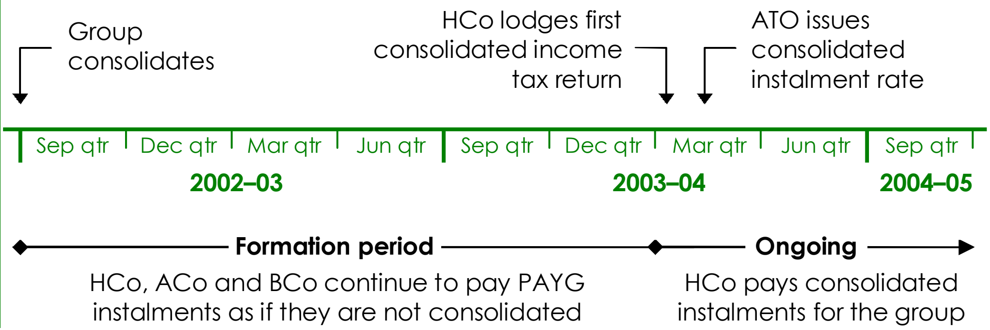
Example

Formation period and ongoing arrangements

HCo has a consolidatable group consisting of itself and its wholly-owned subsidiaries ACo and BCo. All three entities balance their accounts on 30 June and pay quarterly PAYG instalments.

HCo decides to consolidate the group from 1 July 2002 and lodges its first consolidated income tax return on 15 January 2004.

The ATO processes HCo's consolidated income tax return and issues a consolidated instalment rate in February 2004. HCo's first consolidated PAYG instalment is for the quarter 1 January – 31 March 2004 and is due on 21 April 2004.



[176] The consolidated instalment rate calculated from the head company's first consolidated income tax return is also known as the 'initial head company instalment rate'.

Formation period

Reporting and payment

During the formation period, the head company and subsidiary members continue to receive their own activity statements and are responsible for reporting and paying their own PAYG instalment amounts:

- Their due dates for payment continue as before – for example, if a member's usual due date is 28 days after the end of a quarter, this continues to be their due date.
- They continue to use their PAYG instalment rate or amount that applied before the group formed.
- If a member was an annual payer prior to the group forming, it remains so for the formation period.

Note

Instalment income

During the formation period, member entities continue to calculate their instalment income as though they were not members of a consolidated group.

For example, they continue to include income derived from transactions between members of the consolidated group, even though such income is not assessable to the member entity or the head company. This is because the entity's instalment rate, which was worked out from an assessment for an income year when the entity was not a member of a consolidated group, takes into account intragroup transactions in that income year.

Varying

Entities retain their existing right to vary their instalments. However, this could have consequences for the head company of the group, and both the head company and subsidiary member should carefully consider the basis on which any variation is made.

Under the single entity principle, only the head company will have an income tax liability for the formation period (and thereafter).

If any member varies an instalment, the instalments of all members will be considered on a group basis. The head company of the group may be subject to the general interest charge in relation to the instalments payable by the group's members for a particular instalment quarter if the group's instalments for that quarter are less than 85% of one-quarter of the head company's benchmark tax. (Generally, the head company's benchmark tax is its assessed tax reduced by any tax attributable to any net capital gains that are included in its assessable income.)

This means that if any entity varies an instalment, the 'protection' of using the ATO instalment rate or amount is effectively removed for the head company of the group.

Liability

Unpaid instalments

Any unpaid PAYG instalments of group members remain the liability of those members. This applies to instalment liabilities incurred prior to joining the group and during the formation period. It applies even if a member leaves the group.

Credits for PAYG instalments

The head company is entitled to a credit for PAYG instalments payable by a subsidiary member of a group after the joining time of that member. The amount of the credit takes account of the period in which a subsidiary member is actually a member of the group and the extent to which the instalment period falls within the head company's income year.

The head company and subsidiary members need to apportion credits for PAYG instalments on a reasonable basis and claim these credits in their relevant income tax returns.

Members joining or leaving group

Joining member

If a new member with an existing PAYG instalment obligation joins the group during the formation period, it is treated the same as the other subsidiary members – that is, it continues to pay PAYG instalments as if it were not consolidated.

If the new member has just left a 'mature' group – that is, one in which the head company pays PAYG instalments on a consolidated basis – the member will be issued with a PAYG instalment rate and will be required to pay instalments during the formation period of the new group.

Leaving member

If a member leaves the group during its formation period and does not immediately join another group, the leaving member's existing PAYG instalments obligation and activity statements continue without interruption.

If the leaving member joins another group during that group's formation period, the member's instalment obligations continue until the date of effect of the new group's consolidated instalment rate.

If the leaving member joins a 'mature' group, its PAYG instalments obligation generally ceases from the date of joining the new group. However, if the joining time is part-way through the member's quarter it must pay an instalment for that quarter.

→ 'Subsidiary members' final instalments', p. 4

Ongoing arrangements

A head company pays PAYG instalments on a consolidated basis from the date of effect of its consolidated instalment rate – that is, the beginning of the instalment quarter in which the ATO first issues its consolidated instalment rate. The head company receives a separate activity statement to pay these instalments.

Subsidiary members' final instalments

The PAYG instalment obligations of subsidiary members generally cease from the date of effect of the consolidated instalment rate.

If a subsidiary member is joining a mature group, which already has a consolidated instalment rate, any existing PAYG instalment obligations of the member generally cease from the date of joining.

However, if the date of effect or joining time is part-way through a subsidiary member's instalment quarter, the member must pay an instalment for that quarter:

- If the member uses the *instalment rate × instalment income* method, it calculates instalment income from the beginning of its quarter up to the date of effect or joining time.
- If the member pays an instalment amount worked out by the ATO, the whole amount remains payable but can be varied. Note, however, that varying an instalment amount in the formation period could have consequences for the head company of the group.

  → 'Varying', p. 2

If the subsidiary member pays PAYG instalments annually and the date of effect or joining time is part-way through its income year, it is not required to pay an annual instalment for that year. The subsidiary member's income tax liability for the part of the year that it was not a member of a consolidated group is recovered through its income tax assessment.

Reporting and payment

After the head company lodges its first consolidated income tax return, the ATO writes to the head company to advise it of its consolidated PAYG instalment rate, instalment amount (if eligible), due dates for lodgment and other PAYG instalment details for the group.

When instalments are due, the ATO sends the head company a *Consolidated activity statement*, which it completes and returns with its payment. → 'Completing the Consolidated activity statement', C8-1-110

Note

Activity statements for other tax obligations

The *Consolidated activity statement* is separate to the usual activity statement for other tax obligations, such as GST, FBT and PAYG withholding. All members of the group (including the head company) continue to receive an activity statement for any such obligations according to their usual cycle.

Due dates

The head company must lodge its *Consolidated activity statements* quarterly, within 21 days of the end of the quarter. So if the head company balances its accounts on 30 June, its consolidated instalments are due on 21 October, 21 January, 21 April and 21 July.

This is the case even if the head company is entitled to lodge its activity statements for other tax obligations (such as GST and PAYG withholding) up to 28 days after the end of the quarter.

If the head company was previously an annual PAYG instalments payer, it becomes a quarterly payer once it is given a consolidated instalment rate.

Contact and account details

When sending out the *Consolidated activity statement*, the ATO uses some information copied from the head company's existing activity statement account. The following information is re-used for the *Consolidated activity statement*:

- postal address to send the *Consolidated activity statement*
- business address
- electronic dealing information (email address and whether the head company wishes to deal electronically with the ATO)
- bank account details for any refunds resulting from the group's *Consolidated activity statement* – BSB, bank account number, bank account name
- tax agent registration number – this should be the registration number of the tax agent who represents the tax affairs of the group in dealings with the ATO.

If the head company wishes to change any of these details for its *Consolidated activity statement* it should contact the ATO:

- phone **13 28 66**
- email **ConsolidationsUnit@ato.gov.au**
- fax **1300 130 906**

Changes to bank account details must either be emailed or faxed by the group's authorised contact officer.

Options for working out PAYG instalments

The first *Consolidated activity statement* of an income year shows the payment option or options available to the head company. The head company can use only one option in an income year:

- In most cases the head company pays consolidated group PAYG instalments it calculates itself, using the *instalment rate × instalment income* method.

- Some head companies have the option of paying instalment amounts calculated by the ATO.

If the head company's circumstances change, it can vary the instalment rate or amount. → 'Varying', p. 8

PAYG instalment rate, income and amount

Consolidated instalment rate

The consolidated instalment rate is shown on the letter from the ATO and the *Consolidated activity statement*.

The instalment rate is calculated on the same basis as for an unconsolidated company, with one exception: when the adjusted taxable income of the head company is calculated, instead of automatically taking account of the amount of any carry-forward tax loss, the lesser of the following amounts is taken into account:

- the amount of any carry-forward tax loss, and
- the amount of any tax loss deducted in the base year.

Instalment income

Consolidated group instalment income is essentially the business and investment income of the group's members for the quarter just gone, excluding transactions between members of the consolidated group.

It includes only ordinary income that would be assessable to the head company of the group if all the members were part of that head company. Transactions between members of the consolidated group are ignored for income tax purposes because they amount to accounting entries between parts of the same company and as such are not income and not assessable to the head company.

Note

Reporting instalment income

For the head company to pay the group's quarterly PAYG instalments on time, it is important that subsidiary members of the group are prepared to report their contribution to the head company's instalment income shortly after the end of the head company's quarter.

If a subsidiary member has a different quarterly cycle to that of the head company, it may need to adjust its systems to be able to provide quarterly instalment income information according to the head company's quarterly cycle.

Instalment amount

If the head company's base assessment instalment income is $1 million or less, the head company has the option of paying an instalment amount that is calculated by the ATO based on the head company's GDP-adjusted notional tax:

- Generally, the head company's base assessment instalment income is the gross business and investment income shown in its latest income tax return.
- GDP-adjusted notional tax is the tax on the group's business and investment income shown in its latest income tax return, adjusted for likely growth in this income (based on growth in Australia's gross domestic product – GDP).

The option of paying an instalment amount, where it is used, must be used throughout a taxpayer's income year. Therefore, eligible head companies will have this option on their first *Consolidated activity statement* only if:

- the date of effect of the consolidated instalment rate is the beginning of the head company's income year, or
- the head company was already paying instalments using this option, or
- the head company previously paid annual PAYG instalments (these companies will effectively receive a 'new' first quarter for the purposes of PAYG instalments).

If a head company is eligible to use this option in a subsequent year it will be available on the first activity statement of that year.

Commissioner's power to calculate a higher or lower instalment rate or instalment amount

Each year the ATO calculates a head company's instalment rate and/or GDP-adjusted notional tax amount, based on the head company's most recent assessment for its most recent income year.

However, major changes to the composition of a mature consolidated group could significantly affect the head company's expected tax liability for the year. The head company's most recent assessment may then not be an appropriate basis from which to work out the head company's instalment rate or GDP-adjusted notional tax amount. This situation could arise, for example, as a result of a major restructuring of a company group that involves a demerger of the group.

In these situations the Commissioner of Taxation may initiate the calculation of a higher or lower instalment rate or GDP-adjusted notional tax amount that in his opinion is more reasonable. The Commissioner is able to exercise this power if:

- there has been a material change in the membership of a mature consolidated group because one or more entities become, or cease to be, subsidiary members of the group, and
- having regard to the statutory object of the PAYG instalment regime, the Commissioner is of the opinion that it would be reasonable to work out a higher or lower instalment rate or GDP-adjusted notional tax amount.

The Commissioner can exercise this power at any time during an income year, even after a head company has varied its instalment rate or estimated its benchmark tax for a period.

If the Commissioner uses his power to alter either the group's instalment rate or GDP-adjusted notional tax amount, the head company can still vary its rate or amount (subject to penalty if the variation is incorrect).

It is anticipated that the Commissioner would exercise this power only when membership changes materially alter a head company's anticipated tax liability. In many situations, the entry of a new subsidiary member or the exit of an existing subsidiary member will not have a material effect, and the membership changes can be appropriately addressed by applying the group's existing instalment rate to its increased or decreased instalment income.

Varying

A head company is able to vary its consolidated instalment based on its estimate of the expected consolidation outcomes for the year – for example, where it believes a membership change will alter its tax liability. It is liable for a penalty if:

- it uses the *instalment rate × instalment income* method and the varied instalment rate is less than 85% of the head company's benchmark instalment rate for that income year, or
- it uses the GDP-adjusted instalment amount method and the varied amount is based on an estimate that is less than 85% of the head company's benchmark tax.

Members joining or leaving group

A head company must notify the ATO of the entry or exit of a subsidiary member within 28 days, using the approved form.

Joining member

The PAYG instalment obligations of joining members generally cease from the date of joining a mature group. However, if the joining time is part-way through the member's quarter it must pay an instalment for that quarter.

→ 'Subsidiary members' final instalments', p. 4

Leaving member

Head company obligations

If the head company calculates PAYG instalments using the *instalment rate × instalment income* method, its responsibility for the instalment income of the leaving member ceases on the date the member leaves the group.

If the head company pays PAYG instalment amounts calculated by the ATO, the amounts remain payable but can be varied (subject to penalty if the variation is incorrect).

Where a leaving member immediately joins another mature group, the new head company takes up PAYG instalment obligations for the instalment income of its new member from the date the new member joins. If this happens part-way through a quarter, the subsidiary member's former and new head companies need to agree on an allocation of the subsidiary's instalment income on a reasonable basis.

Leaving member obligations

Where a leaving member does not immediately join another mature group, the leaving member begins paying its own PAYG instalments. This occurs whether or not the member had a PAYG instalments obligation prior to joining the consolidated group.

The ATO writes to the leaving member to advise it of its PAYG instalment rate and other details. The entity:

- must use the *instalment rate × instalment income* method of calculating PAYG instalments
- is given the instalment rate of its former head company
- must pay quarterly.

If the exiting member has a different accounting period to that of its former head company, it reverts to its own accounting period for PAYG instalments.

The entity is given a new instalment rate after its first post-consolidation income tax assessment. In its next income year after this assessment the entity may be eligible to pay PAYG instalment amounts worked out by the ATO, which will advise the entity if it is eligible to pay this way.

If the entity's former head company gets a new instalment rate from the ATO during the quarter in which the entity leaves but after it has left, the ATO will also update the leaving entity's instalment rate in line with the former head company's instalment rate.

An entity's first PAYG instalment after leaving a group is based on instalment income from the date of leaving to the end of the quarter. The entity's instalment income during the quarter should be allocated on a reasonable basis between the head company and the entity to account for periods inside and outside the group.

Deregistered companies

Where an entity no longer forms part of a consolidated group it is normally required to separately lodge income tax returns, activity statements and pay its income tax and activity statement obligations. As a deregistered company is not an entity under the tax law, this requirement generally applies only in the following circumstances:

- when the date of deregistration occurs after the date of exit from a consolidated group
- when a deregistered company joins and leaves a consolidated group in the same income year.

In either case, the liquidator has an obligation to ensure that all relevant activity statements and income tax returns are lodged and that any amount owing to the ATO is paid before the company is deregistered.

If a subsidiary member needs to check if they have any lodgment or payment obligations they should contact the ATO:

- phone **13 28 66**
- email **ConsolidationsUnit@ato.gov.au**
- fax **1300 130 906**

Requests to leave the PAYG instalment system should be made in writing, quoting the reference 'B6110', to:

Australian Taxation Office
PO BOX 1129
PENRITH NSW 2751

Note

Instalment income

In a consolidated group, transactions between members of the group are ignored for income tax purposes. However, after an entity leaves a group, any income it receives from transactions with that group's members is included in its instalment income.

PAYG instalment rate for interposed head companies

When a company becomes an interposed head company of a consolidated group (ie, where it chooses under section 124-380 of the *Income Tax Assessment Act 1997* (ITAA 1997) that the consolidated group is to continue in existence after the completion time), it inherits the PAYG instalment rate that applied to the former head company.

In this situation:

- the interposed head company assumes the responsibility for lodgment and payment of the group's PAYG instalment liability, and
- the former head company's PAYG instalment rate applies to the interposed head company, unless and until this rate is later varied.

Note

This application of the 'history rule' in section 45-740 in Schedule 1 of the *Taxation Administration Act 1953* (TAA 1953) applies only to a 'mature' group. The rule does not apply where the group is in the formation period.

PAYG instalment rate for new provisional head company

When a company becomes the new provisional head company (PHC) of a multiple entry consolidated (MEC) group, it inherits the PAYG instalment rate that applied to the former PHC.

That is, if a new PHC is appointed to a MEC group under subsection 719-60(3) of the ITAA 1997:

- the new PHC assumes responsibility for lodgment and payment of the group's PAYG instalment liability, and
- the former PHC's PAYG instalment rate applies to the new PHC, unless and until this rate is later varied.

Note

This application of the 'history rule' in section 45-920 in Schedule 1 of the TAA 1953 applies only to a 'mature' group. The rule does not apply where the group is in the formation period.

References

Taxation Administration Act 1953, Division 45 of Schedule 1 – as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 4
- *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 24

Income Tax Assessment Act 1997, section 124-380, subsection 719-60(3)

Explanatory Memorandums to the:

- New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 12
- New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 8

Revision history

Section C8-1 first published 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
15.4.10	New sections on deregistered companies, interposed head companies and provisional head companies.	For clarification.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Completing the *Consolidated activity statement*

A head company pays PAYG instalments on a consolidated basis from the date of effect of its consolidated instalment rate – that is, the beginning of the instalment quarter in which the Tax Office first issues the rate. The head company receives a separate activity statement, known as a *Consolidated activity statement*, to pay these instalments.

This section provides instructions for completing the *Consolidated activity statement*.

Note

More information

For general information about the treatment of PAYG instalments during the formation period and the ongoing arrangements for mature groups → 'Treatment of PAYG instalments', C8-1.

Options for reporting and paying PAYG instalments

The *Consolidated activity statement* for the first quarter of an income year shows the payment option or options available to the head company.

The head company can use only one option in an income year. Therefore, if the first *Consolidated activity statement* is for a quarter other than the first quarter of the head company's income year, only one option will be available – the option that was used by the head company in previous quarters of that income year. In this event there will be a pre-printed 'X' in the box next to that option. Boxes you can't use will be clearly marked 'do not complete this option'.

If the head company is eligible for an additional option, this will be available in the first activity statement of the next income year.

The options for reporting and paying PAYG instalments on a consolidated basis are broadly the same as those available to companies generally:

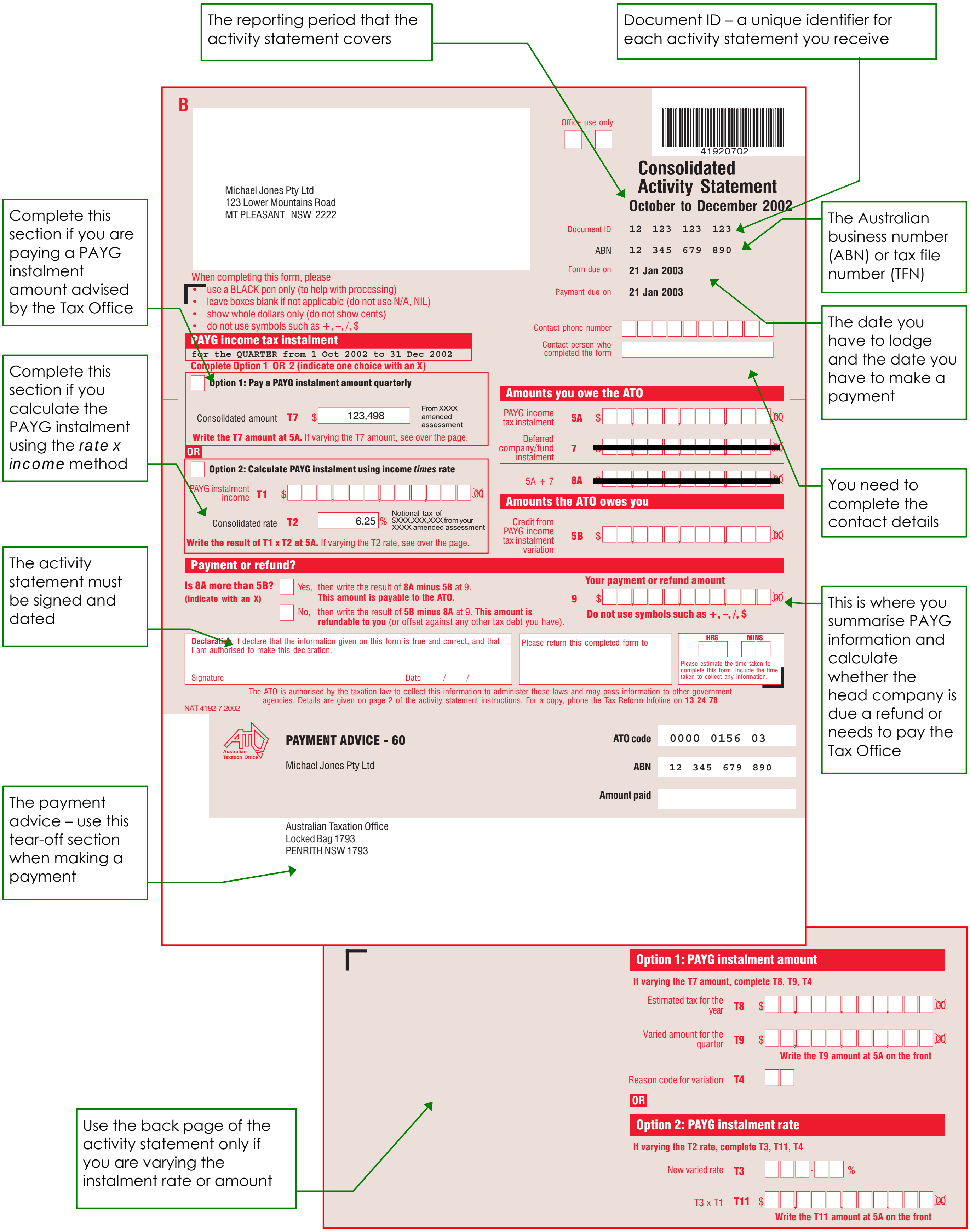
- Option 1: Pay a PAYG instalment amount advised by the Tax Office, or
- Option 2: Calculate your PAYG instalment amount using the *instalment rate x instalment income* method.

Table 1: Eligibility for reporting and payment options

Option 1	Option 2
Pay a PAYG instalment amount worked out by the Tax Office	Pay a PAYG instalment calculated using the *instalment rate x instalment income method*
Available to: Consolidated groups where the instalment income of the head company is $1 million or less*	*Available to:* All consolidated groups*

* May not be available on first *Consolidated activity statement* if it is for a quarter other than the first quarter of the income year.

Figure 1: A guide to the quarterly *Consolidated activity statement*



Option 1 – pay amount advised by Tax Office

☐ **Option 1: Pay a PAYG instalment amount quarterly**			
Consolidated amount	**T7**	$ 123,498	From XXXX amended assessment
Write the T7 amount at 5A. If varying the T7 amount, see over the page.			

The *Consolidated activity statement* will show a PAYG instalment amount at **T7** if the head company is eligible to use this option.

To use this option and pay a PAYG instalment amount advised by the Tax Office, write an 'X' in the box.

If the head company elects to pay using option 1 it is required to continue using this option for the rest of the income year. Subsequent activity statements for the income year will have a pre-printed 'X' in the box.

If this option has already been used by the head company during the income year, there will be a pre-printed 'X' in the box.

If this option is unavailable to the head company – either because it is ineligible or because it has used option 2 in a previous quarter of the income year – it will be marked 'do not complete this option'.

T7
Tax Office instalment amount

The PAYG instalment amount shown at **T7** is generally an amount calculated by the Tax Office. If the head company varied its instalment amount in a previous quarter of the income year, the varied amount is shown.

To pay the amount shown at **T7,** transfer it to **5A**.

Example

The September quarter *Consolidated activity statement* offers a choice of options. The head company, HCo, decides to use option 1 and pay the instalment amount advised by the Tax Office.

HCo writes an X in the option 1 box to indicate its choice. An instalment amount of $5,300 is pre-printed on its activity statement at **T7**. HCo does not want to vary this amount. It transfers the figure of 5,300 to **5A** in the summary section.

X **Option 1: Pay a PAYG instalment amount quarterly**			
Consolidated amount	**T7**	$ 5,300	From XXXX amended assessment
Write the T7 amount at 5A. If varying the T7 amount, see over the page.			

Vary the instalment amount

Option 1: PAYG instalment amount

If varying the T7 amount, complete T8, T9, T4

Estimated tax for the year **T8** $, , , .00

Varied amount for the quarter **T9** $, , , .00

Write the T9 amount at 5A on the front

Reason code for variation **T4**

The head company can vary its instalments if it considers that using the amount shown at T7 would result in it paying more (or less) than its expected tax for the income year.

To vary the PAYG instalment amount, complete the 'Option 1' section on the back of the *Consolidated activity statement*. The head company needs to provide details of its:

- estimated tax for the year, at T8
- varied amount for the quarter, at T9, and
- reason for varying, at T4.

T8
Estimated tax for the year

Estimated tax for the year **T8** $, , , .00

To vary the head company's PAYG instalment amount, first estimate the expected tax on the group's business and investment income for the year. Write this figure at **T8**. The Tax Office uses this figure to calculate the instalment amounts for the remaining quarters of the income year.

The head company may be liable to pay the general interest charge if it varies down and underestimates the tax on the group's business and investment income by more than 15%.

T9
Varied amount for the quarter

Varied amount for the quarter **T9** $, , , .00

Write the T9 amount at 5A on the front

The varied amount for the quarter depends on which quarter is being considered and the amounts paid in previous quarters. Table 2 sets out the calculations for completing **T9** for the relevant period, assuming the head company pays consolidated PAYG instalments from the first quarter of the income year.

If the result of the calculation is a positive amount, write it at **T9**. If it's a negative amount or zero, write '0' at **T9**. (If it's a negative amount, you may wish to claim a credit at **5B**.)

Table 2: Varied amount calculation (if head company pays consolidated PAYG instalments from first quarter of income year)

If the instalment quarter is:	The varied instalment amount is:
The first in the income year for which the head company is liable to pay an instalment	• 25% of the head company's estimated tax for the income year.
The head company's second for that income year	• 50% of the head company's estimated tax for the income year • minus the amount of the head company's first quarter instalment.
The head company's third for that income year	• 75% of the head company's estimated tax for the income year • minus the amount of the head company's first and second quarter instalments • plus any credit the head company claimed for the second instalment.
The head company's fourth for that income year	• 100% of the head company's estimated tax for the income year • minus the amount of the head company's first, second and third quarter instalments • plus any credit the head company claimed for the second and third instalments.

Varying in the first year of consolidated PAYG instalments

The information in table 2 assumes that the head company is paying consolidated PAYG instalments from the first quarter of its income year. This will always be the case in the second and subsequent years of the head company's obligation to pay consolidated PAYG instalments.

However, in the first year, the head company's obligation to pay consolidated PAYG instalments may begin in a quarter other than the first quarter of its income year.

If so, the calculation of a varied amount for any consolidated instalment during that income year will need to take into account the PAYG instalment liabilities and credits of group members prior to the date that the head company began paying consolidated PAYG instalments, as shown in table 3.

Table 3: Varied amount calculation if head company begins paying consolidated PAYG instalments from a quarter other than first quarter of income year

If the instalment quarter is:	The varied instalment amount is:
The second in the income year for which the head company is liable to pay an instalment (including earlier instalment obligations of the company that is now the head company)*	• 50% of the group's estimated tax for the income year** • minus the total of the first quarter instalments of all group members
The head company's third for that income year (including earlier instalment obligations of the company that is now the head company)*	• 75% of the group's estimated tax for the income year** • minus the total of first and second quarter instalments of all group members, including any consolidated instalments of the head company • plus the total (if any) of credits the group members and head company claimed for the second instalment.
The head company's fourth for that income year (including earlier instalment obligations of the company that is now the head company)*	• 100% of the group's estimated tax for the income year** • minus the total of the first, second and third quarter instalments of all group members, including any consolidated instalments of the head company • plus the total (if any) of credits the group members and head company claimed for the second and third instalments.

* That is, include quarters in which the company that is now the head company paid its own PAYG instalments ***and*** quarters in which the head company paid consolidated PAYG instalments. For example, if the head company begins paying consolidated PAYG instalments in the second quarter, but paid its own, non-consolidated PAYG instalment in the first quarter, the calculation of the varied amount should be done on the basis that the quarter being considered is the second quarter.

** Including the estimated tax liability of subsidiary members.

T4
Reason code for variation

Reason code for variation **T4** [ ][ ]

Choose a reason from table 4 that best describes why the head company is varying its instalment amount, and write the appropriate code at **T4**.

If the head company is varying because a subsidiary member has joined or left the group, use reason code 33.

Table 4: Reason codes for varying

Code	Reason	Reason description
21	Change in investments	Your group's or a subsidiary member's investment strategy or policy has changed and this will significantly affect the group's annual tax liability. For example, the sale or purchase of investments such as shares or property.
22	Current business structure not continuing	Members of your group have stopped trading or have changed their structure. For example, a member has been permanently closed, it has stopped trading because of a merger or takeover, or it has gone into bankruptcy or liquidation, or been placed in the hands of a receiver or manager.
23	Significant change in trading conditions	Abnormal transactions relating to your group's income or expenses will significantly affect the group's annual tax liability. For example, a member bought or sold a major piece of machinery or your trading conditions have been affected by local or global competition.
24	Internal business restructure	Your group has restructured – for example, a member has opened or closed branches, or dropped a major product line – and this will significantly affect your annual tax liability.
25	Change in legislation or product mix	A change in legislation, or in the product mix of your group, will significantly change your group's annual tax liability.
26	Financial market changes	Your group contains members who have been affected by domestic or foreign market changes. This reason code is for groups with members involved in financial market trading, including those whose income is affected by changes in financial products, for example, banks, finance and insurance businesses.
27	Use of income tax losses	Your group will be using income tax losses including capital losses that will significantly affect your annual tax liability.
33	Variation due to entering or exiting a consolidated group	A subsidiary member with substantial annual taxable income has either joined or left the group. (This code should be used only by head companies.)

Calculate amounts owed

5A

PAYG income tax instalment

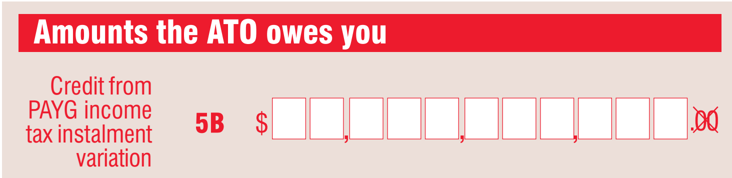

Amounts you owe the ATO

PAYG income tax instalment 5A $ .00

Transfer the amount at **T7** (or **T9** if the head company is varying) to **5A** on the activity statement.

You can choose to write '0' at **5A** instead of the instalment amount if the instalment for the period covered by the activity statement is $50 or less.

5B
Credit from PAYG income tax instalment variation



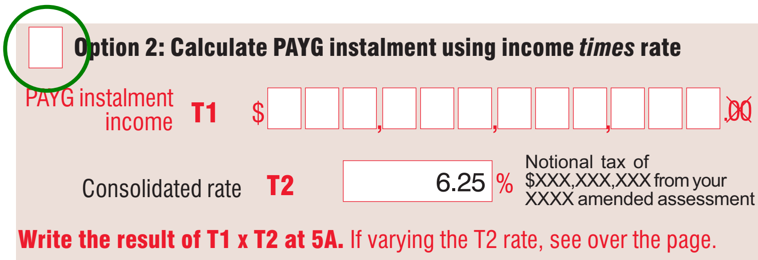
The head company may be entitled to a credit from earlier instalments for the same income year if it varies the instalment amount and the amount of the instalment worked out at **T9** is negative.

If the instalment being varied is the first for the income year, the head company can't claim a credit.

Even if the head company is entitled to a credit, it doesn't have to claim it in the activity statement. Any overpayment of PAYG instalments will be credited to the head company when its annual income tax return is assessed.

To claim a credit, write any negative amount worked out at **T9** as a positive amount (don't show the minus sign) at **5B**.

Option 2 – calculate instalment using *rate x income*



The *Consolidated activity statement* for the first quarter of an income year will show a PAYG instalment rate at **T2**.

To use this option and calculate a PAYG instalment amount using the *instalment rate x instalment income* method, write an 'X' in the box.

If the head company pays using option 2 it is required to continue using this option for the rest of the income year. Subsequent activity statements for the income year will have a pre-printed 'X' in the box.

If this option has already been used by the head company during the income year, there will be a pre-printed 'X' in the box.

If option 1 has already been used by the head company during the income year, option 2 will be marked 'do not complete this option'.

T1
PAYG instalment income

PAYG instalment income **T1** $ [ ][ ][ ],[ ][ ][ ],[ ][ ][ ],[ ][ ][ ] .00

Work out the group's instalment income for the quarter and write this at **T1**. If the group doesn't have any instalment income for the period, write '0'. Do not leave this box blank.

Consolidated group instalment income is essentially the business and investment income of the group's members for the quarter, excluding transactions between members of the consolidated group.

It includes only ordinary income that would be assessable to the head company of the group if all the members were part of that head company. Transactions between members of the consolidated group are ignored for tax purposes because they amount to accounting entries between parts of the same company and as such are not income and not assessable to the head company.

Note

Reporting instalment income

For the head company to pay the group's quarterly PAYG instalments on time, it's important that subsidiary members of the group are prepared to report their contribution to the head company's instalment income shortly after the end of the head company's quarter.

If a subsidiary member has a different quarterly cycle to the head company, it may need to adjust its systems to be able to provide quarterly instalment income information according to the head company's quarterly cycle.

T2
Instalment rate

Consolidated rate **T2** [6.25] % Notional tax of $XXXX,XXX,XXX from your XXXX amended assessment

The rate pre-printed at **T2** will be either:

- the instalment rate worked out by the Tax Office, or
- the most recent varied rate if the head company varied the instalment rate in a previous quarter in the same income year.

To use the rate pre-printed at **T2**, multiply it by the amount shown at **T1** and write the result at **5A**.

The head company can vary its instalment rate if it considers that using the rate provided would result in it paying more (or less) than its expected tax for the income year. To vary the instalment rate, complete **T3**, **T4** and **T11**.

Vary the instalment rate

Option 2: PAYG instalment rate

If varying the T2 rate, complete T3, T11, T4

New varied rate **T3** ☐☐☐.☐☐ %

T3 x T1 **T11** $☐☐,☐☐☐,☐☐☐,☐☐☐ .00

Write the T11 amount at 5A on the front

Reason code for variation **T4** ☐☐

To vary the PAYG instalment rate, complete the 'Option 2' section on the back of the *Consolidated activity statement*.

The head company needs to provide details of its:

- new varied rate, at T3
- reason for varying, at T4, and
- varied amount calculation, at T11.

T3
New varied rate

New varied rate **T3** ☐☐☐.☐☐ %

Write the new varied instalment rate at **T3**.

The head company may be liable to pay a general interest charge if it varies down and underestimates the tax on its business and investment income by more than 15%.

T4
Reason code for variation

Reason code for variation **T4** ☐☐

Choose a reason from table 4 that best describes why the head company is varying its instalment amount, and write the appropriate code at **T4**.

If the head company is varying because a subsidiary member has joined or left the group, use reason code 33.

T11
(T1 x T3)

T3 x T1 **T11** $☐☐,☐☐☐,☐☐☐,☐☐☐ .00

Write the T11 amount at 5A on the front

Multiply the amount at **T1** by the new varied instalment rate that you wrote at **T3**. Write the result at **T11** and transfer this amount to **5A**.

Calculate amounts owed

5A
PAYG income tax instalment

Amounts you owe the ATO

PAYG income tax instalment **5A** $, , , .00

If the head company is using the rate pre-printed at **T2**, multiply this rate by the amount shown at **T1** and write the result at **5A**.

If the head company is varying the instalment rate, transfer the amount you wrote at **T11** to **5A**.

You can choose to write '0' at **5A** instead of the instalment amount if the instalment for the period covered by the activity statement is $50 or less, and the head company is not claiming a credit at **5B.**

5B
Credit from PAYG income tax instalment variation

Amounts the ATO owes you

Credit from PAYG income tax instalment variation **5B** $, , , .00

The head company may be entitled to a credit from earlier instalments for the same income year if it varies its instalment rate and the new varied rate at **T3** is less than the instalment rate pre-printed at **T2**.

A credit will be available only if earlier instalments were worked out using a higher instalment rate. If the instalment being varied is the first for the income year, the head company can't claim a credit.

Even if the head company is entitled to a credit, it doesn't have to claim it in the activity statement. Any overpayment of PAYG instalments will be credited to the head company when its annual income tax return is assessed.

You can use the steps below to calculate the amount of credit that can be claimed in the activity statement:

1. Add up the instalment amounts recorded at **5A** on the head company's previous activity statements for the income year.
2. Add up any credits the head company has claimed for the income year. These are the amounts recorded at **5B** on the head company's previous activity statements for the income year.
3. Subtract the amount at step 2 from the amount at step 1.
4. Add up the head company's instalment income for all earlier quarters in the income year. These are the amounts recorded at **T1** on the head company's previous activity statements for the income year.

5 Multiply the amount at step 4 by the new varied instalment rate you wrote at **T3** in the current activity statement.

6 Subtract the amount at step 5 from the amount at step 3.

If the result is a positive amount, this is the amount of the credit the head company can claim. If the head company wishes to claim the credit in its activity statement, write this amount at **5B**.

Example

The July–September quarter *Consolidated activity statement* offers a choice of options. The head company, HCo, decides to use option 2 and calculate its PAYG instalment for each quarter in the income year.

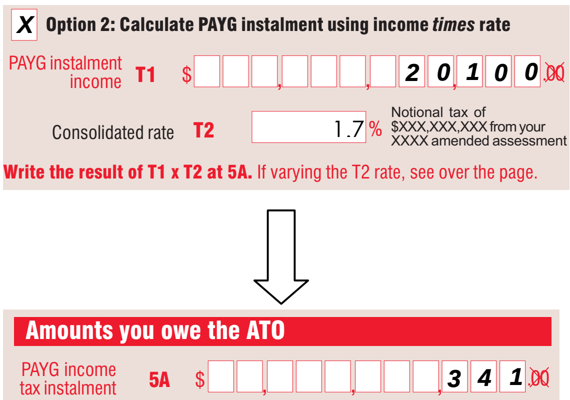
HCo writes an X in the option 2 box to indicate its choice. HCo's income for the quarter is:

- total sales of $22,000 (including $2,000 GST)
- interest and dividends received of $100.

The Tax Office calculated instalment rate pre-printed on the activity statement is 1.7%.

HCo's instalment income is $20,100 ($22,000 less $2,000 GST plus $100 other income). It calculates the instalment amount to pay as follows:

- $20,100 x 1.7% = $341.70
- Write the figure 20,100 at T1.
- Write the figure 341 at 5A.


X **Option 2: Calculate PAYG instalment using income *times* rate**

PAYG instalment income **T1** $ 20,100 .00

Consolidated rate **T2** 1.7 %

Notional tax of $XXX,XXX,XXX from your XXXX amended assessment

Write the result of T1 x T2 at 5A. If varying the T2 rate, see over the page.

Amounts you owe the ATO

PAYG income tax instalment **5A** $ 341 .00

Lodging and paying

The due date for lodging and paying is pre-printed near the top right-hand corner of the activity statement. The activity statement can be lodged and paid in person, by mail or electronically, but should be done on time to avoid interest and penalties. Even if there are no amounts to report for the period, or there is a difficulty paying, it is important to make sure the activity statement is received by the due date.

How to lodge and pay

By mail

Mail the original, completed activity statement with cheque using the pre-addressed envelope provided to one of the following addresses:

From WA, SA, NT, TAS and VIC
Australian Taxation Office
Locked Bag 1936
Albury NSW 1936

or

From NSW, ACT and QLD
Australian Taxation Office
Locked Bag 1793
Penrith NSW 1793

Cheques should be made payable to the 'Deputy Commissioner of Taxation' and crossed 'Not Negotiable'. Don't attach the cheque with pins or staples.

It's important to send the original activity statement, not a copy or a version generated from a commercial software package. Information generated by a commercial software package must be transferred to the original statement.

In person

Payment can be made at Australia Post outlets using the original payment advice form. Payments can be made with cash (a $3,000 limit applies), money order or cheque. EFTPOS is available at most Australia Post outlets for savings and cheque accounts only.

To order additional or replacement payment advice forms phone **13 72 26**.

Electronically

Activity statements can be lodged electronically using:

- the electronic commerce interface (ECI) over the internet, or
- the head company's registered tax agent.

To find out more about lodging activity statements electronically, visit **www.taxreform.ato.gov.au/esd/esd_main.htm** or phone the Tax Office on **1300 139 051**.

Payments can be made by:

- direct credit – initiate an electronic payment using internet banking or a banking software package
- BPAY (Biller code 75556) – use your financial institution's BPAY facility to pay by phone or internet (the EFT code on your activity statement is the BPAY reference number), or
- direct debit – the head company's tax agent can arrange to have payment electronically deducted from the head company's bank account.

The Tax Office does not accept credit card payments.

For more information about direct credit or BPAY:

- phone 1800 815 886
- email **payment@ato.gov.au**

For more information about direct debit:

- phone 1800 802 308
- email **eft-information@ato.gov.au**

Note

If you make a payment at Australia Post, or you pay by electronic means, you must still send your completed activity statement to the Tax Office either by mail or electronically.

Difficulty lodging and paying on time

Phone the Tax Office on **13 28 66** to check whether alternative arrangements can be made.

The activity statement should be lodged by the due date even if payment will not be made on time. A penalty may be applied if the activity statement is not lodged on time, and the general interest charge will be applied to any amount not paid by the due date.

Mistakes

Correct mistakes by striking out the error in black pen. Write the new information as close as possible to the boxes for the label. Tape whiteout can also be used to correct errors but liquid whiteout causes problems with scanning.

After lodging the activity statement

Generally a revised activity statement will need to be lodged to correct an error. Phone the Tax Office on **13 28 66** to obtain a revised activity statement.

Refunds

Generally refunds can only be paid directly into the nominated financial institution account, so it's essential that the Tax Office has the correct account and BSB numbers for the head company. The nominated account must be at a branch of the institution in Australia.

The Tax Office may not issue a refund where a previous activity statement hasn't been lodged or if incorrect bank details have been provided.

Contact the Tax Office on **13 28 66** to change financial institution account details.

Record keeping

Keep a copy of the activity statement and the records used to prepare it for five years after they are prepared, obtained or the transactions completed, whichever is the later, in writing and in English.

Note

More about record keeping

For detailed guidelines and a checklist of the records that a member of a consolidated group needs to keep → 'Record keeping guidelines and checklist', C9-2

Revision history

Section C8-1-110 first published 28 May 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

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Office use only

41920702

Consolidated Activity Statement
October to December 2002

Michael Jones Pty Ltd
123 Lower Mountains Road
MT PLEASANT NSW 2222

Document ID 12 123 123 123

ABN 12 345 679 890

Form due on 21 Jan 2003

Payment due on 21 Jan 2003

Contact phone number

Contact person who completed the form

When completing this form, please
- use a BLACK pen only (to help with processing)
- leave boxes blank if not applicable (do not use N/A, NIL)
- show whole dollars only (do not show cents)
- do not use symbols such as +, –, /, $

PAYG income tax instalment
for the QUARTER from 1 Oct 2002 to 31 Dec 2002

Complete Option 1 OR 2 (indicate one choice with an X)

Option 1: Pay a PAYG instalment amount quarterly

Consolidated amount **T7** $ 123,498 From XXXX amended assessment

Write the T7 amount at 5A. If varying the T7 amount, see over the page.

OR

Option 2: Calculate PAYG instalment using income *times* rate

PAYG instalment income **T1** $ .00

Consolidated rate **T2** 6.25 % Notional tax of $XXX,XXX,XXX from your XXXX amended assessment

Write the result of T1 x T2 at 5A. If varying the T2 rate, see over the page.

Amounts you owe the ATO

PAYG income tax instalment **5A** $ .00

Deferred company/fund instalment **7** $ .00

5A + 7 **8A** $ .00

Amounts the ATO owes you

Credit from PAYG income tax instalment variation **5B** $ .00

Payment or refund?

Is 8A more than 5B? (indicate with an X)

Yes, then write the result of **8A minus 5B** at 9. **This amount is payable to the ATO.**

No, then write the result of **5B minus 8A** at 9. **This amount is refundable to you** (or offset against any other tax debt you have).

Your payment or refund amount

9 $ .00

Do not use symbols such as +, –, /, $

Declaration I declare that the information given on this form is true and correct, and that I am authorised to make this declaration.

Signature Date / /

Please return this completed form to

HRS MINS

Please estimate the time taken to complete this form. Include the time taken to collect any information.

The ATO is authorised by the taxation law to collect this information to administer those laws and may pass information to other government agencies. Details are given on page 2 of the activity statement instructions. For a copy, phone the Tax Reform Infoline on **13 24 78**

NAT 4192-7.2002

Australian Taxation Office

PAYMENT ADVICE - 60

Michael Jones Pty Ltd

ATO code 0000 0156 03

ABN 12 345 679 890

Amount paid

Australian Taxation Office
Locked Bag 1793
PENRITH NSW 1793

Option 1: PAYG instalment amount

If varying the T7 amount, complete T8, T9, T4

Estimated tax for the year	**T8**	$, , , .00
Varied amount for the quarter	**T9**	$, , , .00
		Write the T9 amount at 5A on the front
Reason code for variation	**T4**	

OR

Option 2: PAYG instalment rate

If varying the T2 rate, complete T3, T11, T4

New varied rate	**T3**	. %
T3 x T1	**T11**	$, , , .00
		Write the T11 amount at 5A on the front
Reason code for variation	**T4**	

How to pay

EFT DIRECT CREDIT **Direct credit:** transfer funds directly to the ATO using computer based banking software.

DIRECT DEBIT **Direct debit:** have your payment deducted from your nominated bank account (excluding credit cards).

B PAY **BPAY:** contact your bank, credit union or building society to make this payment from your cheque or savings account. Quote biller code **75556** and your EFT code (shown on the other side of this payment advice form) as the customer reference number.

Mail payments: mail this payment advice form together with your cheque / money order using the envelope provided. Please do not use pins or staples. Do NOT send cash.

AUSTRALIA POST **Post Office:** payments can be made at any Post Office by cash or cheque. A $3,000 cash limit applies. Your payment advice form must be presented with your payment.

- Cheques or money orders should be made payable to the 'Deputy Commissioner of Taxation' and crossed 'Not Negotiable'.
- All cheques must be tendered in Australian currency.

Please note: payments cannot be made by credit card or in person at any ATO branch or ATO*access* site.

C9: Determine tax liabilities, manage obligations

Determine tax liabilities, manage obligations

About this section

Section C9 provides detailed information about determining annual tax liabilities and managing tax obligations in a consolidated group, including:

- guidelines and a checklist of the records that members of a consolidated group need to keep
- arrangements for the income tax return for consolidated groups
- arrangements for group members with a substituted accounting period (SAP)
- detailed worked examples showing the processes and calculations involved in working out certain aspects of tax liabilities in a consolidated group.

For general information about these aspects of consolidation see:

→ 'Determining annual liability', B3-3
→ 'Managing obligations', B3-4

Section contents

Single entity treatment

When a consolidated group is formed, the group is treated as a single entity for income tax purposes.[177] Broadly, this means that on joining a consolidated group the subsidiary members lose their individual income tax identities and are treated as parts of the head company of the consolidated group (rather than as separate entities) for the purposes of determining the head company's income tax liability.

In effect, the consolidated group is treated as if it were a single divisional company. Intragroup assets and liabilities and intragroup transactions have no income tax consequences. The head company is the only entity the income tax law recognises for the purposes of working out the group's income tax liability or losses.

→ Taxation Ruling TR 2004/11

Some of the consequences of the single entity rule for the income tax treatment of consolidated groups are:

- the head company lodges a consolidated income tax return – subsidiary members no longer lodge returns
- the assets and liabilities of subsidiary members are treated as if they were assets and liabilities of the head company
- the actions of subsidiary members in respect of entities outside the group (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
- where an intragroup asset[178] is sold to an entity outside the group, it is treated in accordance with its economic substance from the point of view of the group as a whole, and
- generally, the income tax law will apply to the head company of the consolidated group (of which subsidiary members are treated as parts) in the same way as to any single company.

The Tax Office has issued the following taxation determinations on various aspects of the single entity rule: TD 2004/43, TD 2004/44, TD 2004/49, TD 2004/51, TD 2004/69.

The following taxation determinations deal with circumstances where the single entity rule does not apply or is not relevant: TD 2004/42, TD 2004/50, TD 2004/68, TD 2004/79.

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[177] Section 701-1 ITAA 1997.

[178] That is, an asset where the rights and obligations are between members of a consolidated group, TR 2004/11, paragraph 8(c).

The following taxation determinations deal with circumstances where the single entity rule does not apply to defeat a clearly intended outcome under provisions outside the consolidation rules: TD 2004/48, TD 2004/81.

This section describes the consequences of single entity treatment for:

- trading stock
- interest paid by a head company for funds on-lent to a subsidiary, and
- the sale of an intragroup asset to a non-member.

Trading stock

In a consolidated group, assets that were previously held by individual members as trading stock may change character in the hands of the head company. This is because the assets of all members of a consolidated group become the assets of the head company and the purpose for which they are held is determined by reference to the economic substance for the group as a whole.

For example, depending on the purpose for which the asset is taken to be held by the head company, the asset could be treated for income tax purposes as a consumable (if the trading stock is held for sale only within the consolidated group), a CGT asset or a depreciating asset.

Deductibility of interest

Where a holding company borrows money to lend to a subsidiary, the basis of deductibility of interest paid by the holding company differs in consolidated and non-consolidated situations, although the result may be the same. In a consolidated group, intragroup transactions have no income tax consequences. The deductibility of interest paid to a non-member is determined by looking at the economic substance for the group as a whole of the purpose of the loan and the use to which it is put – that is, income tax law applies to the interest as if the head company was a single company undertaking the borrowing.

→ 'Single entity treatment – deductibility of interest', C9-5-220 (worked example); Taxation Determination TD 2004/36

Sale of intragroup asset to non-member

A transaction between group members may give rise to an 'intragroup asset', such as an option, interest stream or debt. When an intragroup asset is sold or assigned to an entity outside the consolidated group, there are no income tax consequences from the transaction that gave rise to the intragroup asset but the transaction with the outside party is recognised for the purposes of working out the head company's income tax.

The transaction with the outside party is treated according to its economic substance for the group as a whole, without regard to internal transactions. The asset may therefore be treated (for the purposes of working out the head company's income tax) as something different from its legal form.

→ 'Single entity treatment – sale of intragroup asset to non-member', C9-5-230

The Tax Office has issued Taxation Ruling TR 2004/11 and the following taxation determinations related to this topic: TD 2004/33, TD 2004/34, TD 2004/35, TD 2004/39, TD 2004/45, TD 2004/46, TD 2004/82, TD 2004/83, TD 2004/84, TD 2004/85.

Note

Sale of membership interests

Special rules apply where membership interests in a subsidiary member are sold to a non-member by the head company.

The Tax Office has issued the following taxation determinations related to this issue: TD 2004/37, TD 2004/40, TD 2004/41, TD 2004/47.

Is the head company 'in the business' of the subsidiary?

One result of the single entity rule, and of the consequent ignoring of intragroup transactions, is that businesses undertaken by a subsidiary may not be recognised as being carried on by the head company. Where a subsidiary's business involves solely intragroup activity, it will not be relevant to working out the head company's income tax.

For example, a consolidatable group may include a subsidiary that is a finance company and conducts a business of lending exclusively to other entities in the group.

When the group consolidates, the intragroup lending activity does not have any income tax consequences. The head company of the group is not treated as carrying on the business of a finance company for the purpose of working out its income tax position, and the character of its assets and liabilities held through the finance company is determined from the perspective of the head company.

Note

More information

→ 'Single entity treatment – deductibility of interest', C9-5-220 (worked example)

→ 'Single entity treatment – sale of intragroup asset to non-member', C9-5-230 (worked example)

References

Income Tax Assessment Act 1997 – as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), section 701-1

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 2

Taxation Ruling TR 2004/11 – Income tax: consolidation: the meaning and application of the single entity rule in Part 3-90 of the *Income Tax Assessment Act 1997*

Taxation determinations

TD 2004/33 – Income tax: consolidation: capital gains: does a CGT event happen to the head company of a consolidated group if a debt is created within the consolidated group and later transferred to a non-group entity?

TD 2004/34 – Income tax: consolidation: capital gains: does section 104-10 (CGT event A1) of the *Income Tax Assessment Act 1997* apply to the head company of a consolidated group where an option granted within the consolidated group is later transferred to a non-group entity?

TD 2004/35 – Income tax: consolidation and capital gains tax: does section 104-10 (CGT event A1) of the *Income Tax Assessment Act 1997* apply to the head company of a consolidated group where a licence granted within the consolidated group is later transferred to a non-group entity for no capital proceeds?

TD 2004/36 – Income tax: consolidation; can the head company of a consolidated group claim a deduction under section 8-1 of the *Income Tax Assessment Act 1997* for the interest paid on funds borrowed before consolidation and on-lent interest-free to a subsidiary member of the consolidated group?

TD 2004/37 – Income tax: consolidation: are intra-group money lending transactions or dealings taken into account in determining if the head company of a consolidated group is carrying on business as a money lender?

TD 2004/39 – Income tax: consolidation: capital gains: does CGT event A1 in section 104-10 of the *Income Tax Assessment Act 1997* happen to the head company of a consolidated group if an asset is sold by a subsidiary member to an entity outside the group?

TD 2004/40 – Income tax: consolidation: capital gains: does CGT event A1 in section 104-10 of the *Income Tax Assessment Act 1997* happen to the head company of a consolidated group when a contract is made to sell a membership interest in a subsidiary member of the group to a purchaser outside the group?

TD 2004/41 – Income tax: consolidation: capital gains: can membership interests in a subsidiary member of a consolidated group be recognised for the purpose of applying the market value substitution rule in section 116-30 of the *Income Tax Assessment Act 1997* if CGT event A1 happens to the group's head company when a contract is entered into to dispose of the interests?

TD 2004/42 – Income tax: consolidation: capital gains: does the single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* affect the application of CGT event I1 in section 104-160 if a company which is a subsidiary member of a consolidated group stops being an Australian resident?

TD 2004/43 – Income tax: consolidation: capital gains: for the purposes of the capital gains tax provisions in Parts 3-1 and 3-3 of the *Income Tax Assessment Act 1997*, is the head company of a consolidated group taken to have acquired an asset, which a subsidiary member brings to the group, at the same time that the subsidiary member acquired it?

TD 2004/44 – Income tax: consolidation: capital gains: does the transfer of an asset between members of a consolidated group affect the ownership period of the head company for the purposes of applying the small business 15 year exemption in Subdivision 152-B of the *Income Tax Assessment Act 1997*?

TD 2004/45 – Income tax: consolidation: capital gains: how does the controlling individual condition in paragraph 152-110(1)(c) of the *Income Tax Assessment Act 1997* (one of the conditions for the small business 15 year exemption in Subdivision 152-B) apply to the head company of a consolidated group in respect of the sale of an asset brought into the group by a subsidiary member?

TD 2004/46 – Income tax: consolidation: capital gains: is the controlling individual condition in paragraph 152-305(2)(b) of the *Income Tax Assessment Act 1997* (one of the conditions for the small business retirement exemption) applied to the head company of a consolidated group?

TD 2004/47 – Income tax: consolidation: capital gains: does the single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* affect the application of the controlling individual test in paragraph 152-10(2)(a) when a CGT event happens to a share or trust interest that is a membership interest in a subsidiary member (company or trust) of a consolidated group?

TD 2004/48 – Income tax: consolidation: capital gains: for the purposes of Subdivision 125-C of the *Income Tax Assessment Act 1997* , can the head company of a consolidated group meet the requirements of a demerging entity in subsection 125-70(7) where a subsidiary member is demerged from the group?

TD 2004/49 – Income tax: consolidation: capital gains: does the single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* apply in determining whether the consequences in Subdivision 125-C of the *Income Tax Assessment Act 1997* apply to the head company of a consolidated group where one or more subsidiary members hold ownership interests in an entity outside the group that is being demerged?

TD 2004/50 – Income tax: consolidation: capital gains: if a subsidiary member of a consolidated group acquires shares in a company outside the group (the original company) under a scrip for scrip arrangement, is the single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* relevant in determining the eligibility for rollover of shareholders in the original company?

TD 2004/51 – Income tax: consolidation: capital gains: does section 124-784 of the *Income Tax Assessment Act 1997* apply to determine the cost base of equity or debt issued by an acquiring entity to its ultimate holding company as part of a scrip for scrip arrangement if those companies are members of a consolidated group?

TD 2004/68 – Income tax: consolidation: Division 7A: if a private company that is a head company or subsidiary member of a consolidated group makes a payment or a loan, or forgives a debt to a shareholder (or shareholder's associate) external to the consolidated group, does the single entity rule apply to the calculation of the distributable surplus under section 109Y of the *Income Tax Assessment Act 1936*?

TD 2004/69 – Income tax: consolidation: Division 7A: if a private company, as a member of a consolidated group, makes a payment, a loan or forgives a debt to a shareholder (or shareholder's associate), that is also a member of the consolidated group, does the single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* prevent the application of Division 7A of the *Income Tax Assessment Act 1936* to the transaction?

TD 2004/76 – Income tax: consolidation: are the voting interests in a foreign company held by a subsidiary member of a consolidated group treated as being voting interests of the head company of the group when determining whether section 23AJ of the *Income Tax Assessment Act 1936* applies to a dividend paid to the group?

TD 2004/79 – Income tax: consolidation: capital gains: if an entity makes a capital gain prior to becoming a subsidiary member of a consolidated group, can it choose to apply the small business replacement asset roll-over under Subdivision 152-E of the *Income Tax Assessment Act 1997* if it acquires a replacement asset after it has become a member of the group?

TD 2004/81 – Income tax: consolidation: capital gains: does the deregistration of a subsidiary member of a consolidated group cause a 'new event' to happen under paragraph 170-275(1)(a) of the *Income Tax Assessment Act 1997* if, before the subsidiary joined that group, a transfer of shares in it was a 'deferral event' under section 170-255 and the group's head company is the 'originating company' for the deferral event?

TD 2004/82 – Income tax: consolidation: capital gains: can the exemption in section 152-125 of the *Income Tax Assessment Act 1997* apply to a payment made by the head company of a consolidated group to a CGT concession stakeholder of the head company in respect of a capital gain made on the disposal of an asset legally owned by a subsidiary member of the group for which disposal the head company obtained the small business 15 year exemption?

TD 2004/83 – Income tax: can the assignment of an intra-group debt or income stream to an entity that is not a member of the consolidated group give rise to a debt interest for the head company of the group under Division 974 of the *Income Tax Assessment Act 1997*?

TD 2004/84 – Income tax: can Division 16E of Part III of the *Income Tax Assessment Act 1936* apply to a head company of a consolidated group where the principal of an intra-group loan is assigned by a member of the group to a non-member?

TD 2004/85 – Income tax: can Division 16E of Part III of the *Income Tax Assessment Act 1936* apply to a head company of a consolidated group where an intra-group income stream is assigned by a member of the group to a non-member?

TD 2005/3 – Income tax: Income tax: consolidation: will a choice to consolidate under Part 3-90 of the *Income Tax Assessment Act 1997* affect the method of income recognition of the consolidated group?

TD 2005/23 – Income tax consolidation: can the head company of a consolidated group satisfy subsection 25-35(1) of the Income Tax Assessment Act 1997 in relation to a debt that is written off as bad by a subsidiary member, where the debt is in respect of money lent by the subsidiary in the ordinary course of its business of lending money before it became a member of the consolidated group?

Revision history

Section C9-1-110 first published 3 December 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on proposed changes to consolidation rules.	Proposed legislative amendments.
26.10.05	References to new taxation determinations.	
16.12.05	Revisions to 'Sale of intragroup asset', p. 2.	New tax determinations.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Application of the consolidation provisions to cooperative companies

A cooperative company may be eligible to be a member of a consolidatable group. If the group consolidates, its status as a cooperative company, and the associated income tax concessions, may be affected by the operation of the single entity rule. This is because the tests for cooperative company status would be applied to the head company taking into account the objects and activities of all group members.

This section outlines the requirements for a company to qualify for income tax treatment as a cooperative company, and the effects of the consolidation provisions on such a company if it becomes a member of a consolidated group.

Qualifying as a cooperative company

For a company to qualify as a cooperative company and thus claim any concessions it must be established for the purpose of carrying on any business having as its primary object(s) one or more of the objects stated in paragraphs 117(1)(a) to (e) of the *Income Tax Assessment Act* (ITAA) *1936*[179]. These are:

(a) The acquisition of commodities or animals for disposal or distribution among its shareholders.

(b) The acquisition of commodities or animals from its shareholders for disposal or distribution.

(c) The storage, marketing, packing or processing of commodities of its shareholders.

(d) The rendering of services to its shareholders.

(e) The obtaining of funds from its shareholders for the purpose of making loans to its shareholders to enable them to acquire land or buildings to be used for the purpose of residence or of residence and business.

Even when a company qualifies under section 117 it will be deemed not to be a cooperative company in any year in which section 118 applies. This may happen in a year in which the company does not satisfy the requirement to have at least 90% of the value of certain of its dealings with members.

Taxation Ruling TR1999/14 considers the basis on which a company whose business activities include the making of loans to shareholders may qualify as a 'cooperative company'. In deciding whether a company falls within subsection 117(1), two questions need to be asked:

- What *business* or *businesses* is the company carrying on?
- What are the *primary objects* of each business?

[179] Cooperative and mutual companies are dealt with in the ITAA 1936, Part III, Division 9, sections 117 to 121.

Should a company engage in several businesses, *all* must have as their primary object(s) one or more of those listed in paragraphs 117(1)(a) to (e).

Each business carried on by a company may have several primary objects. It is necessary to determine which of the activities of a business can be identified as its core or fundamental activities. Any part of a business that is significant in relation to each of the other parts is a primary object. Secondary objects are those activities that do not impact on the overriding character of the business. They should be no more than occasional or incidental.

In any year in which the company is not or is deemed not to be a cooperative company, the provisions of Division 9 will not apply. This means sections 119 and 120 will not apply in that year to such a company or its shareholders.

Eligibility to consolidate

The table in subsection 703-15(2) of the ITAA 1997 sets out the requirements for entities to be members of a consolidated group.

A cooperative company can be the head company of a consolidated group if it meets all of the requirements in item 1 of the table[180].

Item 2 of the table covers eligibility to be a subsidiary member of a consolidated group. In practice it may be difficult for a company to qualify as both a cooperative company and a subsidiary member of a consolidated or consolidatable group. This is because of a conflict in the ownership requirements for cooperative companies[181] and the requirement for subsidiary members to be wholly-owned subsidiaries of a head company[182]. Under the single entity rule, the objects set out in subsection 117(1) would need to be met by reference to the shareholders in the head company of the consolidated group and not the shareholders in the subsidiary.

Notes

Repeal of exclusion of cooperative companies

Item 4 of the table in subsection 703-20(2) of the ITAA 1997 originally provided that certain cooperative companies could not be members of a consolidated group. Item 4 was repealed with application from 1 July 2002.

For more information on the single entity rule see:

- ' Single entity treatment', C9-1-110
- section 701-1, ITAA 1997
- TR 2004/11.

[180] This is supported by the Explanatory Memorandum to the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, paragraph 4.7.

[181] Section 117, ITAA 1936.

[182] Item 2 of the table in subsection 703-15(2), ITAA 1997.

Impacts of consolidating

Cooperative groups are often structured with a cooperative company as the parent company. Other activities that have not met the primary objects test in section 117 may have been conducted through wholly-owned subsidiaries of the parent cooperative company.

Once a choice to consolidate is made, the head company and all its subsidiary members are treated as if they are a single entity for income tax purposes. This means the objects, businesses and activities of the subsidiaries are treated as if they are the objects, businesses and activities of the head company. The primary objects of each business must be determined and tested against the requirements of subsection 117(1).

Accordingly, the tests for cooperative company status are applied to the head company (in the manner explained in TR 1999/14) after taking into account all objects, businesses and activities of the head company and its subsidiary members. The tests in section 118 are also applied to the head company (including its subsidiary members).

If after taking into account all the objects, businesses and activities of the head company it no longer qualifies as a cooperative company, Division 9 does not apply and any concessions that would have been available under Division 9 are denied to the head company. Any concession available to members of a cooperative company under Division 9 are also denied to those members in any years in which the head company is not or is deemed not to be a cooperative company.

References

Income Tax Assessment Act 1936, Part III, Division 9, sections 117 to 121

Income Tax Assessment Act 1997:

- section 701-1
- Division 703

Explanatory Memorandum to the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, paragraph 4.7

Taxation Ruling TR 1999/14: *Income tax: determining the co-operative status of a company which makes loans to shareholders*

Taxation Ruling TR 2004/11: *Income tax: consolidation: the meaning and application of the single entity rule in Part 3-90 of the* Income Tax Assessment Act 1997

Revision history

Section C9-1-115 first published 26 October 2005.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Income recognition – method used by head company

The head company of a consolidated group is the only entity the income tax law recognises for the purposes of working out the income tax liability or losses of the group. The method of income recognition used by the company will directly affect that calculation.

The consolidation legislation does not prescribe an accounting method, nor does it limit the choice of method of income recognition. The basis of income recognition used by a business should be the most appropriate method for the type of income it derives. In most cases, a choice to consolidate will have no effect on the appropriate basis of income recognition.

→ Taxation Determination TD 2005/3

A consolidated group can be made up of entities conducting a range of business activities, bringing income to account by the same or different methods. A business needs to adopt the method of accounting that gives a 'substantially correct reflex of the taxpayer's true income' (*CT v Executor Trustee and Agency Co of South Australia Limited* (1938) 63 CLR 108).

Earnings method usually most appropriate

The earnings method of accounting will usually be the most appropriate method to be used by a company unless it is an 'artificial, unreal and unreasonably burdensome method of arriving at the income derived' (*FCT v Firstenberg* (1976) 27 FLR 34; 76 ATC 4141; (1976) 6 ATR 297).

Income that is the subject of specific provisions of the *Income Tax Assessment Act 1936* or *1997* will continue to be governed by those provisions.

Taxation Ruling TR 98/1: *Income Tax: determination of income; receipts versus earnings* provides guidance on determining income and the use of the receipts (cash) versus earnings (accruals) methods of accounting.

Paragraph 17 of the ruling states:

> When accounting for income in respect of a year of income, a taxpayer must adopt the method that, in the circumstances of the case, is the most appropriate. A method of accounting is appropriate if it gives a substantially correct reflex of income. Whether a particular method is appropriate to account for the income derived is a conclusion to be made from all the circumstances relevant to the taxpayer and the income.

The alternate methods and their appropriateness to different types of income are then discussed.

Paragraph 39 deals specifically with incorporated entities and makes it clear that the earnings method is the preferred method of income recognition:

> The factors that would mitigate against the receipts method being appropriate for business income of a company include:
>
> – The commercial and accounting principles and practices governing accounts kept by companies generally require the accruals (earnings) method of bookkeeping; and
> – A company generally relies upon employees; it is not able to provide personal services.

Same method likely to be appropriate for all business activities

Paragraph 22 of TR 98/1 is also relevant to consolidated groups, which operate for income tax purposes as one entity but in reality are a mix of divisions or business activities. It states:

> Where a taxpayer has business income from more than one business activity, a separate evaluation should be made for each activity and a determination made as to which method is appropriate for the accounting of that income. In most cases, the same method is likely to be appropriate for income from all of these business activities. Fine distinctions are not necessary where the differences between the various business activities are not significant.

The effect of the single entity rule is to treat the head company of a consolidated group as holding all the assets and liabilities of its subsidiaries, and as having entered into the transactions of its subsidiaries. Subsidiary members are treated as if they are parts or divisions of the head company for income tax purposes → Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraph 2.26.

The process of consolidation will have little impact on the choice of method of income recognition. However, in a limited number of cases where consolidating the group's business activities results in a change in the extent of a particular type of business activity, or a grouping of subsidiaries with similar business activities but different income recognition methods, the method may need to be reconsidered. While it is possible for different methods of income recognition to be used within divisions of the same consolidated group, that would be unusual, unless of course there is income subject to specific tax law provisions.

References

Income Tax Assessment Act 1997, section 6-5

Income Tax Assessment Act 1997, section 701-1

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 2.12 – 2.29

Taxation Ruling TR 98/1 – Income Tax: determination of income; receipts versus earnings

Taxation Determination TD 2005/3 – Income tax: consolidation: will a choice to consolidate under Part 3-90 of the *Income Tax Assessment Act 1997* affect the method of income recognition of the consolidated group?

Revision history

Section C9-1-120 first published 5 April 2004.

Further revisions are described below.

Date	Amendment	Reason
26.10.05	Reference to new taxation determination.	

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Tax-related expenses – post-consolidation expenses relating to a subsidiary's tax affairs

It will be common for expenses to be incurred after consolidation relating to the tax affairs of a subsidiary member for periods before it joined a consolidated group. Such expenses may include the cost of preparing the income tax return for the period before consolidation or contesting in the courts a pre-consolidation assessment. Post-consolidation expenses may also arise from dealing with ancillary matters and other income taxes imposed under various Acts but assessed under the *Income Tax Assessment Act 1997* (ITAA), such as obligations relating to PAYG withholding amounts, PAYG instalments, withholding tax, interest on overpayments, franking deficit tax penalties and the general interest charge (GIC) – but (apart from the GIC) do not include the taxes themselves.

The other deductible tax-related expenditures are:

- the GIC itself
- GST Act penalties for errors in varying instalments, and
- valuation requirements for gifts and conservation covenants.

→ section 25-5, ITAA 1997

This paper addresses the following questions:

- Who can claim for the tax-related expenses of a subsidiary member in regard to its pre-consolidation tax affairs (such as expenses relating to objecting to a pre-consolidation assessment or an audit of the pre-consolidation period)?
- Does a subsidiary member continue to have its own tax affairs after consolidation, separate from those of the head company?
- Can the head company deduct the amount calculated as interest payable on a debit amendment to the subsidiary entity? Does it need to include overpayments under section 15-35 as assessable income?
- Can the head company claim a deduction for a penalty payable by the subsidiary under the GST Act given that the subsidiary is responsible for its own GST obligations?

Subsidiaries are part of the head company

Under the single entity rule, the subsidiary members of a consolidated group are taken to be parts of the head company, for the head company and entity core purposes – i.e. working out the income tax liability of the head company.

→ Taxation Ruling TR 2004/11

Section 25-5 of the ITAA 1997 (dealing with tax-related expenses) relates to working out the income tax liability of the taxpayer (in this case the head company), therefore it is covered by the core purposes.

When looking at a provision of the income tax law to determine the income tax liability of the head company, the provision must be read as if the subsidiary members of the group are parts of the head company rather than separate entities.

Paragraph 2.26 of the Explanatory Memorandum to the first consolidation Bill supports this by indicating that under the single entity rule the head company is taken to have entered into the transactions of the subsidiary members.

Thus, subsection 25-5(1) may be read as follows:

> You [the Head company] can deduct expenditure you [or what is treated as a part of you under the consolidation regime] incur to the extent that it is for:
>
> **(a)** managing your *tax affairs [or those of a part of you]; or
>
> **(b)** complying with an obligation imposed on you [or a part of you] by a *Commonwealth law, insofar as that obligation relates to the *tax affairs of an entity; or
>
> **(c)** the *general interest charge under Division 1 of Part IIA of the *Taxation Administration Act 1953*; or
>
> **(ca)** a penalty under Subdivision 162-D of the *GST Act; or
>
> **(d)** obtaining a valuation in accordance with section 30-212 or 31-15.

Note that, while this section of the *Consolidation reference manual* mainly addresses expenses relating to 'tax affairs' (see paragraphs (a) and (b) above), the same principles apply to the other tax-related expenses covered by subsection 25-5(1) – i.e. under paragraphs (c), (ca) and (d).

Tax affairs

Under paragraphs 25-5(1)(a) and (b) an entity can deduct expenditure incurred in managing its tax affairs or complying with an obligation imposed under a Commonwealth law relating to its tax affairs. The expenditure may relate to a past, present or future year of income of the entity. The single entity rule in conjunction with the entry history rule in section 701-1(5) means that the subsidiary members are treated as parts of the head company and that the head company inherits as history everything that happened to the subsidiary. This includes the tax history of the subsidiary.

Under section 721-15 the members of a consolidated group have joint and several liability for the group's income tax liability. That liability can be modified if there is a tax sharing arrangement under section 721-25 in place. The head company is responsible for any tax liability accrued by itself before formation. A subsidiary member is responsible for its income tax liability for any period when it is not a subsidiary member.

If a subsidiary member contests an assessment for a pre-consolidation period, expenses will be incurred relating to income tax assessed to the subsidiary for a period before it joined the consolidated group.

When these expenses are incurred, the only entity that is recognised for income tax purposes is the head company. Under the entry history rule (section 701-5), the tax affairs of the subsidiary member before joining the consolidated group become those of the head company. This does not mean that the head company is responsible for the subsidiary member's pre-consolidation tax liability; rather that expenditure incurred after the joining time in relation to the subsidiary member's pre-consolidation tax affairs will be deductible to the head company under section 25-5. This outcome is consistent with TD 2003/10 and TD 2003/11, which suggest that after consolidation the 'tax affairs' of the subsidiary members become part of the head company's tax affairs.

Example 1

Sub 1 has a long standing appeal to the High Court relating to an assessment of income for the year ending 30 June 2000. Sub 1 becomes a subsidiary member of a consolidated group on 1 July 2002. It pays legal fees of $45,000 during the year ending 30 June 2004.

The issue of whether the amount is deductible under subsection 25-5(1) goes to the calculation of the head company's income tax liability and therefore relates to the head company core purposes. Under the entry history rule the pre-consolidation tax affairs of the subsidiary member are taken to be the tax affairs of the head company.

While the subsidiary remains liable for the basic tax liability related to the assessment, the head company may deduct, under subsection 25-5(1) of the ITAA 1997, expenses incurred in contesting the assessment.

Example 2

A joining entity needs to lodge its own return for the period up to consolidation. The expense will generally be incurred while it is a subsidiary member.

Who can claim the cost of preparing the return?

The head company may claim expenses incurred in preparing the return.

The general interest charge

Paragraph 25-5(1)(c) allows you to deduct expenditure you incur to the extent that it is for the general interest charge (GIC) under Division 1 of Part IIA of the Taxation Administration Act (TAA). Subsections 8AAB(4) and (5) of the TAA give an index of provisions within the ITAA and other Acts under which the GIC can be imposed. Many of these provisions relate to withholding.

As with expenses relating to a subsidiary's tax affairs, GIC applied in relation to a subsidiary member's pre-consolidation periods is generally deductible by the head company.

Example:

After a group consolidates on 1 July 2002 a subsidiary member receives for its 2001 year return a debit amendment, which incurs a GIC under section 170AA of the ITAA 1936.

Paragraph 25-5(1)(c) relates to working out the income tax liability of a taxpayer, i.e. the head company. In applying this subsection to the head company of a consolidated group, the subsidiary members are parts of the head company (section 701-1); therefore, an expense of a subsidiary member is an expense of a part of the head company. The GIC imposed under section 170AA is an allowable deduction to the head company.

Other matters

- Penalties imposed on a subsidiary under subdivision 162-D of the GST Act are allowable deductions to the head company.
- Expenses for valuations required for gifts and conservation covenants incurred post-consolidation for deductions claimed by a subsidiary member during a pre-consolidation period are allowable deductions to the head company.
- Interest on overpayments payable by the Tax Office under section 15-35 which relate to a subsidiary's pre-consolidation period are to be included as assessable income of the head company.

References

Income Tax Assessment Act 1997, sections 13-35, 25-5, 30-212, 31-15

Taxation Administration Act 1953, Division 1 of Part IIA

A New Tax System (Goods and Services Tax) Act 1999, Subdivision 162-D

New Business Tax System (Consolidation) Act 2002 (No. 68 of 2002)

Explanatory Memorandum to New Business Tax System (Consolidation) Bill (No. 1) 2002

Taxation Determination TD 2003/10 – Income tax: is expenditure incurred by a head company in obtaining valuations in respect of the formation of a consolidated group or entities joining a consolidated group an allowable deduction under section 25-5 of the *Income Tax Assessment Act 1997*?

Taxation Determination TD 2003/11 – Income tax: is expenditure incurred by an entity in obtaining valuations for the purposes of either entering into a consolidated group as a subsidiary member, or working out the future income tax liability of a consolidated group of which it would be a subsidiary member an allowable deduction to that entity under section 25-5 of the *Income Tax Assessment Act 1997*?

Taxation Ruling TR 2004/11 – Income tax: consolidation: the meaning and application of the single entity rule in Part 3-90 of the *Income Tax Assessment Act 1997*

Revision history

Section C9-1-130 first published 5 April 2004.

Further revisions are described below.

Date	Amendment	Reason
26.10.05	Reference to new taxation ruling.	
30.6.09	Correction to legislative reference.	Correct error.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Application of Part IVA to elections to consolidate

Introduction

The *Income Tax Assessment Act 1997* has been amended to provide for certain companies, trusts and partnerships in a group to be taxed as if they were one taxpayer. The opportunity to be taxed as one taxpayer (in technical language, 'to consolidate') is a 'choice' offered by the Act to the head entity of a group of companies, trusts and partnerships; and in many circumstances exercising the choice results in taxation that is less in comparison with the tax payable by the separate members of a group if the choice is not exercised.

Many taxpayers are at present re-organising their affairs with a view to exercising the choice to consolidate.

The Commissioner of Taxation has been asked to provide his opinion on when the general anti-avoidance provisions of the *Income Tax Assessment Act 1936*, that is, Part IVA of that Act, will or may apply to schemes involving such re-organisations. If Part IVA applies to a scheme, the Commissioner is empowered, but not compelled, to make a determination to cancel a tax benefit obtained in connection with it.

The purpose of this paper is to provide guidance to taxpayers and tax practitioners on the application of Part IVA. The paper will be updated from time to time as needed.

Section 177C(2)

Subsection 177C(2) provides that a tax benefit is not obtained by a taxpayer in connection with a scheme if it is—

> … attributable to the making of an agreement, choice, declaration, election or selection, the giving of a notice or the exercise of an option (expressly provided for by this Act … or the *Income Tax Assessment Act 1997* [with certain exceptions]) by any person …

provided—

> the scheme was not entered into or carried out by any person for the [sole or dominant] purpose of creating any circumstance or state of affairs the existence of which is necessary to enable the declaration, agreement, election, selection, choice, notice or option to be made, given or exercised, as the case may be.

Except in the case of certain CGT rollovers, this exclusion applies to schemes that are more broadly defined than merely making the election[183]. The decision

[183] Subsection (2A) excludes tax benefits obtained from certain CGT elections from the operation of Part IVA only if the scheme consists of the election and nothing more. Thus for CGT even the limited choice principle available for revenue elections is excluded.

to consolidate is a 'choice' within the meaning of subsection 177C(2)[184]. Therefore tax benefits attributable to the choice to consolidate are not tax benefits as defined (unless the relevant subparagraph (ii) of subsection 177C(2) is applicable).

'Attributable'

When is a tax benefit 'attributable' to an election? 'Attributable' simply means 'capable of being attributed', and 'attribute', in the relevant sense, means 'to ascribe as an effect to a cause'[185]. The Act therefore asks whether the tax benefit is to be ascribed to the election, rather than to something else. If it is appropriate to ascribe the tax benefit to something other than the election, subsection 177C(2) has no application. The question will ordinarily be one of fact. But much will depend on the nature of the election. When, for example, an amount is excluded from the assessable income of a taxpayer, or an allowable deduction is allowed to a taxpayer, directly by making an election to exclude that income or obtain that deduction, it will be self-evident that the tax benefit is attributable to the making of the election. The election will be the direct cause of the tax benefit.

However, the choice to consolidate is not of that type. It is an unusual election. First, it is made only by the head company. Second, it applies not only to the members of the group at the time it is made, but to members joining the group after it is made. And third, and most important, its direct effect is only to render certain statutory fictions applicable to the members of the group (in order to tax the members of the group as if they were one taxpayer, namely, the head company). The tax effects of choosing to consolidate flow from the application of those statutory fictions. The statutory fictions affect the application of almost every substantive provision of the Act so far as they relate to taxpayers to whom the choice to consolidate applies.

When an election to consolidate is made, the effect of these fictions is, among other things, that the head entity is taken to have the allowable deductions that but for the election would be deductions of the members of the group, and to incur the capital losses of its subsidiaries; similarly, the subsidiaries cease to derive their assessable income, for it is taken to be derived by the head entity. Thus each subsidiary ceases to have income included in its assessable income, and each head entity is allowed deductions or taken to incur capital losses that but for the election it would not be allowed or be taken to have incurred.

The omission of an amount from the assessable income of a member (and its derivation by the head company), and the incurring of an allowable deduction by the head company (instead of the member) are in themselves obviously to be attributed to the election to consolidate. The choice to consolidate is the

[184] See section 703-50 of the *Income Tax Assessment Act 1997*: 'A company may make a choice in the approved form … that the consolidatable group is taken to be consolidated … if the company was the head company of the group …'

[185] Shorter Oxford Dictionary, 2nd Edition.

direct cause of these effects of the statutory fictions. These effects would otherwise be tax benefits within the meaning of subsection 177C(1). However, by reason of subsection 177C(2), the Part is prevented from applying unless subpara.177C(2)(a)(ii), and its equivalents for each tax benefit, applies.

Not all tax benefits affected by the consolidation rules will be attributable to the choice to consolidate in the relevant sense. The effect of the choice to consolidate may have a merely incidental connection with obtaining a tax benefit. Thus, a member of a group might enter into a scheme to obtain an allowable deduction that, but for consolidation would be allowable to it. The scheme might be defined to include, all the steps giving rise to the allowable deduction under the substantive law, but not the election to consolidate. In the same way, a member might carry out a scheme that resulted in an amount being omitted from what but for consolidation would be its assessable income. In these cases, the effect of the election to consolidate is merely, in the first case, that the head company obtains the deduction, rather than the subsidiary, and in the second case, that it is the head company's assessable income that is reduced by the scheme, rather than the subsidiary's. In these two cases the tax benefit arises from the scheme, not from the election to consolidate. The election to consolidate is merely incidental to the obtaining of the tax benefit; the tax benefit is not therefore 'attributable' to the choice the taxpayer has made. Thus, subsection 177C(2) does not operate to prevent Part IVA from applying to the scheme.

Consolidation also contains other elections, such as those relating to the 'available fraction' (losses) and to working out the cost of assets (relevant to capital allowance deductions and CGT). These may have a direct effect on deductions, and, insofar as they affect the calculation of future capital gains, an indirect effect on assessable income. Again, since these effects will amount to tax benefits that are normally directly attributable to the election, subsection 177C(2) will prevent the Part from applying unless subpara.177C(2)(b)(ii) applies. Likewise, however, s.177C(2) will not prevent the Part from applying to those cases where the cause of the tax benefit is not the election, but a separate scheme.

Subparagraph (ii)

In those cases where the tax benefit obtained from a scheme is attributable to an election to consolidate, or one of the other elections, the application of Part IVA will depend on whether subparagraph (ii) in the relevant paragraph of subsection 177C(2) applies. The subparagraph applies where the scheme is entered into or carried out for the purpose of enabling the election to be made. The test of purpose is expressed in words affected by subsection 177A(5), and therefore 'the purpose' to which it refers means the sole or dominant purpose of the scheme.

In the Commissioner's view, if a scheme is found to have a dominant purpose of enabling an election to be made, then for the purposes of subparagraph (ii), it is still necessary to undertake the analysis required by s.177D to see if the scheme was entered into or carried out for the dominant purpose of obtaining the tax benefit. (There is no contradiction is saying that a scheme may be solely or dominantly entered into to enable an election to be made, and also solely or dominantly entered into or carried out to obtain a tax benefit, provided the election itself is made solely or dominantly to obtain a tax benefit: as, indeed, one would generally expect to be the case.)

What circumstances or state of affairs is necessary to enable a choice to consolidate to be made?

Subsection 703-50(1) provides that:

> A company may make a choice in the *approved form[186] given to the Commissioner within the period described in subsection (3)[187] that a consolidatable group is taken to be consolidated on and after a day that is specified in the choice and is after 30 June 2002, if the company was the *head company of the group on the day specified.

Put briefly, a head company is a resident, taxable company that is not a wholly-owned subsidiary of another resident, taxable company; while a consolidatable group consists of the head company and at least one wholly-owned, resident, taxable subsidiary of the head company. A company is a wholly-owned subsidiary of a head company if all the membership interests in it are beneficially owned by the head company or its other wholly-owned subsidiaries[188].

Broadly speaking, then, the circumstances to which subparagraph (ii) might apply are causing a company to be the beneficial owner of all the shares in at least one other company on a particular day, and for its own shares not to be wholly owned beneficially by another resident company on that date.

There is a distinction to be made between the circumstances necessary for an election to be made, and circumstances that extend or contract its effect. An election may be made if there is a head company in relation to at least one subsidiary, but the existence of more than one subsidiary is not necessary for an election to consolidate to be made. Hence, if a company is already a head company in relation to a consolidatable group and thus in a position to choose to consolidate that group, a scheme that merely increases (or diminishes) the number of subsidiaries in the group affected by the election to consolidate, does not seem to be one that could be entered into for the purpose of enabling the election to be made. (Insofar as a tax benefit is obtained by a taxpayer in connection with such a scheme, it may not be a tax benefit attributable to the election.)

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[186] See s.388-50 of the schedule to the Taxation Administration Act 1953 for definition. In essence, it is a declaration plus such information as the Commissioner requires.

[187] Between the specified date in the choice and the date for lodging a return for the first income year ending after the specified day.

[188] See s.703-30. Some shares are disregarded; non-share equity is also disregarded.

On the other hand, a scheme to turn a subsidiary into a head company and thereby enable it to make a choice to consolidate would go to the power to choose to consolidate. If reorganisations are made solely or dominantly to allow particular companies to become head companies that would not otherwise be head companies in respect of the group so that that particular company can make the choice for which s.703-50 provides, rather than another company, subpara (ii) will operate to ensure that there is a tax benefit under s.177C; Part IVA may then apply. All the head company's tax deductions are tax benefits, and all the amounts of assessable income its subsidiaries no longer derive are also tax benefits. (Note that subsection 170C(2) is not confined to tax benefits obtained by the taxpayer's *own* election[189].) Similarly, schemes to split a consolidatable group into a number of such groups to enable a number of new head companies to choose to consolidate their groups might be schemes to which Part IVA would apply, if the necessary purpose is present. Likewise, a company that had no subsidiaries at all, and that acquired a subsidiary dominantly to enable it to make an election to consolidate, or which arranged for itself to be acquired by a head company to enable that head company to make an election to consolidate, might have entered into and carried out a scheme to which Part IVA could apply, since these schemes bring into existence the state of affairs which must exist for the choice to be available.

It is then a question, in each of these cases, of whether there was some other purpose for the re-organization than enabling the taxpayers to obtain tax benefits. That question must be answered by reference to s.177D. That is, does the re-organization show, on its face, by reference to the manner in which it was conducted, its form and substance, its effects, and so on, that it was undertaken in that particular way to obtain those tax benefits?

Some general observations about re-organizations

The scenarios provided hereunder furnish concrete examples of what is, and is not, likely to be caught by s.177D in this way. But certain general observations are apposite.

First, in those situations where the relevant scheme includes the making of an election to consolidate the result that is achieved by the scheme in relation to the Act with respect to the head company must be compared with the result that would, but for the scheme, ensue for the separate, or differently consolidated, companies. There would not necessarily be a difference. It follows that, in itself, no great weight attaches merely to the consequence that a re-organization permits consolidation. Likewise no great weight attaches to the mere prospect, at no particular point in time, of future tax benefits of no particular character or amount flowing from consolidation. (In both cases, however, the words 'merely' and 'mere' are to be emphasised.)

Second, a re-organization of a company group may produce efficiencies, savings and conveniences, some unrelated to tax, others related to ease and

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[189] Subsection 177C(2) refers to tax benefits obtained by the taxpayer attributable to an election exercised by any person.

cost of complying with tax laws. The achievement of efficiencies in tax compliance is an object of the consolidation legislation[190]. The re-organization of a company group that exhibits a purpose of permitting an election to consolidate may still be explicable by purposes other than the purpose of obtaining tax benefits.

Third, if, however, there is a conjunction of contrivance of manner in the way in which the re-organization is effected, a consequent distinction of form and substance, and a substantial tax benefit immediately in view that is not outweighed or offset by corresponding tax detriments, or by commercial advantages that could only be achieved in that particular way, then most likely Part IVA applies to the scheme.

Fourth, in particular, the distinction of form and substance is likely to be illuminating where the election to consolidate is in issue. Consolidation is legislation that puts substance before form. The premise of consolidation is this: where there is an identity of interest between companies, partnerships and trusts (as there is, when they are all owned by the same persons) there is in substance only one taxpayer, which should only be taxed once on its economic gains and benefit once only from economic losses—economic gains and losses being the gains and losses in substance, not form. The substance of the relationship between two companies is therefore a good indicator of whether the companies should, or should not, be consolidated. If there is a lack of identity of interest in companies in substance, bringing about the circumstances that enable the head company to choose to consolidate those companies may be a scheme to which Part IVA applies. If there is an identity in substance between two entities, failure to consolidate may be the outcome of a scheme to which Part IVA applies[191]. Similarly, the rules for attributing cost to assets held by a consolidated group on the basis of the costs of shares in the members are framed on the premise that in substance one is attributable to the other. Where, then, a scheme seems by its manner to be framed to attribute a value to assets that is substantially at variance with the genuine value of that asset, then that result may amount to an abuse of the Act.

Cancellation of a tax benefit

When Part IVA applies to a scheme, the Commissioner must determine, under s.177F, to cancel the tax benefits obtained in connexion with it for the Part to take effect. Although s.177F confers a discretion on the Commissioner, it is not essentially a discretion whether to apply Part IVA, but how to apply it. As the explanatory memorandum says:

> The essential function of section 177F is to enable the Commissioner of Taxation, against the background of the other sections mentioned, to determine precisely what tax adjustments should be made in the assessments of the taxpayer concerned and of other taxpayers affected by the scheme. Sub-section (1) effectively calls on the Commissioner to make

[190] Section 700-10(c).

[191] The 'all in principle' of consolidation.

a formal determination as to how much of the amount of the identified tax benefit is to be cancelled and directs him, where he has made such a determination, to take such assessing and other action as he considers necessary to give effect to it.

It is a peculiar feature of the election to consolidate that it can result in tax benefits consisting of the entirety of allowable deductions or assessable income of consolidated taxpayers. The Commissioner has power under s.177F to cancel all tax benefits obtained by taxpayers in connexion with the scheme, and not merely the tax benefit that it was the dominant purpose of some person to obtain. However, the Commissioner will generally apply Part IVA in such a way as to only remove the actual tax advantage obtained by the head company.

For example, when a company ('the loss company') has both assessable income and allowable deductions, and the allowable deductions exceed the assessable income, if an election to consolidate becomes applicable to it, the entirety of the allowable deductions of the company will be a tax benefit obtained by the head company (and the entirety of the assessable income becomes a tax benefit obtained by the loss company). The mischief of the scheme, and the actual tax advantage derived from it by the head company, was the excess of the allowable deductions over the assessable income of the loss company. It is this tax advantage that should be denied under s 177F where Part IVA has application in relation to the scheme.

One approach to achieving this outcome is to cancel the allowable deductions of the head company only to the extent of the actual tax advantage. Another approach is to disallow the whole of the tax benefit, and for the relevant taxpayer (in most instances the head company) to seek a compensatory adjustment under subsection 177F(3). Under this later approach it would still be necessary for the taxpayer to demonstrate that the adjustment was 'fair and reasonable' in the circumstances. Arithmetically the consequence is the same taxable income under either approach.

Whether either of these methods is appropriate is essentially a question of fact. But the taxpayer who ventures into a scheme involving the election to consolidate takes the risk that the business of the relevant subsidiary company might be sunk in the affairs of the group so deeply that it is not possible to reliably identify the quantum of the actual tax advantage, especially for years subsequent to the scheme, with the result that the group is taxed on assessable income resulting from the scheme, but denied allowable deductions.

The following examples illustrate the Commissioner's approach to cancelling tax benefits.

Example 1

Assume:

- a parent company of a consolidatable group enters into a scheme to acquire a loss company as a wholly owned subsidiary and following acquisition of the company elects to consolidate;

- but for the application of Part IVA, the parent company as head company of the group would obtain a tax benefit from the scheme by virtue of the operation of Part 3-90, namely access upon consolidation to the losses of the loss company; and
- the facts and circumstances of the acquisition are such as to show that the dominant purpose behind acquiring the loss company was a tax avoidance purpose;
- the loss company brings $100 worth of carry forward revenue losses into the consolidated group and the available fraction of the loss bundle is 0.5.

Variant 1

In its first income year, the head company of the consolidated group derives assessable income of $210, $40 of which was generated by the loss company. In this example, but for the application of Part IVA, the parent company has derived a tax benefit in connection with the scheme being the full amount of the revenue losses brought into the group by the loss company. However, but for the scheme the loss company would have been entitled to off set its $40 of income against $40 of its carry forward loss. The actual tax advantage to the head company is therefore not the full amount of the revenue loss. It is instead the net (that is, $60) revenue loss available to the head company to off set other assessable income derived by the head company in the relevant year. In respect of this first year the Commissioner would cancel this actual tax advantage rather than the full amount of the losses brought into the group by the loss company.

A Part IVA determination and amended assessment would issue to the parent company as head company of the consolidated group (being the relevant taxpayer).

Variant 2

As in variant 1, the head company of the consolidated group derives income of $210 in its first income year. If the objective facts are not sufficient to allow for a determination of the extent to which the income derived by the group has been generated by the loss company, the Commissioner would cancel the entire tax benefit obtained by the parent company as head company of the consolidated group in connection with the scheme, namely the full amount of the carry forward losses brought into the consolidated group by the loss company. A Part IVA determination and amended assessment would issue to the parent company as head company of the consolidated group (being the relevant taxpayer). The Commissioner would consider making compensating adjustments under subsection 177F(3) of the *Income Tax Assessment Act 1936* where the taxpayer is able to demonstrate a fair and reasonable basis for such an adjustment.

Variant 3

In its first income year the head company of the consolidated group derives $80 worth of income, all of which was generated by the loss company. Assume further that in its second income year, the parent company as head company of the consolidated group derives $40 worth of income, $10 of which was generated by the loss company. The head company of the consolidated group has obtained a tax benefit from entering into the scheme in relation to its first income year (namely, as a result of the application of the loss fraction, $40 of carry forward loss is offset against the $80 of income). However, the head company has not obtained an actual tax advantage from the scheme. In the absence of the scheme the loss company would have been able, in the first year, to off set all of its assessable income against its carry forward loss. Since in the first year all of the assessable income of the consolidated group is generated by the loss company the Commissioner would not apply subsection 177F(1) in relation to the first income year.

However, in the second income year the head company of the consolidated group has obtained an actual tax advantage from entering into the scheme. In the absence of the scheme the loss company would have been able to off set $10 of the remaining $60 of carry forward loss against its $10 of assessable income. However, as a result of the scheme the head entity is able to off set more than that $10 against its assessable income (namely $20). The Commissioner would cancel the amount by which the carry forward loss deduction available to the head company in the second year exceeds $10. To this end, a Part IVA determination and amended assessment would issue to the head company, the relevant taxpayer.

In future years the head company would continue to have access to the remaining amount, if any, of the carry forward loss brought into the group by the loss company (for example, $50 in the third year). However, if in any future income year some or all of that loss was offset against an amount of assessable income greater than the amount of the assessable income derived by the head entity in that year as a direct consequence of the loss company being a member of the group, then the excess amount of the deduction allowed would be cancelled as a tax benefit.

Example 2

Assume:

- a non-resident parent company wholly owning an Australian corporate group enters into a scheme to interpose a company (Interposed Co) between it and the Australian resident head of the corporate group;
- Interposed Co elects to consolidate;
- but for the application of Part IVA, Interposed Co would, as a result of the scheme, be entitled to $20 more of deductions for depreciation than would have been available to the group but for the scheme. This greater entitlement to deductions results from a resetting of the tax cost of the group's assets following consolidation;
- the facts and circumstances of the acquisition are such as to show that the dominant purpose behind the introduction of Interposed Co into the corporate group was a tax avoidance purpose.

In this example, but for the application of Part IVA, the full amount of deductions (including deductions for depreciation) which accrue to Interposed Co is a tax benefit obtained in connection with the scheme. In the absence of the scheme, Interposed Co would have had no entitlement to any of these deductions. Consequently, the tax benefit is the full amount of the deductions allowable to Interposed Co. However, the Commissioner will not cancel the entire tax benefit obtained in connection with the scheme. The Commissioner will, rather, only cancel the actual tax advantage arising to the group in connection with the scheme (most obviously, the increased entitlement to a deduction for depreciation).

Scenarios

Index to scenarios

In summary:

- Scenarios 1-4 involve the interposition of an entity resulting in the formation of a consolidatable group;
- Scenario 5 involves the leaving out of an entity from a consolidatable group prior to the group consolidating;
- Scenario 6 involves the shifting of value out of a consolidatable group prior to consolidation;
- Scenarios 7-11 involve the disposal of an interest in a group company prior to the group consolidating;
- Scenario 12 involves the post-consolidation dissolution of a company;
- Scenarios 13-17 involve the purchase of a minority interest in a group company prior to consolidation;
- Scenario 18 involves the use by a consolidatable group of a special purpose vehicle to issue preference shares to unrelated investors while maintaining 100% ownership of its subsidiaries;
- Scenario 19 involves the use by a consolidatable group of non-share equity interests to maintain economic control over a related entity.

Relevant policy issues and legislative design principles

In considering the following scenarios it is useful to recall the following policy issues and legislative design principles of consolidation:

- At its highest level, the policy intent of the consolidation regime is reflected in section 700-10 of the *Income Tax Assessment Act 1997*. The consolidation regime seeks to benefit corporate groups through the removal of the double taxation of gains, reducing compliance costs and improving business efficiency. Consolidation also seeks to improve the integrity of the taxation of corporate groups, including through the removal of loss duplication and by ignoring intra-group transactions;
- Consolidation is optional, but once a choice to consolidate has been made by a head company, that choice is irrevocable;
- A consolidatable group cannot consist of a single company, but once a choice has been made by the head company of a consolidatable group to

consolidate, subsequent changes to the group structure can result in the consolidated group consisting of a single entity member (see para 3.9 of the EM to the May 2002 Bill);

- A consolidatable group consists of a head company and all the head company's resident wholly-owned subsidiaries. A subsidiary member of a consolidatable group does not have an option not to be part of a consolidated group if the head company chooses to consolidate (the 'all in principle' – see paras 3.4 and 3.16 of the EM to the May 2002 Bill);
- In determining whether a company is a wholly owned subsidiary, regard is only had to the 'share' interests issued in that company, and debt interests are to be ignored (see para 3.6 of the EM to the May 2002 Bill). The debt/equity rules in Div 974 of the *Income Tax Assessment Act 1997* are used as a basis for identifying debt interests;
- Entry into the consolidation regime is restricted to resident Australian companies and is generally restricted to groups who have a resident holding company at the top of their structure (see para 3.4 of the EM to the New Business Tax System (Consolidation) Bill (No 1) 2002 ('the EM to the May 2002 Bill').

Policy context

Each of the scenarios includes a section that discusses the policy context that is considered relevant to the issues raised in that scenario. The discussion of policy is not intended to indicate the operation of Part IVA is determined by reference to the policy underlying a particular provision. It simply indicates that such underlying policy is part of the contextual matrix that should be considered when analyzing the potential operation of Part IVA.

Disclaimer

The application of Part IVA of the ITAA 1936 depends on a careful weighing of all the relevant circumstances of each case, and the relative weight that should be attached to each of those circumstances. The purpose of one or more of the participants in any particular arrangement is to be determined having regard the matters listed in section 177D of the ITAA 1936. Therefore, in the absence of all relevant information it is not possible to state definitively whether a particular transaction will attract the operation of Part IVA.

The scenarios do not constitute a public ruling, and are in no sense binding upon the Commissioner.

For the purposes of each of the scenarios it is assumed that the arrangements are effective under the ordinary income tax provisions. However this may not be the case in any actual arrangement. Further, no attempt has been made to discuss the impact of other provisions of the tax law which may have application in relation to the scenarios described below (for example, the value shifting provisions). Taxpayers seriously contemplating entering into a particular arrangement who wish to obtain more formal advice regarding:

- whether Part IVA has application in relation to the arrangement; and/or
- the application of other specific provisions;

may wish to approach the ATO or their professional adviser.

Scenario 1: Interposition of a company to form a consolidatable group

Canadian Brakes Pty Ltd (CBPL) is the only Australian subsidiary of the Canadian Brakes Corporation of Toronto as at 13 December 2002. At that date, CBPL has on its books depreciating assets such as plant and equipment (with a written down value of $200 million) and intangibles (with a written down value of $300 million). A proportion of the plant and equipment on CBPL's books was acquired prior to 21 September 1999 and was being depreciated by CBPL at accelerated rates.

CBPL has a tax year-end of 31 December 2002 and claimed $40m as a depreciation expense in its tax accounts for that year.

The group gets a briefing[192] on 13 December 2002 from its accountants on the new consolidation regime and in particular the tax cost-setting rules. The Canadian parent decides to form a consolidated group by inserting a resident company to be called New Canadian Brakes Pty Ltd (NCBPL) as the new entry point into Australia. To achieve this result, the Canadian parent first incorporates a new Australian subsidiary, NCBPL. The Canadian parent then rolls over its shareholding in CBPL to NCBPL in exchange for all of the shares in NCBPL.

The following diagram illustrates the company group structure both before and after the restructuring:

NCBPL notifies the ATO on 5 February 2003 that it is a head company and has formed a consolidated group as at 1 January 2003 with one wholly-owned subsidiary member, namely CBPL.

NCBPL chooses not to apply the consolidation regime's transitional rules regarding the setting of cost. On this basis the cost setting rules operate to reset the tax cost of CBPL's assets on entry into the consolidated group. NCBPL further chooses to reset the tax cost of the assets CBPL has previously been depreciating at accelerated rates and commence depreciating the assets at a rate calculated in accordance with Division 40 of the *Income Tax Assessment Act 1997* rather than continue to depreciate the assets at accelerated rates. After applying the Allocable Cost Amount (ACA) method of resetting the tax cost of assets, CBPL brings into the consolidated group depreciable assets, the tax costs of which have been reset to $400m and intangibles the tax costs of

[192] As was noted by the High Court in FC of T v Consolidated Press Holdings Ltd & Ors; CPH Property Pty Ltd v FC of T 'it is expected that those who participate in a complex, international, commercial transaction will be concerned about its tax implications, and will seek expert advice … In some cases the actual parties to a scheme subjectively may not have any purpose, independent of that of a professional advisor in relation to the scheme … but that does not defeat the operation of s 177D'.

which have been reset to $100m. It has done this by allocating the ACA on the basis of the market valuation of its assets as at 1 January 2003.

Given this resetting of the assets' tax costs, NCBPL as head company of the consolidated group claims, in the year ended 31 December 2003, in relation to the assets CBPL brings into the group, a deduction for depreciation which is several million dollars more than would have been available to CBPL had it not become a member of a consolidated group. This is the result even though a deduction for depreciation available to NCBPL on some individual assets in the year ended 31 December 2003 (in particular, some of those assets that had previously been depreciated at accelerated rates) is less than the corresponding deduction that would have been available to CBPL had it continued to hold the assets.

The increase in depreciation has come about simply by the insertion of a new head company, by applying the ACA method to reset tax costs and by allocating the ACA on the basis of market values.

It is assumed for the purposes of this scenario that the legal entity CBPL held its asset register stable from 1 January 2002 to 31 December 2003 and that it had relatively minor asset acquisitions and disposals over this two year period.

The scheme

For the purposes of section 177A of the ITAA 1936, the scheme could consist of the interposition of NCBPL between CBPL and the Canadian Brakes Corporation of Toronto followed by the choice by NCBPL to consolidate.

The tax benefit

By interposing NCBPL between CBPL and the Canadian Brakes Corporation of Toronto, a consolidatable group consisting of CBPL and NCBPL is created. Upon consolidation, NCBPL obtains an uplift on the tax costs in respect of the assets held by CBPL via the consolidation cost setting rules.

In these circumstances there are a number of tax benefits under paragraph 177C(1)(b), namely the full amount of all of the various types of deductions available to NCBPL. In the absence of the scheme, that is in the absence of the creation of a situation in which NCBPL could choose to consolidate, NCBPL would not have been entitled to any deductions.

However, the actual tax advantage obtained by NCBPL is simply the difference between the amount of depreciation deductions NCBPL is entitled to and the depreciation deductions that CBPL would have been entitled to but for the scheme. It is this amount, if any, that the Commissioner would cancel under section 177F, and not the total amount of deductions available to NCBPL.

Purpose

On the basis of the limited information set out above one might conclude that the sole reason for the interposition of NCBPL was to obtain the benefit that would follow from formation of a consolidated group, in particular, the greater deductions compared to those that would have been available had CBPL not become a member of a consolidated group.[193]

Policy context

In the absence of the interposition of NCBPL, CBPL would not be able to take advantage of the consolidation measures as, but for the scheme, there is no wholly owned Australian resident group. Further, the way in which NCBPL has been put into a position to be able to elect to consolidate and thus the manner in which it has obtained the tax benefits, is such as to show on its face a tax avoidance purpose as the prevailing reason for the interposition of NCBL. This points towards Part IVA having application. The interposition of NCBPL between CBPL and the foreign parent company solely in order to bring into existence an Australian resident group, and thereby obtain an immediate tax benefit, is inconsistent with the policy behind the consolidation regime.

Scenario 2: Interposition of a company to form a new head company of a consolidatable group

As at 13 December 2002 Australia Engines Sub Pty Ltd (AESPL) is an Australian subsidiary of Australian Engines Pty Ltd (AEPL), an Australian resident company, which in turn is a subsidiary of the US Engines Corporation of Ohio.

The group gets a briefing on 13 December 2002 from its accountants on the new consolidation regime and in particular the cost-setting rules. The accountants recommended that, prior to consolidation, a resident company be interposed between AEPL and the US Engines Corporation of Ohio. The US parent acts on this advice and incorporates a new Australian subsidiary, Head Co, and then rolls over its shareholding in AEPL to Head Co in exchange for the issuing of shares in Head Co. Head Co has no assets apart from the shares it owns in AEPL and carries on no business in its own right. The group consisting of Head Co, AEPL and AESPL subsequently consolidate.

The following diagram illustrates the company group structure both before and after the restructuring:

Head Co chooses not to apply the consolidation regime's transitional rules regarding the setting of cost. On this basis, the cost setting rules operate to

[193] A different result may follow had the facts of the scenario been altered such that the deductions for depreciation which NCBPL as head company of the consolidated group is entitled to are less in the first few years after consolidation (for example as the result of the loss of accelerated depreciation) than the deductions CBPL would have been entitled to but for the scheme, but are more in later years than the corresponding deductions CBPL would have been entitled to but for the scheme. In this variant, the net present value of the increased deductions may be such as to point towards Part IVA not having application.

reset the tax costs of AEPL's (and AESPL's) assets on entry into the consolidated group. Given this resetting of the assets' tax costs, in the year ended 31 December 2003, Head Co claims $70m in depreciation deductions. If Head Co had not been interposed between US Engines Corporation of Ohio and AEPL, and the group consisting solely of AEPL and AESPL had chosen to consolidate, AEPL, as the head company of this alternative consolidated group, would have been entitled to only $40m in depreciation deductions in relation to the assets it brought into the group. This follows because the head company of a consolidated group brings its assets into the group at their existing value: the head company of a consolidated group cannot reset the tax costs of its own assets.

The scheme

For the purposes of section 177A of the ITAA 1936, the scheme could consist of the interposition of Head Co between AEPL and the American Parent company.

The tax benefit

By interposing Head Co between AEPL and the American parent, a consolidatable group consisting of Head Co, AEPL and AESPL has been created. In the absence of the scheme it seems reasonable to assume that AEPL, as the potential head company of the consolidatable group comprising AEPL and AESPL, would have chosen to consolidate that consolidatable group. Consequently, in the absence of the scheme, Head Co would not have been entitled to any deductions. In these circumstances, there are a number of tax benefits, namely the full amount of all the various types of deductions otherwise allowable to Head Co, and not simply the difference between the deductions that Head Co was entitled to and what AEPL would have been entitled to if it was the head company of the consolidated group consisting of AEPL and AESPL.[194]

However, the actual tax advantage obtained by Head Co is simply the difference between the amount of depreciation deductions Head Co is entitled to and the amount of depreciation deductions that AEPL would have been entitled to had it been the head company of a consolidated group comprising itself and AESPL. It is this amount, if any, that the Commissioner would cancel under section 177F.

Purpose

On the basis of the limited information set out above, one might conclude that the sole reason for the interposition of Head Company was to obtain the benefit that would follow from formation of a consolidated group having a company other than AEPL as its head, in particular, the greater deductions

[194] But for the scheme, Head Co would not have been entitled to any deductions.

than would have been available had the group consisting solely of AEPL and AESPL consolidated.

Policy context

In the absence of the interposition of Head Co, any choice to consolidate AEPL and AESPL would result in AEPL, as the head company of the consolidated group, having to bring its assets into the group at their existing value. It is a design feature of the asset model underpinning the consolidation measure that head companies retain existing values for their assets (see, for example, paragraph 1.13 of the EM to the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002). In this situation AEPL would not, but for the scheme, have been entitled to the benefit of the cost setting rules, and would not have been the beneficiary of the increase in its own assets' tax values. These considerations point towards the application of Part IVA.

Scenario 3: Interposition of a head company to form a consolidatable group

Australian Gears Pty Ltd (AGPL) is the only Australian subsidiary of the US Gears Corporation of Wisconsin as at 13 December 2002. AGPL carries on the business of the local manufacture, distribution and sale of gears, as well as the business of importing gears made overseas for sale in Australia. AGPL also has an arm which undertakes R&D activities into the design and engineering of gears. Recently AGPL further diversified its business setting up an arm which produces high quality watches using an innovative gear mechanism developed as a byproduct of the R&D activities. As at 13 December 2002, AGPL has significant depreciable assets.

AGPL has a tax year-end of 31 December 2002 and claimed $20m as a depreciation expense in its tax accounts for that year.

In a briefing the company's external tax advisers noted that increased deductions for depreciation, via the resetting of the tax costs of AGPL's assets, would arise from inserting a new head company to serve as the entry point into Australia.

The advisers also noted that such a restructuring provided an opportunity to split the various distinct business activities being undertaken by AGPL into separate subsidiaries, namely one subsidiary which carries on the business of manufacturing gears, another carrying on the business of distributing and selling the locally manufactured gears, a third carrying on the business of importing gears made overseas, a fourth to carry on the R&D activities of the group, and a fifth to carry on the business of manufacturing watches for sale. An objective financial analysis of this proposed restructure demonstrated that significant, non-tax, economic benefits would be achieved. In particular, the advisers emphasized that such a restructure would allow a greater focus on the management and improvement of each individual business. Finally, the advisers noted that the restructure would facilitate easy divestment of one or more of the businesses if in the future such a course of action were pursued.

The relevant board of director's minutes indicates that based on these briefings the decision was made to form a corporate group consisting of a new resident head company called New Australian Gears Pty Ltd (NAGPL) - the new entry point into Australia - with five wholly owned subsidiaries. Four of the subsidiaries are newly created companies. The fifth subsidiary is AGPL. At the end of the restructure, AGPL carries on the sole business of manufacturing gears. The four other business activities previously carried on by AGPL are rolled over into the other four subsidiaries. NAGPL as a head company has no assets apart from the shares it owns in AGPL and the other four subsidiaries and carries on no business in its own right.

NAGPL notifies the ATO on 5 February 2003 that it is a head company and has formed a consolidated group as at 1 January 2003 with five wholly-owned subsidiary members.

The following diagram illustrates the company group structure both before and after the restructuring:

NAGPL chooses not to apply the consolidation regime's transitional rules relating to the setting of cost. On this basis, the cost setting rules operate to reset the tax costs of the assets of the subsidiaries on entry into the consolidated group. Given this resetting of asset tax costs, in the year ended 31 December 2003 NAGPL, as head company of the consolidated group, claims deductions for depreciation, relating only to the assets which were owned and used by AGPL prior to the corporate restructure, that are $70 million greater than would have been available to AGPL had it not entered a consolidated group.

The scheme

For the purposes of section 177A of the ITAA 1936, the scheme could consist of the interposition of NAGPL between AGPL and the US Gears Corporation of Wisconsin followed by the election by NAGPL to consolidate.

The tax benefit

By interposing NAGPL between AGPL and the US Gears Corporation of Wisconsin and rolling over assets previously owned by AGPL into newly created subsidiaries, a consolidatable group consisting of NAGPL and its five subsidiaries is created. Given the objective non-tax economic benefits that would be obtained by re-organizing the existing company into separate companies, each carrying on a different business, it is considered reasonable to assume that in the absence of the scheme some type of re-organization would still have occurred.

For example, the re-organization could have proceeded on the basis that AGPL transfers all the assets representing each of the businesses to separate newly incorporated companies and in consideration for that transfer receives all the shares in each of those new companies. In this way AGPL would become the head company of the new group, and would not itself carry on any business. Alternatively, AGPL could have retained the assets representing the business of manufacturing gears, and transferred all the other businesses to separate new companies. Under this approach AGPL would both become the consolidated group's head company, and carry on one of its businesses.

Under either of these approaches, but for the scheme, NAGPL would not have been entitled to any deductions, including the increased deductions for depreciation. Consequently, a number of tax benefits arise in respect of the deductions allowed to NAGPL namely the full amount of all of the various types of deductions otherwise allowable to NAGPL.[195]

However, the actual tax advantage obtained by NAGPL is simply the difference between the amount of the depreciation deductions NAGPL is entitled to and the amount of the depreciation deductions that AGPL would have been entitled to had it been the head company of a consolidated group. It is this amount, if any, that the Commissioner would cancel under section 177F. As discussed above there are at least two possible restructures that would leave AGPL as the head company: one where AGPL is simply a holding company; and a second where AGPL is both a holding company and carries on an active business. In determining the amount of the actual tax advantage obtained by NAGPL it would be necessary to determine which of these two alternative restructures is the most likely. For the purposes of this scenario it is assumed that a restructure that leaves AGPL as a pure holding company better reflects the non-tax economic reasons for the creation of a multiple entity structure.

Purpose

On the basis of the information provided it is objectively difficult to conclude that NAGPL was interposed between AGPL and the American parent company solely or dominantly to obtain a tax benefit. AGPL as a company prior to the structure carried on five distinct business activities. The restructuring enabled this distinct business to be disaggregated and rolled over into separate companies with a number of economic and commercial advantages. A move from a divisional company structure to separate businesses is not, in isolation, something from which one can infer a tax avoidance purpose.

Policy context

Absent the interposition of NAGPL, AGPL would not be able to take advantage of the consolidation measure. This is because entry into consolidation is restricted to certain corporate *groups*. However NAGPL was

[195] But for the scheme NAGPL would not have been entitled to any deductions.

not interposed between AGPL and the foreign parent company solely or dominantly in order to bring into being a consolidatable group and hence an immediate tax benefit in the nature of an increased entitlement to depreciation deductions. It appears that AGPL always intended to take advantage of consolidation to restructure with all the consequent non-tax economic benefits. This points towards the general anti-avoidance rules having no application.

Scenario 4: Interposition of a new entity and restructuring to form a consolidatable group

Company A, an Australian resident company, is a wholly owned subsidiary of a non-resident company (Overseas Co), which, in turn, is a wholly owned subsidiary of Parent Co, also a non-resident company. The assets of Company A are valued at $10m in its accounts. The market value of the assets is $100m. Parent Co acquires the shares in a newly incorporated Australian resident company, Interposed Co. The subscription for shares is satisfied by the issue by Parent Co of a promissory note in favour of Interposed Co with a face value of $100m. Immediately after issuing shares in its self to Parent Co, Interposed Co purchases Parent Co's shares in Overseas Co.[196] The purchase is satisfied by Interposed Co endorsing the promissory note received from Parent Company in favour of Parent Co. This purchase makes Overseas Co a wholly owned subsidiary of Interposed Co. The interposed entity does not undertake any activities apart from issuing shares to Parent Co and purchasing, from Parent Co, Parent Co's shareholding in Overseas Co.

Through a change in residency, Overseas Co subsequently becomes an Australian resident company. The structure of the group after the change of residency is as follows: Company A is a wholly owned subsidiary of Overseas Co (now an Australian resident) which is a wholly owned subsidiary of Interposed Co (an Australian resident) which, in turn, is a wholly owned subsidiary of Parent Co (a non-resident).

The following diagram illustrates the company group structure both before and after the restructuring:

The group consisting of Interposed Co, Overseas Co and Company A consolidates allowing a 'pushdown' of the $100m paid by Interposed Co for the shares in Overseas Co. This results in the tax costs of the assets of Company A being reset in proportion to their market values. The depreciation deductions available to Interposed Co are calculated on the basis of these reset values. This results in Interposed Co being entitled to greater depreciation deductions than would have been available if the values had not been reset.

[196] Parent Co's shares in Overseas Co are not assets to which section 136-25 of the ITAA 1997 applies.

The scheme

For the purposes of section 177A, the scheme could consist of:

- the interposition of Interposed Co between Parent Co and Overseas Co;
- Overseas Co becoming an Australian resident company; and
- the election by Interposed Co to consolidate.

The tax benefit

In the absence of the scheme there was not a consolidatable group. By the interposition of Interposed Co between Parent Co and Overseas Co, and Overseas Co becoming an Australian resident company, a consolidatable group is created. The creation of a consolidated group allows Interposed Co (the head company of the consolidated group) to obtain tax deductions that it would not have otherwise been entitled to. Consequently, a number of tax benefits arise, namely the full amount of all of the various types of deductions allowed to Interposed Co.[197]

However, the actual tax advantage obtained by Interposed Co is simply the difference between the amount of depreciation deductions Interposed Co is entitled to and the amount of depreciation deductions that company A would have been entitled to but for the scheme. It is this amount, if any, that the Commissioner would cancel under section 177F.

Purpose

The interposition of a company making use of round robin financing and the subsequent change of the residency of Overseas Co in such a way that the economic ownership of the group both before and after the restructuring is the same while the tax costs of the assets of Company A are reset yielding an immediate tax benefit indicates that the objective purpose of entering into the scheme was to obtain a tax benefit.

Policy context

As in Scenario 1, it is clear that absent the interposition of Interposed Co and the coming on shore of Overseas Co, Company A would not have been able to take advantage of the consolidation measure. This follows because, absent the scheme, the tax costs of the assets of Company A would not have been reset.[198]

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[197] But for the scheme, Interposed Co would not have been entitled to any deductions.

[198] The consolidations legislation does contain rules which allow non-resident entities to be interposed between group members. These rules operate as a transitional measure. Assuming the conditions associated with these rules were met, a consolidatable group (consisting of Interposed Co and Company A) comes into existence even without Overseas Co becoming an Australian resident company. However, should Interposed Co elect to consolidate prior to Overseas Co coming on shore, the tax costs of Company A's assets would not be reset. This is as a consequence of the general rule that the tax costs of assets held in a transitional foreign held subsidiary cannot be reset (see paras 4.34 – 4.37 of the EM to the December Bill).

Accordingly, the entering into of what appears a contrived series of transactions designed to bring into being a consolidatable group, and hence create an immediate tax advantage in the nature of an increased entitlement to depreciation deductions, suggests the general anti-avoidance rules should have application.

Scenario 5: Leaving out entities from a group prior to consolidation[199]

A non-resident parent company owns 100% of the shares in Company A which is a resident of Australia. Company A in turn has two wholly-owned subsidiaries Companies B and C, both of which are residents of Australia. The parent company asks its professional advisers for an analysis of all the costs and benefits of various consolidation scenarios.

The professional advisers have provided a report that includes the following points.

- Company A has a modified market value of $10 and no losses.
- Company B has a modified market value of $100 and a loss of $100.
- Company C has a modified market value of $100 and no losses.
- If all three Australian resident companies form a consolidated group, the available fraction for Company B's loss is 100/210 = 0.476. The available fraction is the proportion that the loss entity's modified market value at the joining time bears to the adjusted market value of the group at that time. It is a proxy for determining the proportion of the group's income generated by the loss entity.
- However, if Company C is left outside the consolidated group, the available fraction will be 100/110 = 0.909.
- It is predicted that Company A and Company B will have between them sufficient assessable income in the first year of consolidation to benefit from the higher available fraction.
- Excluding Company C from the consolidated group will therefore allow the group to utilise the $100 loss at a faster rate than had Company C been part of the consolidated group.

The non-resident parent decides to only consolidate companies A and B. In order to give effect to this decision, the non-resident parent purchases all of the shares in Company C owned by Company A. The purchase price paid by the non-resident parent is equal to the CGT cost base of the shares owned by Company A ($10). CGT rollover relief is available and claimed under Division 126-B of the *Income Tax Assessment Act 1997*.

[199] For the purposes of this scenario, the available fractions are worked out on the basis that the value donor concession rules are not available. It is further assumed that section 707-325(2) does not have application; this may not be the case.

The following diagram illustrates the company group structure both before and after the restructuring:

After the restructuring is complete, Company A elects to consolidate. The available fraction in respect of Company B's loss bundle is 100/120 = 0.833. The difference between this available fraction and that calculated by the professional advisers arises from the fact that Company A has received $10 as consideration for the sale of the shares in company C, while the original calculation proceeded on the basis that there was no such consideration.

The scheme

For the purposes of section 177A, the scheme could consist of the purchase by the parent company of all the shares owned by Company A in Company C.

The tax benefit

As a result of the disposal by Company A of all of the shares it owns in Company C to the parent company, the available fraction in respect of Company B's loss bundle within the consolidated group consisting of Companies A and B is increased relative to what the available fraction would have been had Companies A, B and C consolidated. This increase in the available fraction means the losses brought into the group by Company B can be utilised at a faster rate than they could have been had Companies A, B and C consolidated. That is, Company A, as the head company of the consolidated group, is entitled in the first year after consolidation to a greater deduction than would have been the case but for the scheme. The tax benefit obtained by Company A is the difference between the amount of the loss deduction allowable in the first year to Company A and the amount of the loss deduction that it would have been entitled to in that year if the scheme had not occurred. It is this amount, if any, that the Commissioner would cancel under section 177F.[200]

Purpose

No purpose other than the obtaining of a tax benefit suggests itself having regard to the terms of the scheme. Therefore, on the basis of the information provided, it is reasonable to conclude that the sole purpose of the restructuring was to enable the consolidated group to obtain greater allowable deductions

[200] Company A also obtains an omitted income tax benefit from the scheme: but for the scheme, Company C would have been a subsidiary member of a consolidated group consisting of Companies A, B and C. That is, but for the scheme, the income generated by Company C would have been the assessable income of Company A as head company of the consolidated group. If the omitted income benefit is cancelled under section 177F, then Company A may be entitled to a compensating adjustment under section 177F(3) in respect of some or all of the deductions that would have been allowable to it but for the scheme (that is, but for Company C remaining outside the consolidated group).

through greater access to Company B's losses than would have been available had Companies A, B and C consolidated.

Policy context

It is a design feature of the consolidation measure that wholly owned Australian resident subsidiaries of a foreign resident company will not be prevented from forming a consolidated group where the foreign resident has more than one strand of investment into Australia. Moreover, each 'entry level' entity within each strand of investment is free to choose to group with other 'entry level' entities and form a multiple entry consolidated (MEC) group, form a consolidated group or remain unconsolidated (see paragraph 4.3 of the EM to the New Business Tax System (Consolidation) Bill (No 1) 2002). This approach was designed to meet the operational needs of certain foreign owned groups which operate their subsidiaries on an autonomous basis.

The present scenario does not present the case of a group which can, without restructuring, take advantage of these choices available to wholly owned Australian resident subsidiaries of a foreign resident company. Further, the facts of the present scenario point towards the restructuring having been undertaken solely in order for the group to avoid the consequences of the 'all in principle' and bring itself within the scope of the operation of the MEC rules with their attendant advantages.[201] From a policy position, this suggests that the general anti-avoidance rules should have application.

More generally, arrangements, including group restructures, entered into to manipulate available fractions or otherwise increase the rate of loss utilisation by a consolidated group are not consistent with the intended policy outcome. The potential application of Part IVA in these situations was referred to in paragraph 8.102 of the EM to the May 2002 Bill.

Scenario 6: Shifting of value out of a consolidatable group prior to consolidation[202]

A non-resident parent company owns 100% of the shares in Company X which is a resident of Australia. Company X in turn has two wholly-owned subsidiaries Companies Y and Z, both of which are residents of Australia. Company X has a modified market value of $10 and no losses. Company Y has a modified market value of $100 and a tax loss of $100. Company Z has a modified market value of $100 and no tax losses.

[201] Note however that in being left out of the consolidated group, Company C misses out on the compliance benefits associated with grouping with Companies A and B and further forgoes the opportunity of having the cost of its assets reset.

[202] For the purposes of this scenario, the available fractions are worked out on the basis that the value donor concession rules are not available.

Company Z declares a franked dividend of $70 in favour of Company X. Company X in turn declares a franked dividend of $70 in favour of the non-resident parent company.

Subsequent to the declaration of dividends, the group consisting of Companies X, Y and Z consolidate.

The scheme

For the purposes of section 177A, the scheme could consist of the declaration of a dividend by Company Z in favour of Company X followed by the declaration of a dividend by Company X in favour of the non-resident parent company.

The tax benefit

As a result of the declaration of the dividends, the modified market value of Company Z has decreased from $100 to $30. The modified market value of Company X remains unchanged as the value of its new assets (the dividend declared by Company Z) is offset by its new liability (the dividend declared by Company X in favour of the non-resident parent). The reduction in the modified market value of Company Z results in the available fraction in respect of the loss bundle Company Y brings into the group increasing from 100/210 = 0.476, to 100/140 = 0.714. Assuming that the consolidated group has sufficient assessable income in the first year of consolidation to benefit from the higher available fraction, the increase in the available fraction means the losses brought into the group by Company Y can be utilised at a faster rate than they could have been had $70 of the value in Company Z not been 'shifted' to the parent company by way of a dividend. That is, Company X, as the head company of the consolidated group, is entitled to a greater deduction than would have been the case but for the scheme. This is a tax benefit obtained in connection with the scheme. The amount of the tax benefit obtained by Company X is the difference between the amount of the loss deduction allowable in the first year to Company X and the amount of the loss deduction that it would have been entitled to in that year if the scheme had not occurred. It is this amount, if any, that the Commissioner would cancel under section 177F.

Purpose

Given that the scheme consists solely of the payment of dividends by Companies Y and Z, and that there are no additional relevant facts, it is difficult to posit objectively that the dominant purpose of entering into the scheme is to enable Company X, as the head company of the consolidated group, to obtain a tax benefit. There are many commercial reasons which may explain why a chain of dividends was declared for the benefit of the non-resident parent company, the ultimate economic owner of the group[203]. These points suggest that Part IVA will not have application.

This conclusion could well, however, be different if further matters bearing on the manner of carrying out the scheme and its form and substance indicated that that the dividend was a distribution in form only. Should, for example, there be evidence that the declared dividends remain unpaid or are loaned back by the non-resident parent to the group; or were immediately recapitalised by an issue of shares, or the like; or that the company could not in commercial prudence make a distribution in the circumstances, a different conclusion might follow. Similarly, the conclusion may be different if Company Z had previously had a policy over a lengthy period of not paying dividends (that is, a 100% profit retention policy), or the dividend declared by Company Z represented all of the pre-dividend market value of the company, thereby rendering Company Z essentially valueless.

Scenario 7: Disposal of a minority interest in a group company prior to the group consolidating[204]

A non-resident parent company owns 100% of the shares in Company L which is a resident of Australia. Company L in turn has two wholly-owned subsidiaries, Companies M and N, both of which are residents of Australia. Company L has a modified market value of $10 and no losses. Company M has a modified market value of $100 and a tax loss of $100. Company N has a modified market value of $100 and no tax losses.

Prior to consolidating, the group undergoes the following restructure:

- Company L disposes of 5% of its shareholding in Company N to a third party for $5;
- Company L then rolls over the remaining 95% of its shareholding in Company N to Company M and claims CGT rollover relief;
- Company L receives additional shares in Company M in return for the transfer of the shares in Company N to Company M.

The following diagram illustrates the company group structure both before and after the restructuring:

Subsequent to the restructure, Companies L and M consolidate.

[203] By way of contrast with the situation in Scenario 6, Scenario 7 does not present a situation in which the 'all in principle' has been offended.

[204] For the purposes of this scenario, the available fractions are worked out on the basis that the value donor concession rules are not available. It is further assumed that section 707-325(2) does not have application; this may not be the case.

The scheme

For the purposes of section 177A, the scheme could consist of:

- the disposal by Company L of 5% of its shareholding in Company N for valuable consideration;
- the disposal by Company L of the remaining 95% of its shareholding in Company N to Company M; and
- the claiming of CGT rollover relief in relation to the disposal.

The tax benefit

As a result of the scheme, the available fraction in respect of the loss bundle Company M brings into the group has increased from 100/210 = 0.476 to 195/210 = 0.929. This increase in the available fraction reflects the fact that the modified market value of Company M has increased from $100 to $195 as a result of the scheme (the modified market value of Company M includes the amount attributable to its membership interest in Company N, a non-member company of the consolidated group ($95)).

Assuming that the consolidated group has sufficient assessable income in the first year of consolidation to benefit from the higher available fraction, the increase in the available fraction means the loss bundle brought into the group by Company M can be utilised at a faster rate than they could have been had Companies L, M and N consolidated. That is, Company L, as the head company of the consolidated group, is entitled to a greater deduction than would have been the case but for the scheme. The tax benefit obtained by Company L is the difference between the amount of the loss deduction allowable in the first year to Company L and the amount of the loss deduction that it would have been entitled to in that year if the scheme had not occurred. It is this amount, if any, that the Commissioner would cancel under section 177F.[205]

Purpose

In substance, by a combination of:

- a sale by Company L of a relatively small percentage of its equity interest in Company N to a third party; and
- rolling over the remainder of its interest to Company M,

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[205] Company L also obtains an omitted income tax benefit from the scheme: but for the scheme, Company N would have been a subsidiary member of a consolidated group consisting of Companies L, M and N. That is, but for the scheme, the income generated by Company N would have been the assessable income of Company L as head company of the consolidated group. If the omitted income benefit is cancelled under section 177F, then Company L may be entitled to a compensating adjustment under section 177F(3) in respect of some or all of the deductions that would have been allowable to it but for the scheme (that is, but for Company N remaining outside the consolidated group).

the group has maintained an effective economic control of Company N while increasing substantially the rate at which it can access the losses Company M brings into the group. On the basis of the information provided, the manner in which the scheme has been carried out is contrived and has no obvious commercial justification. This points towards the application of Part IVA.

Policy context

Similarly to Scenario 5, the facts of Scenario 7 point towards the restructuring having been undertaken in order to avoid the consequences of the 'all in principle'. However, in this example, the consequences of the 'all in principle' are not simply avoided. In addition, the value of the company excluded from the group increases the modified market value of Company M. This increase in the modified market value of Company M ultimately results in an increase in the rate at which the group can access the losses brought into the group by Company M.[206] From a policy position, these considerations suggest that the general anti-avoidance rules should have application.

More generally, as noted in relation to Scenario 5, arrangements, including group restructures, entered into to manipulate available fractions or otherwise increase the rate of loss utilisation by a consolidated group are not consistent with the intended policy outcome. The potential application of Part IVA in these situations was referred to in paragraph 8.102 of the EM to the May 2002 Bill.

Scenario 8: Disposal of a minority interest in a group company prior to the group consolidating[207]

A non-resident parent company owns 100% of the shares in Company L which is a resident of Australia. Company L in turn has two wholly-owned subsidiaries, Companies M and N, both of which are residents of Australia. Company L has a modified market value of $10 and a tax loss of $100. Company L has no available capital losses. Company M has a modified market value of $100 and no tax losses. Company N has a modified market value of $100 and no tax losses.

Prior to consolidating, Company L disposes of 5% of its shareholding in Company N to a related third company for $5 triggering a capital gains tax liability. This related third company could not become part of the consolidated group comprising Company L, Company M and Company N, nor could it form a MEC group with Companies L, M and N, as the non-resident parent

[206] Note however that in being left out of the consolidated group, Company N misses out on the compliance benefits associated with grouping with Companies L and M and further forgoes the opportunity of having the cost of its assets reset.

[207] For the purposes of this scenario, the available fractions are worked out on the basis that the value donor concession rules are not available. It is further assumed that section 707-325(2) does not have application; this may not be the case.

only owns 90% of its shares, the other 10% being owned by non-related Australian residents.

The following diagram illustrates the company group structure both before and after the restructuring:

Subsequent to the restructure, Companies L and M consolidate.

The scheme

For the purposes of section 177A, the scheme could consist of the disposal by Company L of 5% of its shareholding in Company N for valuable consideration.

The tax benefit

As a result of the scheme, the available fraction in respect of the loss bundle Company L brings into the group has increased from 10/210 = 0.048 to 110/210 = 0.524. This increase in the available fraction reflects the fact that the modified market value of Company L has increased from $10 to $110 as a result of the scheme (the modified market value of Company L includes the amount attributable to its membership interest in Company N, a non-member company of the consolidated group ($95) and the consideration of $5 received for disposal of the membership interests in Company N to the related third party).

Assuming that the consolidated group has sufficient assessable income in the first year of consolidation to benefit from the higher available fraction, the increase in the available fraction means the losses brought into the group by Company L can be utilised at a faster rate than they could have been had Companies L, M and N consolidated. That is, Company L, as the head company of the consolidated group, is entitled to a greater deduction than would have been the case but for the scheme. The tax benefit obtained by Company L is the difference between the amount of the loss deduction allowable in the first year to Company L and the amount of the loss deduction that it would have been entitled to in that year if the scheme had not occurred. It is this amount that, if any, the Commissioner would cancel under section 177F.[208]

Purpose

As in Scenario 7, in substance as a result of the sale by Company L of a relatively small percentage of its equity interest in Company N to a third party,

[208] Company L also obtains an omitted income tax benefit from the scheme: but for the scheme, Company N would have been a subsidiary member of a consolidated group consisting of Companies L, M and N. That is, but for the scheme, the income generated by Company N would have been the assessable income of Company L as head company of the consolidated group.

the economic group, including the non-resident parent company, has maintained an effective economic control of Company N while increasing substantially the rate at which it can access the losses Company L brings into the group. On the basis of the information provided, the manner in which the scheme has been carried out is contrived and has no obvious commercial justification. This points towards the application of Part IVA. The fact that the shares in Company N were sold to a related third party ultimately controlled by the non-resident parent of Company L increases the likelihood that Part IVA will apply.

However, the transaction as implemented triggers a potential capital gain for Company L. The size of this potential net capital gain arising from the scheme must be taken into consideration when determining a participant's sole or dominant purpose in entering into the scheme. For example, if the expected net capital gain is greater than Company L's expected tax benefit in the first year, then there may be doubts as to whether the dominant purpose of any participant in entering into the scheme was to obtain the tax benefit in that first year. Alternatively, further evidence may suggest that the dominant purpose of a participant in entering into the scheme was to obtain a tax benefit in the first year, notwithstanding the capital gain arising in that year. In any case, one of the participants in the scheme may still have a dominant purpose of allowing Company L to obtain a tax benefit (in the form of greater loss deductions) in the second or a subsequent year.[209]

Scenario 9: Disposal of an interest in a group company prior to the group consolidating[210]

A non-resident parent company owns 100% of the shares in Company A which is a resident of Australia. Company A has a resident wholly-owned subsidiary, Company B, which in turn has a resident wholly owned subsidiary, Company C. Company A has a modified market value of $10 and no tax losses. Company B has a modified market value of $100 and a tax loss of $100. Company C has a modified market value of $100 and no tax losses.

Prior to consolidating, Company B disposes of 50% of its shareholding in Company C to the non-resident parent for $50. Company B claims rollover relief in respect of this disposal.

The following diagram illustrates the company group structure both before and after the restructuring:

[209] In this situation, the tax benefit obtained in the first year could still be cancelled being a tax benefit obtained in connection with the scheme for the purposes of subsection 177F(1) of the ITAA 1936.

[210] For the purposes of this scenario, the available fractions are worked out on the basis that the value donor concession rules are not available. It is further assumed that section 707-325(2) does not have application; this may not be the case.

Subsequent to the restructure, Companies A and B consolidate.

The scheme

For the purposes of section 177A, the scheme could consist of the disposal by Company B of 50% of its shareholding in Company C for valuable consideration.

The tax benefit

As a result of the scheme, the available fraction in respect of the loss bundle Company B brings into the group has increased from 100/210 = 0.476 to 200/210 = 0.952. This increase in the available fraction reflects the fact that the modified market value of Company B has increased from $100 to $200 as a result of the scheme (the modified market value of Company B includes the amount attributable to its membership interest in Company C, a non-member company of the consolidated group ($50) and the consideration of $50 received in respect of the disposal).

Assuming that the consolidated group has sufficient assessable income in the first year of consolidation to benefit from the higher available fraction, the increase in the available fraction means the losses brought into the group by Company B can be utilised at a faster rate than they could have been had Companies A, B and C consolidated. That is, Company A, as the head company of the consolidated group, is entitled to a greater deduction than would have been the case but for the scheme. The tax benefit obtained by Company A is the difference between the amount of the loss deduction allowable in the first year to Company A and the amount of the loss deduction that it would have been entitled to in that year if the scheme had not occurred. It is this amount, if any, that the Commissioner would cancel under section 177F.[211]

Purpose

In this scenario, Company B has sold a large percentage of its equity interest in Company C, but the sale is to the ultimate parent of the group. As a consequence, the group has maintained total economic control of Company C while increasing substantially the rate at which it can access the losses Company B brings into the group. On the basis of the information provided, the manner in which the scheme has been carried out is contrived and has no obvious commercial justification. This points towards the application of Part IVA.

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[211] Company A also obtains an omitted income tax benefit from the scheme: but for the scheme, Company C would have been a subsidiary member of a consolidated group consisting of Companies A, B and C. That is, but for the scheme, the income generated by Company C would have been the assessable income of Company A as head company of the consolidated group.

Scenario 10: Disposal of a minority interest in a group company prior to the group consolidating

A holding company immediately before 1 July 2002 owns all the shares in a number of subsidiaries, including a finance subsidiary. The finance subsidiary lent a substantial amount in a previous year of income to Debtor Co, another of the group's subsidiaries. The loan was lent in the ordinary course of its business of lending money to group companies. No part of the loan to Debtor Co was repaid by the due date. The finance company has a strong expectation that the debt will become bad in the near future. Post consolidation any bad debt owed by one group member of the consolidated group to another group member would not be taken into account in calculating the head company's taxable income.

Subsequent to the realisation that Debtor Co was unlikely to be able to repay any of the loan, but before a choice is made to consolidate the group, the finance subsidiary issues a 1% shareholding to an unrelated third party for valuable consideration. The remaining 99% of the issued shares are retained by the holding company. The amount raised from this share issue is substantially less than the potential reduction in the tax payable that may arise as a consequence of the finance subsidiary being able to obtain a bad debt deduction for the loan made to Debtor Co.

Soon after this issue of shares by the finance subsidiary, the holding company elects for the wholly owned group of which it is the head company to consolidate. As the finance company is no longer a wholly owned subsidiary of the holding company, the finance company does not become a member of the consolidated group. Subsequently, the finance company writes off the debt owed to it by Debtor Co. The finance company claims a deduction for the amount of the debt under section 25-35 of the ITAA 1997.[212]

The scheme

For the purposes of section 177A, the scheme could consist of the issue by the finance company of shares in itself to the third party.

The tax benefit

In these circumstances the tax benefit under paragraph 177C(1)(b) is the full amount of the deductions available to the finance company. But for the scheme, it is reasonable to assume that the finance company would not have issued shares to the third party. Rather, the finance company would have remained a wholly owned subsidiary of the holding company and become a member of the consolidated group. It follows that but for the scheme, no

[212] For the purposes of this scenario, it is assumed that the commercial debt forgiveness provisions contained in Schedule 2C to the ITAA 1936 have no application.

deductions would have been allowable to the finance company: as a result of the single entity principle, the bad debt would not be recognised.[213]

However, the actual tax advantage obtained by the finance company is simply the difference between the deductions the finance company is entitled to as an entity outside the consolidated group, and those deductions that the head company would have been entitled to as a consequence of the finance company being a member of the consolidated group. It is this amount, if any, that the Commissioner would cancel under section 177F, and not the total amount of deductions available to the finance company.

Purpose

In the absence of anything indicative of a non-tax related purpose for the issue of a small shareholding to a third party which raises comparatively little capital for the finance company, the facts objectively suggest the dominant, if not sole purpose, of the scheme is to obtain a tax benefit in the form of a deduction that would not be available but for the scheme.

Policy context

The facts of this scenario point towards the share issue having been undertaken in order for the group to avoid the consequences of the 'all in principle' and the 'single entity principle'. While the issue of shares in the finance company to a third party results in the finance company remaining outside the consolidated group with the consequent tax advantages, the group effectively gives up very little economic ownership of the company. Furthermore, under the compulsory acquisition rules contained in the *Corporations Act 2001*, the group could, subject to the statutory limitations on the exercise of the power, compulsorily acquire the third party's interest in the finance company at a later time, bringing the finance company into the group. This suggests that the general anti-avoidance rules should have application.

Scenario 11: Disposal of a minority interest in a group company prior to the group consolidating

Assume the same facts as in Scenario 10 with the following modifications. The finance company is lacking in funds and needs to raise capital. Rather than issuing a 1% shareholding to the third party, the company instead issues a 20% shareholding to the third party. Also assume that the amount raised from this share issue is substantially more than the potential reduction in the tax payable that may arise as a consequence of the finance subsidiary being able to obtain a bad debt deduction for the loan made to Debtor Co. The rights attaching to

[213] The holding company also obtains an omitted income tax benefit from the scheme: but for the scheme, the finance subsidiary would have been a subsidiary member of a consolidated group consisting of the holding company and its 100% wholly owned subsidiaries. That is, but for the scheme, the income generated by the finance subsidiary would have been the assessable income of holding company as head company of the consolidated group.

the shares issued to the third party provide that party with rights equivalent to those attaching to the shares owned by the holding company. Finally, assume that the issue of the shareholding to the third party occurs three days prior to the holding company electing to consolidate.

The scheme and the tax benefit

As in Scenario 10, the finance company obtains a tax benefit (the deductions not otherwise available, including the bad debt deduction) in connection with a scheme (the issue by the finance company of shares in itself to the third party).

Purpose

However, in contrast to Scenario 10, on the facts of Scenario 11 it would be difficult to posit that the objective purpose of entering into the scheme is to obtain of the tax benefit. The arrangement does not appear to be dominantly 'tax driven'. The manner in which the shares are issued is unremarkable; the form and substance of the scheme correspond—it is a capital raising in a way that gives a significant and meaningful economic interest in itself to the third party. The scheme is explicable by the purpose of raising capital. The fact that the issue of the shareholding in the finance subsidiary occurred only three days prior to the holding company electing to consolidate points, of itself, only weakly towards the possible application of Part IVA.

Policy context

In contrast to Scenario 10, the group has in reality suffered a significant reduction of its economic interest in the finance subsidiary. The arrangements do not appear to have been entered into for the purpose of getting around the 'all in principle'. Rather shares in the finance company were issued in order to raise needed capital. These considerations suggest that the general anti-avoidance provisions should not have application.

Scenario 12: Post consolidation dissolution of a company

Airline Co owns all the shares in Zeppelin Co, a failed airline. Zeppelin Co, purchased some years earlier, has no assets, no longer has any (commercial) goodwill attached to its name, and has been wound up. The only step remaining is the deregistration and dissolution of the company. Zeppelin Co has a large mixture of capital and revenue losses from a crash that occurred two years after its acquisition by Airline Co. The group has not been able to fully recoup these losses. A decision to transfer all of Zeppelin's assets, business operations and staff, and then wind up Zeppelin Co on the grounds that its continued existence served no commercial purpose was made six months before 1 July 2002, and, with the exception of deregistration, carried out. After 1 July 2002, the group consisting of Airline Co and Zeppelin Co consolidate. Zeppelin Co satisfies the relevant loss transfer tests and its losses are transferred into the consolidated group. Zeppelin Co is then deregistered on 31 December 2003.

Airline Co has other subsidiaries and would have been able to consolidate even if Zeppelin Co had been deregistered.

The scheme and purpose

The course of action of continuing to conduct the company's affairs, such as they are, amounts to a scheme (as is the winding up itself). The plan to deregister the company only after electing to consolidate is also a scheme. But for the scheme, the original proposal to wind the company up would have been carried out in full, and the company deregistered. The time at which the scheme was entered into and the length of the period during which it was carried out, together with the manner in which the scheme is carried out, would be the deciding factors. While no inference of a dominant purpose of obtaining a tax benefit could be made merely from allowing a company that existed prior to consolidation to continue to exist after consolidation, nor from the mere fact that deregistration did not occur at the earliest possible time, a long delay in deregistration would be difficult to explain on non-tax commercial grounds. A winding up entered into for non-tax reasons may be carried out in an abnormal way to obtain a tax benefit from losses and for that dominant purpose. However, in this case, the short period of time involved does not support that inference. These points suggest that Part IVA will not have application.

Scenario 13: Purchase of minority interests in a group company prior to consolidation

Parent Co owns 99% of the issued shares in Sub Co. The remaining 1% of the issued shares are held by the directors of Sub Co as directors' qualifying shares; these shares do not attract the operation of subsection 703-35(4) (regarding employee shares). Sub Co has generated a large amount of losses from its business activities. Following a change to the constitution of Sub Co removing the requirement for directors of Sub Co to hold shares in the company, Parent Co acquires the remaining shares in Sub Co from Sub Co's directors making Sub Co a wholly owned subsidiary of Parent Co. Sub Co and Parent Co subsequently consolidate. Sub Co satisfies the relevant loss transfer test enabling it to bring its losses into the consolidated group. In the absence of this share purchase neither Parent Co, nor Sub Co, could become members of a consolidatable group.

The scheme

For the purposes of section 177A, the scheme could consist of the purchase by Parent Co of the remaining shares in Sub Co making Sub Co a wholly owned subsidiary of Parent Co followed by the election of Parent Co to consolidate.

The tax benefit

As a result of the scheme, Parent Co is entitled to a number of separate deductions that Sub Co would otherwise have been entitled to in the absence of the scheme. Parent Co is also entitled to a deduction in respect of the carry forward losses that Sub Co brings into the consolidated group. In these circumstances, a number of different tax benefits arise. Those tax benefits are the difference between the full amount of a deduction having a particular character that is allowable to Parent Co as head company of a consolidated group that includes Sub Co as a member, and the amount of the deduction of that character that Parent Co would have been entitled to in the absence of the scheme. [214] [215]

Purpose

Since Sub Co was the only subsidiary of Parent Co, the purpose of the scheme, it might be inferred, was to enable the Parent Co to choose to consolidate. Consequently, subsection 177C(2) will not apply. The question is whether it might also be inferred from the scheme that the purpose for purchasing the shares was to obtain a tax benefit for losses. The scheme might also be explicable as a result of the elimination of the directors' shareholding requirement for other reasons, or by reference to the cost advantages of consolidation. The small number of shares, and relatively minor non-tax effects derived from purchasing them, make the case on or near the borderline. Effects point to the purpose of obtaining a tax benefit. However, there is nothing in the manner of the scheme, as described, that particularly indicates a prevailing purpose of tax avoidance, and the form and substance of the scheme correspond. Duration of the scheme, assuming the shares are to be held indefinitely, will assist the taxpayer. The circumstances in which Sub Co was acquired as a subsidiary and in which the loss arose are not included in the scheme, and therefore cannot point to a purpose of tax avoidance. If closer examination of the facts did not reveal material adverse to the taxpayer, one would not conclude that the dominant purpose of the scheme was to obtain a deduction for losses.

Policy context

As a matter of policy, there is no mischief in the mere acquisition of minority interests owned by a third party in a group subsidiary by the group prior to consolidation. However, if the original owners of the minority interests retain an economic interest in the subsidiary post disposing of their shares to the group the position would be different from a policy perspective, and the conclusion under section 177D might also be different.

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[214] Sub Co obtains an omitted income tax benefit from the scheme. But for the scheme Sub Co would not have been a subsidiary member of a consolidated group, and the income generated by Sub Co would have been its assessable income and not that of the head company of the consolidated group. Sub Co may be entitled to a compensating adjustment under subsection 177F(3) in respect of some or all of the deductions that would have been allowable to it but for the scheme (that is, but for Sub Co becoming a member of the consolidated group).

[215] Parent Co may be entitled to a compensating adjustment, under subsection 177F(3) in respect of some, or all, of the assessable income that is generated by Sub Co's activities that Parent Co derives as a consequence of being consolidated with Sub Co.

Scenario 14: Purchase of minority interests in a group company prior to consolidation

Parent Co owns 85% of the issued shares in Sub Co. The remaining 15% of the issued shares are held by a number of parties. Sub Co has generated a large amount of losses from its business activities. Parent Co has other subsidiaries, and would be able to consolidate even if Sub Co was not a wholly owned subsidiary. Parent Co acquires the remaining shares in Sub Co for the full market value of those shares, and the previous minority owners retain no legal or economic interest in Sub Co. The share acquisition makes Sub Co a wholly owned subsidiary of Parent Co. Parent Co elects to form a consolidated group and Sub Co becomes a member of the consolidated group. Sub Co satisfies the relevant loss transfer test enabling it to bring its losses into the consolidated group.

The scheme

For the purposes of section 177A, the scheme could consist of the purchase by Parent Co of the remaining shares in Sub Co, making Sub Co a wholly owned subsidiary of Parent Co.

The tax benefit

As a result of the scheme, Parent Co is entitled to a number of separate deductions that Sub Co would otherwise have been entitled to in the absence of the scheme. Parent Co is also entitled to a deduction in respect of the carry forward losses that Sub Co brings into the consolidated group. In these circumstances, a number of different tax benefits arise. Those benefits are the difference between the full amount of a deduction having a particular character that is allowable to Parent Co as head company of a consolidated group that includes Sub Co as a member, and the amount of the deduction of that character that Parent Co would have been entitled to in the absence of the scheme.[216] [217]

Purpose

Objectively speaking it is difficult to conclude on the basis of the facts of this scenario that the dominant purpose of Parent Co in purchasing the remaining shares in Sub Co was to obtain a tax benefit, being deductions attributable to

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[216] Sub Co obtains an omitted income tax benefit from the scheme. But for the scheme Sub Co would not have been a subsidiary member of a consolidated group, and the income generated by Sub Co would have been its assessable income and not that of the head company of the consolidated group. Sub Co may be entitled to a compensating adjustment under subsection 177F(3) in respect of some or all of the deductions that would have been allowable to it but for the scheme (that is, but for Sub Co becoming a member of the consolidated group).

[217] Parent Co may be entitled to a compensating adjustment, under subsection 177F(3) in respect of some, or all, of the assessable income that is generated by Sub Co's activities that Parent Co derives as a consequence of being consolidated with Sub Co.

the access by Parent Co of the losses of Sub Co. In the absence of unusual features, a real outlay of money for a substantial stake in a company would ordinarily be explained by reference to a purpose of deriving income from holding the shares.

Policy context

As noted in relation to Scenario 13, as a matter of policy, there is no mischief in the mere acquisition of minority interests owned by a third party in a group subsidiary by the group prior to consolidation if the original owners of the minority interests do not retain an economic or legal interest in the subsidiary post disposal of the shares to the group. The mere buying out of a minority interest in order to consolidate is consistent with the desired policy outcome that groups will consolidate to access the intended benefits of the consolidation regime and will then be necessarily subject to the improved integrity aspects of the regime.

Scenario 15: Purchase of minority interests in a group company prior to consolidation

Parent Co, the parent company of a corporate group, owned 85% of the issued shares in Sub Co that was deregistered a number of years after having ceased to carry on any business activities. Prior to deregistration, the remaining 15% of the issued shares were held by a number of parties. At the time of deregistration, Sub Co was carrying a large amount of losses that the group had not been able to access under the income tax loss grouping provisions. Parent Co has other subsidiaries, and would be able to consolidate. Parent Co applies to the court to have Sub Co reinstated and the court makes an order for the reinstatement of the company. Parent Co subsequently acquires the remaining shares in Sub Co for the full market value of those shares. The previous minority owners retain no legal or economic interest in Sub Co. The share acquisition makes Sub Co a wholly owned subsidiary of Parent Co. Parent Co elects to form a consolidated group and Sub Co becomes a member of the consolidated group. Sub Co satisfies the relevant loss transfer test enabling it to bring its losses into the consolidated group.

The scheme

For the purposes of section 177A, the scheme could consist of the application by Parent Co for the reinstatement of Sub Co followed, after the company's reinstatement, by the purchase by Parent Co of the remaining shares in Sub Co making Sub Co a wholly owned subsidiary of Parent Co.

The tax benefit

As a result of the scheme, Parent Co is entitled to a deduction via its access to the losses Sub Co brings with it into the consolidated group.[218] But for both

[218] It is assumed that Sub Co has a non-zero, albeit very small, modified market value.

the reinstatement of Sub Co, and the purchase by Parent Co of the remaining shares in Sub Co, Parent Co would not have been able to access Sub Co's losses. The entitlement of Parent Co to a deduction is a tax benefit obtained in connection with the scheme.

Purpose

Scenario 15 illustrates a situation where the presence of unusual facts points to a conclusion that what is a real outlay for a substantial stake in a company nonetheless is objectively not explicable by reference to a purpose of deriving income from the holding of shares but rather the purpose of obtaining a tax benefit. Sub Co, but for the scheme, had ceased to exist. Furthermore, prior to deregistration of the company, Sub Co was a 'dormant' company: Sub Co had not carried on any business activities for a number of years prior to deregistration. All these facts point to the application of Part IVA.

Scenario 16: Purchase of minority interests in a group company prior to consolidation

Parent Co owns 85% of the issued shares in Sub Co. The remaining 15% of the issued shares are held by Mr X, an individual taxpayer. Parent Co has other subsidiaries, and would be able to consolidate even if Sub Co was not a wholly owned subsidiary. Sub Co has generated a large amount of losses from its business activities. Parent Co acquires the remaining shares in Sub Co making Sub Co a wholly owned subsidiary of Parent Co, subject, however, to a call option issued by Parent Co in favour of Mr X, and a put option issued by Mr X in favour of Parent Co over the shares. The put and call options cannot be exercised for a period of three years. Under an enforceable collateral arrangement between all the parties it is agreed that Sub Co will not pay distributions to shareholders during the three years following the transfer of the shares from Mr X to Parent Co. The difference between the price paid by Parent Co for Mr X's 15% share holding, and the price payable by Mr X for a 15% shareholding under either the put or call options, is approximately 50% of the net present value of the expected reduction in tax payable by Parent Co as a result of the losses brought into the group by Sub Co.

It is expected that all of the losses that Sub Co brings to the consolidated group will be utilised within three years. Sub Co and Parent Co subsequently consolidate. Sub Co satisfies the relevant loss transfer test enabling it to bring its losses into the consolidated group.

The following diagram illustrates the key aspects of the scheme:

The scheme

For the purposes of section 177A, the scheme could consist of:

- the purchase by Parent Co of the remaining shares in Sub Co making Sub Co a wholly owned subsidiary of Parent Co; and

- the granting of a call option by Parent Co in favour of Mr X, and the granting of a put option by Mr X in favour of Parent Co over the shares.

The tax benefit

As a result of the scheme, Parent Co is entitled to a number of separate deductions that Sub Co would otherwise have been entitled to in the absence of the scheme. Parent Co is also entitled to a deduction in respect of the carry forward losses that Sub Co brings into the consolidated group. In these circumstances, a number of different tax benefits arise. Those benefits are the difference between the full amount of a deduction having a particular character that is allowable to Parent Co as head company of a consolidated group that includes Sub Co as a member, and the amount of the deduction of that character that Parent Co would have been entitled to in the absence of the scheme. [219] [220]

Purpose

Objectively speaking, the fact that Parent Co as the head of the consolidated group has obtained access to the losses of Sub Co via consolidation, while Mr X who originally owned the 15% shareholding bought by Parent Co has retained a significant economic interest in the shareholding (by way of the put and call options), suggests that the dominant purpose of Parent Co in entering the scheme was to obtain a tax benefit from the scheme.

Policy context

In contrast to Scenarios 13 and 14, this scenario is not one of a mere acquisition of minority interests prior to consolidation. By acquiring 100% of the issued shares in Sub Co subject to put and call options issued over a substantial fraction of its shareholding in the subsidiary, Parent Co is effectively seeking to gain access to the advantages offered by consolidation in a situation where, in substance, Sub Co is not economically its wholly owned subsidiary. The manner in which the scheme is carried out, and the lack of congruence between form and substance point to the scheme having been entered into in that particular way dominantly to obtain tax benefits. The result also offends the design principle underlying consolidation that the consolidation regime is only available to a head company and its wholly owned subsidiaries.

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[219] Sub Co obtains an omitted income tax benefit from the scheme. But for the scheme Sub Co would not have been a subsidiary member of a consolidated group, and the income generated by Sub Co would have been its assessable income and not that of the head company of the consolidated group. Sub Co may be entitled to a compensating adjustment under subsection 177F(3) in respect of some or all of the deductions that would have been allowable to it but for the scheme (that is, but for Sub Co becoming a member of the consolidated group).

[220] Parent Co may be entitled to a compensating adjustment, under subsection 177F(3) in respect of some, or all, of the assessable income that is generated by Sub Co's activities that Parent Co derives as a consequence of being consolidated with Sub Co.

Scenario 17: Purchase of minority interests in a group company prior to consolidation

Xco owns 51% of the shares in Zco. Yco owns the remaining 49% of the shares. The market value of a 49% shareholding in Zco is $49,000,000.

Zco has a large amount of carry forward losses.

Xco buys all of the shares in Zco held by Yco for $1. At the same time Zco issues $49,000,000 of debt instruments (notes) to Yco. These notes are a form of 'synthetic shares' under which the amount of interest payable on each note is equal to the amount of dividend paid by Zco to its actual shareholder (namely Xco) during the year. The notes are only redeemable when Zco is wound up. The redemption amount is the higher of either the face value of the notes, or 49% of the market value of Zco's net assets (after taking into account amounts owed to other creditors). The synthetic shares do not count as membership interests for the purposes of the consolidation measure. The synthetic shares are, however, treated as equity under Div 974 of the ITAA 1997 and can support the payment of frankable non-share dividends. Xco subsequently chooses to form a consolidated group with Zco.

The following diagram illustrates the key aspects of the scheme:

The scheme

For the purposes of section 177A, the scheme could consist of:

- the purchase by Xco of the shares Yco owns in Zco for nominal consideration;
- the issue by Zco of non-share equity interests in itself to Yco with face value equal to the market value of Yco's previous shareholding in Zco; and
- the choice by Xco to consolidate.

The tax benefit

As a result of the scheme, Xco is entitled to all the current year deductions that Zco would otherwise have been entitled to. Xco is also entitled to deductions in respect of the losses that Zco brings into the consolidated group. But for the purchase of the shares by Xco it would not have been eligible to form a consolidated group. In these circumstances, a number of separate tax benefits arise. Those benefits are the difference between the full amount of the various deductions allowable to Xco as head company of a consolidated group that includes Zco as a member, and the deductions, if any, of that type that Xco would have been entitled to in the absence of the scheme. [221] [222]

[221] Zco obtains an omitted income tax benefit from the scheme. But for the scheme Zco would not have been a subsidiary member of a consolidated group, and the income generated

Purpose

The facts of this scenario point towards the objective dominant purpose of entering into the scheme being the obtaining of a tax benefit by Xco. In particular, the purchase by Xco of Yco's shareholding in Zco for nominal consideration followed immediately by the issue by Zco of non-share equity interests in itself to Yco objectively appears to be solely for the purpose of allowing Yco to retain an economic interest in Zco comparable to that which it owned prior to the purchase of its shareholding by Xco while also allowing Zco to enter a consolidated group with Xco. This indicates that Part IVA should have application.

Policy context

As with Scenario 16, this scenario is not one of a mere acquisition of minority interests prior to consolidation. By acquiring 100% of the issued shares in Zco in circumstances where, immediately after the share acquisition, Zco issues non-share equity interests in itself to Yco, Xco is effectively seeking to gain access to the advantages offered by consolidation in a situation where, in substance, Zco is not economically its wholly owned subsidiary. It is a design feature of the consolidation regime that non-share equity interests are ignored for the purpose of determining whether one entity has a membership interest in another entity. However, the present scenario does not present the case of a group which could, but for the scheme, take advantage of this design feature. Instead, the facts of the present scenario point towards the scheme having been undertaken in order for the group to avoid the consequences of the principle that only wholly owned subsidiaries of a head company are able to become members of a consolidated group and bring itself within the scope of the exclusion from the definition of membership interests of non-share equity. Indeed, prior to the scheme being carried out, there was in fact no consolidatable group. The manner in which the scheme is carried out, and the lack of congruence between form and substance point to the scheme having been entered into in that particular way predominantly in order to obtain tax benefits. This suggests the general anti-avoidance rules should have application.

Scenario 18: The use of a special purpose vehicle to issue preference shares to unrelated investors

Parent Co is the head company of an Australian corporate group. Subco, a wholly owned subsidiary of Parent Co, is the holding company of a wholly

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by Zco would have been its assessable income and not that of the head company of the consolidated group. Zco may be entitled to a compensating adjustment under subsection 177F(3) in respect of some or all of the deductions that would have been allowable to it but for the scheme (that is, but for Zco becoming a member of the consolidated group).

[222] Xco may be entitled to a compensating adjustment, under subsection 177F(3) in respect of some, or all, of the assessable income that is generated by Zco's activities that Xco derives as a consequence of being consolidated with Zco.

owned subgroup. Sub Co is only one of a number of subsidiaries wholly owned directly by Parent Co. The sub-group of which Sub Co is the holding company has considerable losses which cannot presently be fully utilised by other members of the corporate group.

For commercial reasons, Sub Co wishes to issue preference shares to certain unrelated investors.

If Sub Co was itself to issue preference shares, the company and the subgroup which it heads would not be able to consolidate with the remainder of the corporate group.[223] Instead, the following arrangement is entered into:

- A special purpose vehicle is incorporated;
- Sub Co subscribes for all the issued shares in the special purpose vehicle;
- The special purpose vehicle issues preference shares to the investors. The shares are equity interests within the meaning of Div 974 of the ITAA 1997;
- Sub Co simultaneously issues an equivalent number of notes to the special purpose vehicle. The special purpose company uses the proceeds from issuing the preference shares to fund the purchase of the notes. The notes do not constitute membership interests under the consolidation legislation but are non-share equity interests within the meaning of Div 974 of the ITAA 1997 and can support the payment of frankable non-share dividends;
- The rights attaching to the preference shares owned by the investors in the special purpose vehicle are substantially the same as the rights attaching to the non-share equity interests owned by the special purpose vehicle in Sub Co;
- The special purpose vehicle does not undertake any activities other than the issuing of the preference shares to the investors and the subscribing for notes in Sub Co;
- Franked distributions on the notes are paid by Sub Co to the special purpose vehicle. The special purpose vehicle pays an equivalent franked distribution on the preference shares to the investors.

The following diagram illustrates the company group structure both before and after the restructuring:

Parent Co elects to consolidate. Each of the members of the subgroup headed by Sub Co, being wholly owned subsidiaries of Parent Co, become members of the consolidated group. The special purpose vehicle is not a member of the

[223] Sub Co could, nonetheless, form a consolidated group with its subsidiaries as group members.

consolidated group as the preference shares are treated as membership interests when determining if the special purpose vehicle is wholly owned.

The scheme

For the purposes of section 177A, the scheme could consist of:

- the incorporation of the special purpose company;
- the purchase by Sub Co of all the issued shares in the special purpose company;
- the issue by the special purpose company of preference shares to external investors; and
- the simultaneous purchase by the special purpose company of non-share equity interests in Sub Co.

The tax benefit

But for the use by Sub Co of an interposed special purpose vehicle to issue preference shares to the external investors Sub Co would not have been eligible to enter a consolidated group with Parent Co. Based on normal commercial practice it would be reasonable to assume that in the absence of the scheme Sub Co would have issued preference shares in itself directly to the external investors, and hence would have ceased to be a wholly owned subsidiary of Parent Co.

In these circumstances a number of separate tax benefits are obtained by Parent Co. Those benefits are the full amount of all of the various types of deductions available to Parent Co as a result of Sub Co being a member of the group[224]. In the absence of the scheme Parent Co would not have been entitled to any of those deductions.[225]

Purpose

The facts of this scenario suggest that the objective dominant purpose of entering into the scheme was the obtaining of a tax benefit by Parent Co. For example, while the form of the scheme is that of an issue of notes by Sub Co and a simultaneous issue of preference shares by the special purpose company, in substance Sub Co has undertaken all the commercial risk associated with funding the preference shares. The changes in the financial positions of the

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[224] Sub Co obtains an omitted income tax benefit from the scheme. But for the scheme Sub Co would not have been a subsidiary member of a consolidated group, and the income generated by Sub Co would have been its assessable income and not that of the head company of the consolidated group. Sub Co may be entitled to a compensating adjustment under subsection 177F(3) in respect of some or all of the deductions that would have been allowable to it but for the scheme (that is, but for Sub Co becoming a member of the consolidated group).

[225] Parent Co may be entitled to a compensating adjustment, under subsection 177F(3) in respect of some, or all, of the assessable income that is generated by Sub Co's activities that Parent Co derives as a consequence of being consolidated with Sub Co.

relevant persons and the other commercial consequences of the scheme will be substantially the same as the changes that might reasonably have been expected to flow if the scheme had not been carried out.

Policy context

It is a design feature of consolidation that non-share equity interests are ignored for the purpose of determining whether one entity has a membership interest in another entity. However, analogously with Scenario 17, the facts of the present scenario point towards the creation and interposition of the special purpose vehicle having been undertaken in order for the group to avoid the consequences of the principle that only wholly owned subsidiaries of a head company are able to become members of a consolidated group and bring itself within the scope of the exclusion from the definition of membership interests of non-share equity. The manner in which the scheme is carried out, and the lack of congruence between form and substance point to the scheme having been entered into in that particular way dominantly to obtain tax benefits. This suggests the general anti-avoidance rules should have application.

Scenario 19: The use by a consolidatable group of non-share equity interests to maintain economic control over a related entity

Parent Co is the parent company of an Australian resident corporate group. As part of a plan to diversify the business activities conducted by the group, Parent Co wishes to incorporate a new company. It is expected that this newly incorporated company will produce losses of approximately $10 million over the first three years of the company's existence before starting to produce a profit. Parent Co does not expect that the group would be able to make significant use of these losses during that three year period.

Y Co, an unrelated third party, is expected to produce significant trading profits over the next few years. Y Co does not have access to any losses.

Y Co incorporates a new company - X Co - which then carries on the new business that Parent Co had intended to establish. All of the directors of X Co are directors of Parent Co, and X Co's officers are former officers of Parent Co. Yco pays $7 million for all the A class shares in X Co. No other shares are issued by X Co. The amount paid by Y Co for its shareholding in X Co is roughly equivalent to the discounted value of the losses X Co is expected to make over three years. Parent Co subscribes for $100 million worth of convertible notes issued by X Co. The convertible notes do not count as membership interests for the purposes of the consolidation measure but are non-share equity interests for the purposes of Div 974 of the ITAA 1997. The convertible notes are convertible one for one into B class shares in X Co three years after the date of issue. Under the constitution of X Co rights of A class shareholders are subordinated in all respects to the rights of B class shareholders. For example, there is no requirement to pay a dividend on A class shares, and A class shareholders only receive a nominal amount per share upon winding-up. In economic effect once the convertible notes are exercised, Y Co will not be able to participate in any profits X Co may make.

Y Co chooses to form a consolidated group with X Co.

The scheme

For the purposes of section 177A, the scheme could consist of:

- the purchase by Y Co of A class shares in X Co;
- the issue by X Co of convertible notes convertible into B class shares and the purchase by Parent Co of these issued notes; and
- the choice by Y Co to consolidate.

The tax benefit

As a result of the scheme, Y Co, a third party unrelated to the group, is entitled to all the deductions that arise as a consequence of the carrying on of the business by X Co. It is only the fact that X Co issues non-share equity interests in itself to Parent Co rather than ordinary shares that allows Y Co to consolidate with X Co. In the absence of the scheme it seems reasonable to assume that the $100 million in funding actually provided by Parent Co would have been provided via a subscription for shares rather than convertible notes. That is, but for the scheme it seems reasonable to assume that Y Co would not have wholly owned X Co. In fact it seems reasonable to assume that but for the scheme Y Co would not have acquired shares in X Co. The tax benefit is therefore the full amount of the deductions that Y Co obtains as a consequence of being in a consolidated group with X Co.[226]

Purpose

The facts of this scenario point towards the objective dominant purpose of the scheme being the obtaining of a tax benefit by Yco. In particular, the facts of the scenario suggest that the arrangement has been structured in this particular way solely for the purpose of allowing Parent Co to own a long term controlling economic interest in X Co while also allowing Y Co to utilise the losses made by X Co during the start up phase.

Note: a similar conclusion as to purpose would be likely to follow if, rather than being subordinated to the rights of the B class shareholders, the class A shares carried substantive rights and Parent Co had a call option which, when exercised, would allow it to purchase Y Co's shareholding for fair market value.

Policy context

By acquiring 100% of the issued shares in X Co in circumstances where, immediately after the share acquisition, X Co issues convertible notes in itself to Parent Co, Y Co is effectively seeking to gain access to the advantages offered by consolidation in a situation where, in substance, X Co is not

[226] Y Co may be entitled to a compensating adjustment, under subsection 177F(3) in respect of some, or all, of the assessable income that is generated by X Co's activities that Y Co derives as a consequence of being consolidated with X Co.

economically its wholly owned subsidiary. As noted in relation to Scenario 17, it is correct to state that it is a design feature of consolidation that non-share equity interests are ignored for the purpose of determining whether one entity has a membership interest in another entity. However, the present scenario does not present the case of a group which could, but for the scheme, take advantage of this design feature underpinning the legislation. Instead, as with Scenario 17 and 18, the facts of the present scenario point towards the scheme having been undertaken in order for the group to avoid the consequences of the principle that only wholly owned subsidiaries of a head company are able to become members of a consolidated group and to bring itself within the scope of the exclusion from the definition of membership interest of non-share equity. Indeed, as with Scenario 17, prior to the scheme being carried out, there was in fact no consolidatable group. Further, prior to the scheme being carried out, Y Co had no economic interest in X Co and, in the longer term, it can be expected that Y Co will have no meaningful economic interest in X Co. The manner in which the scheme is carried out, and the lack of congruence between form and substance point to the scheme having been entered into in that particular way dominantly to obtain tax benefits. This suggests the general anti-avoidance rules should have application.

Revision history

Section C9-1-220 first included in the *Consolidation reference manual* 3 December 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on proposed changes to consolidation rules.	Proposed legislative amendments.
26.10.05	Note on proposed changes deleted.	Legislative amendment.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Record keeping guidelines and checklist

Purpose and status

Purpose

These guidelines are intended to help business managers and their tax advisers meet the documentation and record keeping requirements of the consolidation regime.

Status

These guidelines do not attempt to set out in comprehensive detail the obligations of taxpayers under consolidation. The record keeping requirements set out here are based on the tax law generally. Therefore, while a taxpayer may exercise discretion and judgement about the form and content of the documentation required to meet their obligations under section 262A of the *Income Tax Assessment Act 1936* or section 121-20 of the *Income Tax Assessment Act 1997*, they must keep any such documentation according to the record keeping requirements of the tax law generally.

By following these guidelines, taxpayers can be more confident that they have met their compliance obligations and that consequently the ATO will perceive them as low risk to revenue.

Contents

Why keep business records?

There are four reasons why taxpayers should keep documentation recording transactions and other acts relevant to the taxation laws:

1 statutory requirements to keep records

2 penalties for failure to keep or retain records

3 the practical advantage of reduced risk of tax audits and adjustments and improved communication with the ATO, and

4 the burden of proof, which rests with taxpayers in the event of dispute.

Statutory requirements

Section 262A of the *Income Tax Assessment Act 1936* (ITAA 1936) requires a person, including a company, carrying on a business to keep records that record and explain all transactions and other acts engaged in by the person that are relevant for any purpose of the Act.[227] In particular, the section 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, choice, estimate, determination or calculation made by the person under that Act, and particulars showing the basis for and the method by which an estimate, determination or calculation was made.

These records must be in writing in the English language or made readily accessible and convertible into writing in English.

Similarly, section 121-20 of the *Income Tax Assessment Act 1997* (ITAA 1997) requires taxpayers to keep records of every act, transaction, event or circumstance that can reasonably be expected to be relevant to working out whether they have made a capital gain or capital loss from a CGT event as described in Division 104 of the ITAA 1997. It does not matter whether the CGT event has already happened or may happen in the future.

As with section 262A of the ITAA 1936, the records must be in English or be readily accessible and convertible into English. The records must also show details of how the act, transaction, event or circumstance is relevant to working out whether a taxpayer has made a capital gain or loss. The records must then be retained until the end of five years after it becomes certain that no CGT event can happen where the records could reasonably be expected to be relevant.

Where a consolidated group has life insurance company subsidiary members, special consolidation rules will apply to that group to take into account the existing rules for the taxation of life insurance companies. Section 262A of the ITAA 1936 will apply to records relevant for the purpose of these special rules.

[227] Defined by section 6 of the *Income Tax Assessment Act 1936* to include the *Income Tax Assessment Act 1997*.

The ATO has issued the following rulings to provide guidance to taxpayers about their record keeping obligations under the taxation laws:

- *TR 96/7 – Income tax: record keeping – section 262A – general principles*
- *TR 2005/9 – Income tax: record keeping – electronic records*

Other taxation rulings mentioned later in this paper discuss income tax documentation issues for taxpayers with specific types of transactions, such as cross-border related party dealings.

The ATO also provides information on record keeping requirements that is specially designed for small business. → *Record keeping for small business*

Penalties

If taxpayers fail to keep records relevant to the assessment of their income tax, they could become liable to the administrative penalty that applies to a breach of section 262A of the ITAA 1936 or to prosecution for an offence under section 8L of the *Taxation Administration Act 1953* (TAA 1953).

Less risk of audit and dispute, better communication

The Commissioner of Taxation has a statutory obligation to ensure compliance with the taxation laws. There are sound practical reasons why taxpayers should retain all documentation that records and explains all tax-law relevant transactions and other acts they engage in. The keeping of such documentation helps mitigate the risk of audit by and dispute with the ATO. It also helps taxpayers communicate their position to the ATO.

Providing proof

In addition, appropriate record keeping helps taxpayers meet the burden of proof in the event of dispute. Sections 14ZZK and 14ZZO of the TAA 1953 prescribe that the taxpayer has the burden of proving that a disputed assessment is excessive. This is the case whether the taxpayer is seeking a review of an assessment or is appealing against an objection decision.

In discharging their onus of proof, a taxpayer must not only show that the assessment is wrong, but must also positively establish the correction that makes it right or more nearly right (see *Trautwein v. FC of T* (1936) 56 CLR 63; *FC of T v. Dalco* (1990) 168 CLR 614; 90 ATC 4088; (1990) 20 ATR 1370; *FC of T v. Australia and New Zealand Savings Bank Limited* (1994) 181 CLR 466; (1994) 29 ATR 11; 94 ATC 4844; *Allard v. FC of T* 92 ATC 4897; (1992) 24 ATR 493).

If there is a dispute, a taxpayer who has documentation about transactions will be better placed to discharge their burden of proof.

Requirements for retaining records

Head company to retain records

As the head company has absorbed the subsidiaries for all purposes of the ITAA 1936 and ITAA 1997, it is regarded as the taxpayer for all income tax purposes relating to the period of consolidation. Consequently, the head company will be required to meet all its subsidiaries' obligations under section 262A of the ITAA 1936 and section 121-20 the ITAA 1997 as they relate to the process of consolidation and the assessment of future income tax liabilities.

The head company is responsible for keeping records to record and explain all transactions and other acts even though a subsidiary may have engaged in transactions relevant for the purpose of the act.

Physical transfer of the records will not always be necessary, as the effect of the consolidation measure is that the head company's obligation to keep records will be discharged if a subsidiary member keeps the records.

Note

Record keeping arrangements

The head company will need to enter into arrangements with subsidiary members to ensure that records required under the taxation laws are correctly kept.

When a subsidiary member leaves a group, both the head company and the leaving entity should ensure they retain copies of, or have access to, the relevant tax records required to meet their obligations under section 262A.

Period of record retention

A person must keep records for five years after they are prepared or obtained or five years after the completion of the transaction or acts to which they relate (whichever is the later).

Additionally, section 121-25 of the ITAA 1997 requires a taxpayer to retain records until the end of five years after it becomes certain that no CGT event (or no further CGT event) can happen. Where a net capital loss is made, taxpayers may need to keep records for a longer period, depending on whether the loss will be applied against a future gain. In this event, taxpayers are required to keep their records for five years after any CGT event where a gain is made that is reduced by applying the net capital loss.

Under the consolidation regime, records relating to the choice to consolidate and the process of consolidation will need to be kept in addition to records relating to transactions and acts of subsidiary members that are relevant to the determination of the head company's future income tax liabilities. In order to evidence a consolidated income tax return, the head company should retain the choice in writing on an ongoing basis. Where the group deconsolidates, the written choice must be kept for at least five years after the last consolidated return is lodged, or for a longer period depending on the group's particular circumstances.

Consolidation-specific records

Overview

A consolidated group or multiple entry consolidated group (MEC group) is treated as a single entity for income tax purposes. As a consequence of this, the head company of the group must retain, in addition to the records needed to determine its income tax liability, records that document, among other things:

- the choice in writing:
  - to form a consolidated group
  - to form a MEC group
  - to create a MEC group from a consolidated group
  - to appoint a new provisional head company for a MEC group, or
  - for a new eligible tier-1 company to become a member of a MEC group.
- the process of forming the consolidated group or MEC group
- the tax history of the joining entities under the entry history rule
- entries and exits of subsidiary members
- events that result in an entity being no longer eligible to be a head company of a consolidated group or provisional head company of a MEC group
- events where a consolidated group no longer has subsidiary members, and
- consolidation eliminations or adjustments to derive the income tax outcomes for the head company of the group.

Information documenting the formation of a consolidated group

The additional records to be kept by a consolidated or MEC group may include records containing particulars of:

- market value of assets of a joining entity at the joining time
- market value of assets at the time membership interests were acquired
- how the values of assets were calculated when implementing the choice to consolidate
- how the allocable cost amount (ACA) was calculated for each subsidiary entity
- use of transitional option or new tax values for assets set through cost setting rules
- CGT cost bases at the joining time
- opening trading stock values or the amount of the outgoing incurred in acquiring trading stock on hand at the joining time
- adjustable values for depreciating assets at the joining time

- value of all liabilities of a joining entity that may be recognised by the Australian Accounting Standards or authoritative pronouncements of the Australian Accounting Standards Board
- modified market value of a joining entity
- adjusted market value of the consolidated group
- special rules relating to consolidated groups that have life insurance company subsidiary members
- documentation of all inter-member eliminations and tax adjustments applicable to the consolidated group, and
- tax sharing agreements covering the group's income tax-related liabilities.

Tax-specific records that may be required

Under the Corporations Law, entities generally prepare financial reports in accordance with the accounting standards. The law and accounting standards generally require an entity to detail different classes of assets and liabilities, income details and other reporting requirements.

As well as producing financial statements, entities will need to maintain additional records in accordance with the requirements of the income tax laws. Also, when entities form a consolidated or MEC group, records documenting the choice to consolidate, the consolidation process and determining the head company's future income tax liabilities will need to be kept.

As well as maintaining the required records, there are additional requirements to notify the Commissioner; for example, where a choice is made or where there are changes in membership. → 'Choice in writing', C7-1-110; 'Consolidated group – notices to be given to the Commissioner', C7-1-120; 'MEC groups – notices to be given to the Commissioner', C10-1-110

Records that may be required on specific aspects of the consolidation regime include:

Choice to consolidate

Consolidated group

Statement by the head company that it has made a choice to form a consolidated group, including:

- name of the head company
- date on which consolidation is to take effect
- date the choice in writing was made.

→ 'Choice in writing', C7-1-110

MEC group

Statement by the eligible tier-1 companies of the foreign resident company (top company) of their choice to form a MEC group, including:

- names and details of all the eligible tier-1 companies making the choice to form a MEC group
- the date on which consolidation is to take effect
- the date the choice in writing was made
- the name of the provisional head company appointed by the eligible tier-1 companies at formation.

→ 'Choice in writing', C7-1-110

Creation of a MEC group from a consolidated group

A statement by the head company of a consolidated group that a MEC group comes into existence at the time one or more other companies become eligible tier-1 companies of the top company including:

- name of head company of the consolidated group
- names and details of the specified companies who became eligible tier-1 companies of the top company at that time
- date the choice was made.

→ 'Choice in writing', C7-1-110

Membership

- A record of the members of the consolidated group and membership interests in each of the member entities. A chart of the group structure with particulars of membership interests at relevant dates would satisfy this requirement. Related entities excluded from the consolidated group should be shown with reasons for their exclusion if this is not explicit or obvious. All non-resident entities interposed between members of the group should also be included.
- Particulars, including number, class and value, of shares in member entities issued under arrangements for employee shareholdings. When determining the market value of employee share interests, a valuation short cut option may be available. → *Market valuation for tax purposes* at **www.ato.gov.au**
- Dates of movements of members into and out of the consolidated group. When entities join or leave the consolidated group, particulars of changes to membership interests and assets brought into the group or taken from the group by the leaving entity.
- The date on which a head company with a substituted accounting period (SAP) chooses consolidation to take effect.

MEC groups – additional information may be required

- Particulars of membership interests in all eligible tier-1 Australian resident subsidiaries of a foreign resident company.
- Particulars of the foreign resident company's membership interests in all other Australian entities.
- Statement that the PHC has made a choice for a new eligible tier-1 company to become a member of the MEC group, including:
  - particulars about the eligible tier-1 company
  - name of the PHC
  - date the choice was made.

→ 'Choice in writing', C7-1-110

- Particulars of PHC that ceases to be eligible to be PHC.
- A statement that a new PHC has been appointed jointly by all the remaining eligible tier-1 companies from the date on which the previous PHC ceased to be eligible, including:
  - names of eligible tier-1 companies who jointly appointed the new PHC
  - name of the new PHC
  - date of the choice.

→ 'Choice in writing', C7-1-110; 'Making a choice to consolidate and notifying', B3-1; 'Changing group membership', B3-5

Subsidiary member leaves the consolidated group

- Date and particulars of change in membership interests or other event that causes a subsidiary member to leave a consolidated group.
- Documents containing particulars of the head company's cost setting for the net assets in the leaving entity just before the leaving time.
- Particulars of the head company's cost setting of membership interests in the leaving entity.
- Particulars of liabilities owing to other members of the consolidated group by the leaving entity.
- Particulars of the market valuation, when required, of any liabilities owing to other members of the consolidated group by the leaving entity.
- Documents containing particulars of any ongoing arrangements involving income, expenditure, assets or liabilities between a member of the consolidated group and the leaving entity – such as loans subject to interest, the provision of property under lease or prepayments for the future provision of goods and services.
- Supporting calculations for the cost setting of membership interests in the leaving entities where two or more entities cease to be subsidiary members of the group at the same time.

- Supporting calculations for setting costs of membership interests in the entities affected where the leaving entity holds membership interests in other subsidiary members of the consolidated group, as these other subsidiary members will also cease to be members of the group at the leaving time. The cost of membership interests in each of the leaving entities must be worked out on a 'bottom-up' basis.
- Supporting calculations where the leaving entity's assets that had a pre-CGT factor and where membership interests in the leaving entity are deemed to be pre-CGT assets.

→ 'Changing group membership', B3-5; 'Pre-CGT membership interests in a leaving entity (with pre-CGT factor attached to assets)', C2-5-710

Consolidated group ceases to exist

- Dates and particulars of change in the membership interests in the head company or other event that causes the consolidated group to cease to exist
- Head company notification to ATO of cessation.
- Records of tax events and transactions at the time of the group ceasing to exist.
- Market valuations, where required, to establish the cost base of membership interests and tax values for assets.
- When the head company becomes a subsidiary member of another consolidated group, supporting calculations for available fraction adjustments and changes to the cost base of membership interests and tax values of assets. → 'Changing group membership', B3-5

Treatment of assets and cost setting rules

- Asset register – to contain additional information to that required by section 121-35 of the ITAA 1997. The register should show the type of asset of the joining entity and the asset's terminating value immediately before consolidation. It should also show the cost base of the membership interests in the joining entity as the starting point for the calculation of the allocable cost amount (ACA), and any pre-CGT factor applicable to that membership interest in a joining entity that is a pre-CGT asset.
- Depreciation schedule, showing adjustable value (cost) and depreciation details
- Statement of whether the head company has chosen to use the transitional provisions and retain existing tax costs for the assets of each joining entity.
- Documentation of a company's choice to continue to claim accelerated depreciation in respect of a depreciating asset where the joining entity was entitled to accelerated depreciation.
- Records showing the group's cost setting process, including:
  - steps one to eight of the calculation of the ACA for a joining entity
  - particulars of retained cost base assets, and

- allocation of balance of ACA to the reset cost base assets.

- Particulars of a joining entity's liabilities in accordance with the accounting standards or authoritative pronouncements of the Australian Accounting Standards Board, identifying whether the liabilities are owed to third parties or other group members. (Where the accounting standards or authoritative pronouncements of the Australian Accounting Standards Board do not apply to the joining entity it is still necessary to identify the relevant liabilities by reference to those liabilities that can or must be identified under the accounting standards or authoritative pronouncements of the Australian Accounting Standards Board.)
- Documentation to support any adjustments made to liabilities to account for differences between liabilities taken into account under generally accepted accounting principles and under the income tax laws. Where the historical information required for calculating these adjustments is no longer available, the adjustment should be determined on the most reliable basis for estimation available. Where the historical records identifying income tax payable on profits of a joining entity are not available to the joined group, the head company can use the most reliable basis for estimation available.
- Documentation containing particulars of where a liability taken into account in working out the ACA of a joining entity is later discharged for a different amount and the difference is treated as a capital gain or loss at the time of discharge.
- Documentation containing particulars of where a mistake in working out the tax cost setting amounts for the assets of a joining entity has been brought to account as a capital gain or loss. The head company must, as soon as practicable after becoming aware of the errors, notify the Commissioner in the approved form. → Notification forms and instructions at **www.ato.gov.au/consolidation**; 'Dealing with errors in TCSAs and changes in liabilities when discharged', C2-1-050
- Documentation containing particulars of where the head company has chosen to reduce the tax cost setting amount for an entity's depreciating assets to the terminating value for those assets.
- Documentation containing particulars of where the head company chooses to add back the whole or part of an adjustment for over-depreciation when working out its cost base for membership interests in a leaving entity.
- When entities join or leave the consolidated group, particulars of changes to membership interests and assets brought into the group by the joining entity or taken from the group by the leaving entity.
- Documentation where, for certain pre-CGT assets held by a head company at formation time, the head company chooses to use their formation time market values instead of terminating values when calculating costs of membership interests for an entity leaving a group.

- Where an entity joins a consolidated group on or after 10 February 2010 (or the head company makes a choice to apply the pre-CGT proportion rules to an entity that joins on or after 1 July 2002), the pre-CGT status of membership interests in the joining entity is preserved by working out a pre-CGT proportion (measured by market value) at the joining time. Records required include:
  - documents containing particulars of all membership interests in the joining entity, including date of purchase, number and type of membership interests and cost of membership interests, and
  - documentation supporting the market valuation of membership interests → *Market valuation for tax purposes* at **www.ato.gov.au**

→ 'Determining asset values', B2-2; 'Treatment of assets', C2-1; 'Pre-CGT status of membership interests in a joining entity – pre-CGT proportion rules', C2-4-813

- Where an entity joins a consolidated group before 10 February 2010 (and the head company does not make a choice to apply the pre-CGT proportion rules to an entity that joins before 10 February 2010), the pre-CGT status of membership interests in the joining entity is preserved by attaching a pre-CGT factor to the assets of the joining entity at the joining time. Records required include:
  - documents containing particulars of all membership interests in the joining entity, including date of purchase, number and type of membership interests and cost of membership interests
  - documentation supporting the market valuation of membership interests → *Market valuation for tax purposes* at **www.ato.gov.au**
  - particulars of the calculation of the pre-CGT factor.

→ 'Determining asset values', B2-2; 'Treatment of assets', C2-1; 'Pre-CGT factor for assets of a joining entity', C2-4-810

MEC groups – additional information

- Particulars of pooled cost bases of membership interests where the pooling rules apply.

Market valuations

The extent of information and documentation that a taxpayer creates, obtains and keeps in regard to a market valuation should depend on:

- the complexity of the market valuations involved
- the value of the asset being valued relative to other assets of the taxpayer, and
- the degree of judgement or objectivity inherent in the market valuation process.

Where market valuations have been used for the purposes of consolidation, including establishing the cost of membership interests, tax values for assets or an available fraction for a bundle of losses, the market valuation report and supporting documentation should contain as a minimum:

- description of the asset valued
- purpose and context of the market valuation
- specific market value
- date or period to which the market valuation relates
- description of methodologies employed
- information on which the market valuation is based, and
- details of any assumptions relied on in the market valuation.

→ *Market valuation for tax purposes* at **www.ato.gov.au**

Franking accounts

On consolidation, the franking surpluses of subsidiary members are transferred to the head company, which operates a single franking account for the group.

The head company will retain records for the single franking account and records to support compliance with the franking account rules for consolidated groups. From 1 July 2002, franking accounts will be operated in accordance with the rules set out in the *New Business Tax System (Imputation) Act 2002.*

Records must be kept of:

- all franking account surpluses transferred from the joining entities to the head company's consolidated franking account, and
- particulars of the treatment of any deficit in a subsidiary's franking account.

→ 'Transferring franking credits', B2-4; 'Treatment of franking credits', C5-1

International provisions

Advance Pricing Arrangements

Where a subsidiary member or head company of the consolidated group has entered into an APA, the head company must, in effect, retain all records relied on in concluding the APA and discharging any obligations pursuant to the APA.

As part of discharging the agreed APA obligations, the head company will need to record and report data as required to the ATO. The relevant APA data and information for the APA annual compliance report are agreed to and explicitly stated in the final documentation, setting out the terms of the APA agreed to with the ATO.

Unless otherwise stated in the APA, all records must be kept in accordance with the record keeping requirements under the Act.

The head company will continue to be responsible, as part of the APA, for the compliance with the APA and preparation of an annual compliance report for each year of the APA. That report will contain sufficient information to detail the actual results for the year and to demonstrate compliance with the terms and conditions of the APA.

The annual APA compliance report is separate to any requirement the head company has to self-assess and lodge a single income tax return for the consolidated group.

The APA program aims to provide taxpayers with an opportunity to reach an agreement with the ATO on the future application of the arm's length principle in their international dealings with related parties. One of the stated benefits of this program is to reduce the record keeping burden on taxpayers.

→ Practice Statement *PS LA 2011/1: ATO's Advance pricing arrangement program – to explain the policies and procedures of the advance pricing arrangement program*.

Transfer pricing

Taxation Ruling *TR 98/11: Income tax: documentation and practical issues associated with setting and reviewing transfer pricing in international dealings* provides guidance on the documentation and records that a head company should retain when setting and reviewing transfer prices for the international related-party dealings of the consolidated group.

Foreign income tax offsets and pre-commencement excess foreign income tax

Taxpayers should retain records to support compliance with the foreign income tax offset rules for dealing with foreign income tax paid on amounts included in assessable income and the transfer of pre-commencement excess foreign income tax to the head company of a consolidated group when the group is formed and when an entity joins the group.

For general information on the record keeping requirements for foreign income tax offsets, see → *Guide to foreign income tax offset rules* at **www.ato.gov.au**

Records covering the transfer of pre-commencement excess foreign income tax should show, among other things, the amount of the pre-commencement excess foreign income tax that is transferred, the year in which the excess foreign income tax arose, and that the 12 month or other holding period necessary for utilisation of the joining entity's pre-commencement excess foreign income tax has been satisfied.

→ 'Treatment of foreign income tax offsets, excess foreign tax credits, attribution surpluses, conduit foreign income and irrevocable elections', B2-5; 'Foreign income tax offsets – transitional rules', C6-2-120

Controlled foreign companies (CFC) and foreign investment funds (FIF)

In accordance with the single entity principle, only the head company will be able to operate attribution accounts for the purposes of consolidation. The pre-consolidation balances of these accounts will be transferred to the head company to facilitate the use of any pre-consolidation surpluses during consolidation.

Subsidiary members of a consolidated group will have inoperative attribution accounts during the period of consolidation once the balances in those accounts have been transferred to the head company.

When a subsidiary member with an interest in a CFC, FIF or foreign life policy (FLP) leaves a group, it will take a portion of the surpluses the head company holds in relation to the leaving subsidiary member's interest in the CFC, FIF or FLP it takes with it.

Records to be kept by the head company include:

- particulars of the proportion of the attribution surplus transferred by the head company to a leaving subsidiary member, and
- particulars of amounts transferred by each subsidiary member to the attribution accounts operated by the head company.

FIF rules from 2010-11 onwards

The FIF rules were repealed with effect from the 2010-11 income year. From the 2010-11 year onwards:

- when a company becomes a subsidiary member of a consolidated group and it has a post-FIF abolition surplus, the surplus is transferred to the head company of that group
- when a company leaves a consolidated group and takes with it interests in a FIF or FLP, the head company transfers to the leaving company a proportion of the post-FIF abolition surplus that it has in relation to those interests.

The head company must keep records of the post-FIF abolition surplus transferred to it at the joining time and the proportion of the post-FIF abolition surplus transferred to a leaving subsidiary member.

Note

From 1 July 2008, attribution tax accounts are no longer required to track underlying foreign tax paid. → 'Treatment of foreign income tax offsets, excess foreign tax credits, attribution surpluses, conduit foreign income and irrevocable elections', B2-5

Conduit foreign income

The head company will need to keep records to explain the amount of conduit foreign income it has at the time it makes a distribution declared to be conduit foreign income. If the head company makes a declaration before making the distribution it will need to have a record to explain the amount of its conduit foreign income at the time of the declaration.

→ 'Treatment of foreign income tax offsets, excess foreign tax credits, attribution surpluses, conduit foreign income and irrevocable elections', B2-5

Losses

Documentation will need to evidence compliance with the two sets of rules that govern losses and consolidated and MEC groups, namely:

- When an entity becomes a subsidiary member of a consolidated or MEC group, its unused carry forward losses are transferred to the group if the losses satisfy modified versions of the usual tests for deducting and applying losses.
- The rate at which transferred losses can be used will generally be restricted to approximate the rate of use that the joining entity would have experienced had it remained outside the consolidated or MEC group.

From a compliance perspective, sufficient records would need to be maintained to allow changes in ownership and business activity to be tracked on a 12-month basis or other period as appropriate.

A head company would be required to maintain records that will provide an adequate trail to explain and confirm the composition of loss bundles and calculation of available fractions. Specifically, records would need to identify:

- the nature and source of all losses transferred to the head company
- the different 'sorts' of losses in each bundle
- the different 'sorts' of losses listed in the legislation:[228]
  - a tax loss (that is, a loss deductible against all assessable income)
  - a film loss
  - a net capital loss
- a bundle for each entity
- when available fractions are adjusted due to the occurrence of an adjustment event
- where the use of transferred losses is apportioned as the available fraction applied for only part of the income year

[228] As amended by *Tax Laws Amendment (2007 Measures No. 4) Act 2007*. For more information see → 'Amount of transferred losses that can be utilised – foreign loss component of a tax loss', C3-4-560.

- when the head company has chosen to cancel the transfer of a loss
- when losses do not satisfy the transfer tests, as they are effectively cancelled in that they may not be used by any entity
- where a debt of the head company is forgiven, the debt particulars, any agreements, payment arrangements, deeds entered into and calculation of the reduction of losses transferred, and
- where a group consolidates during the transitional period and chooses to use the concessional treatment for the utilisation of certain losses over three years.

When a head company uses the value donor concession in applying or utilising transferred losses, the following documentation and records are required to be kept:

- particulars of membership interests during the transitional period for the head company, loss entity and value donor
- the calculation of the available fraction
- details of the calculation of the modified market values
- a record of the dates when a head company has chosen to consolidate and use this concession
- changes to loss bundles due to the operation of the value donor concession, and
- where the real loss-maker or the value donor transfers foreign losses to the group, two separate sets of fractions: one that ignores the operation of the value donor rules and one that ignores their application, as foreign losses cannot be transferred.

→ 'Transferring and using losses', B2-3; 'Treatment of losses', C3-1; *Market valuation for tax purposes* at **www.ato.gov.au**

Substituted accounting periods (SAPs)

To retain access to grouping provisions until the date of consolidation, consolidated groups with a head company with a SAP must choose to consolidate from the first day of their next income year commencing after 1 July 2003. This choice will need to be documented.

→ 'Substituted accounting period (SAP)', C9-4-110

Liability for the payment of income tax

The head company is responsible for the income tax liabilities of the entire group from the date of consolidation. Where a tax sharing agreement is in place, the head company must keep the agreement and retain all records relied on in drafting and entering into it.

Unless otherwise stated in the agreement, all records must be kept in accordance with the record keeping requirements under the Act.

→ 'Determining annual liability', B3-3; 'Managing obligations', B3-4

Record keeping checklist

About this checklist

This checklist of record keeping requirements for consolidated groups is a guide only, and should be read in conjunction with the more detailed record keeping guidelines earlier in this section and the head company tax return instructions.

By following these guidelines, taxpayers can be more confident that they have met their compliance obligations and that consequently the ATO will perceive them as low risk to revenue.

Formation of a consolidated group

Having decided to consolidate, a head company must retain records documenting the decision and the implementation of consolidation. These records are in addition to those usually retained to ascertain the income tax liability of the head company.

These additional records may contain particulars of:

- ☐ market value of assets of a joining entity at the joining time
- ☐ market value of assets at the time membership interests were acquired
- ☐ how the values of assets were calculated when implementing the choice to consolidate
- ☐ how the allocable cost amount was calculated for each subsidiary entity
- ☐ use of transitional option or new tax values for assets set through cost setting rules
- ☐ CGT cost bases at the joining time
- ☐ opening trading stock values or purchase prices for trading stock on hand at the joining time
- ☐ adjustable values for depreciating assets at the joining time
- ☐ value of all liabilities of a joining entity that may be recognised by the Australian Accounting Standards or Statements of Accounting Concepts
- ☐ modified market value of a joining entity
- ☐ adjusted market value of the consolidated group
- ☐ special rules relating to consolidated groups that have life insurance company subsidiary members

Tax-specific records that may be required

Choice to consolidate

- [ ] Written statement of choice to form a consolidated group or MEC group

Membership

- [ ] A record of the wholly-owned members of the consolidated group and the head company's membership interest in each of the member entities
- [ ] A list of related entities excluded from the consolidated group and all non-resident entities interposed between members of the group
- [ ] Particulars, including number, class and value, of shares in member entities issued under arrangements for employee shareholdings
- [ ] Dates of movements of entities into and out of the consolidated group

For multiple entry consolidated (MEC) groups

- [ ] particulars of membership interests in all the eligible tier-1 companies
- [ ] particulars of the ultimate foreign parent's membership interests in other Australian entities

  - [ ] Written statement of choice where a new eligible tier-1 company becomes a member of a MEC group
  - [ ] Written statement of choice where new provisional head company is appointed
  - [ ] Particulars of provisional head company that becomes ineligible to be provisional head company.

Subsidiary member leaves the consolidated group

- [ ] Date and particulars of change in membership interest or other event that causes a subsidiary member to leave a consolidated group
- [ ] Particulars of the head company's cost setting for the net assets of the leaving entity just before the leaving time
- [ ] Particulars of the head company's cost setting of membership interests in the leaving entity
- [ ] Particulars of cost setting of membership interests in the affected entities where more than one entity leaves the consolidated group
- [ ] Particulars of any liabilities – including their market valuation, when required – owing to other members of the consolidated group by the leaving entity
- [ ] Particulars of any ongoing arrangements involving income, expenditure, assets or liabilities between a member of the consolidated group and the leaving entity
- [ ] Supporting calculations for pre-CGT factors, where applicable, for assets the leaving entity takes from the consolidated group

Consolidated group ceases to exist

- ☐ Date and particulars of change in membership interests or other event that causes the consolidated group to cease to exist
- ☐ Head company notification to ATO of cessation
- ☐ Records of tax events and transactions at the time of the group ceasing to exist
- ☐ Market valuations, where required, to establish the cost base of membership interests and tax values for assets

Asset rules and valuation

Asset register listing:

- ☐ – description of asset of the joining entity
- ☐ – date of acquisition
- ☐ – adjustable value
- ☐ – the asset's terminating value immediately before consolidation
- ☐ – cost base of the membership interests in the joining entity
- ☐ – calculation of the allocable cost amount apportionment to the reset cost base assets
- ☐ – pre-CGT factor applicable to membership interest in a joining entity that is a pre-CGT asset
- ☐ Depreciation schedule detailing adjustable values and depreciation
- ☐ Statement of whether the head company has chosen to use the transitional provisions and retain existing tax costs for the assets of each joining entity
- ☐ Documentation of choice to continue to claim accelerated depreciation
- ☐ Records showing the group's cost setting process
- ☐ Particulars of the head company's choice to reduce the tax cost setting amount for an entity's depreciating assets to the terminating value for those assets
- ☐ Particulars of the head company's choice to add back the whole or part of an adjustment for over-depreciation when working out its cost base for membership interests in a leaving entity
- ☐ Particulars of where a capital gain or loss has been returned, instead of recalculated to correct for errors, in the tax cost setting amounts for the assets of a joining entity
- ☐ Particulars of where a capital gain or loss has been returned where a liability taken into account in working out the ACA of a joining entity is discharged for a different amount
- ☐ Particulars of the head company's choice to use formation time market values for certain pre-CGT assets instead of terminating values when calculating costs of membership interests for an entity leaving a group
- ☐ Particulars of a joining entity's membership interests that have had their pre-CGT status preserved, including date of purchase, number, type, cost and market valuation of membership interests, and calculation of the pre-CGT proportion or pre-CGT factor, where applicable

- ☐ Particulars of changes to membership interests and assets brought into the group by the joining entity or taken from the group by the leaving entity

MEC groups – additional information

- ☐ Particulars of the pooled cost bases of membership interests where the pooling rules apply

Market valuation

A market valuation report and supporting documentation containing as a minimum:

- ☐ – description of the asset valued
- ☐ – purpose and context of the market valuation
- ☐ – specific market value
- ☐ – date or period to which the market valuation relates
- ☐ – description of methodologies employed
- ☐ – information on which the market valuation is based
- ☐ – assumptions relied on in the market valuation

Franking accounts

- ☐ Particulars of franking account surpluses transferred from joining entities to the head company's consolidated franking account

International provisions

- ☐ Records relied on in concluding an Advance Pricing Arrangement (APA) and discharging any obligations pursuant to it
- ☐ Annual compliance report for an APA
- ☐ Transfer pricing documentation: see *Taxation Ruling TR 98/11, Income tax: documentation and practical issues associated with setting and reviewing transfer pricing in international dealings*

Pre-commencement excess foreign income tax

- ☐ Records of the transfer of pre-commencement excess foreign income tax to the head company of a consolidated group at formation time and when an entity joins the group

Controlled foreign companies (CFC) and foreign investment funds (FIF)

- ☐ Records of attribution accounts maintained for the purposes of the CFC and FIF measures for entities that join, form or leave a consolidated group

Conduit foreign income

- [ ] Records to explain the amount of conduit foreign income the head company has at the time it makes a distribution declared to be conduit foreign income

Losses

- [ ] Particulars of the nature and source of all losses transferred to the head company
- [ ] Particulars of the different 'sorts' of losses in each bundle

Particulars of the different 'sorts' of losses listed in the legislation:[229]

- [ ] – a tax loss (that is, a loss deductible against all assessable income)
- [ ] – a film loss
- [ ] – a net capital loss
- [ ] Records disclosing the composition of the various loss bundles and the calculation of an available fraction for each bundle
- [ ] Record of the recalculation of the available fraction when an adjustment event occurs
- [ ] Record of a head company's choice to cancel the transfer of a loss
- [ ] Record of a head company's choice to use concessional measures that apply to a head company in deducting or utilising transferred losses
- [ ] Record of a head company's choice to utilise transferred losses over three years

When a head company uses the value donor concession:

- [ ] – particulars of membership interests during the transitional period for the head company, loss entity and value donor
- [ ] – the calculation of the available fraction
- [ ] – the calculation of the modified market values
- [ ] – the dates when a head company has chosen to consolidate and use this concession

Other

- [ ] Records to support inter-member eliminations on consolidation
- [ ] Records to support tax adjustments applicable to the consolidated group
- [ ] General ledger audit trails for tax information

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[229] As amended by *Tax Laws Amendment (2007 Measures No.4) Act 2007*. For more information → 'Amount of transferred losses that can be utilised – foreign loss component of a tax loss', C3-4-560.

Revision history

Section C9-2 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on recent changes to consolidation rules.	Legislative amendments.
26.10.05	Note on recent changes deleted.	Legislative amendment.
12.9.06	Correction of editorial error, p. 8.	
30.6.09	Updates for foreign income tax offset and conduit foreign income rules, pp. 13, 14, 20, 20.	Legislative amendments.
6.5.11	Updates to include reference to the pre-CGT proportion calculation.	Legislative amendments.
	Updates to reflect changes to the choice provisions for consolidated and MEC groups.	Legislative amendments.
	Removal of reference to withdrawn TR 95/23 and insertion of reference to new PS LA 2011/1.	PS LA 2011/1 replaces TR 95/23.

Substituted accounting period (SAP)

Key points

- A consolidated group can be formed from 1 July 2002 even where the head company or subsidiary members have substituted accounting periods (SAPs).
- The accounting periods of the individual group members do not need to be aligned before the head company forms a consolidated group.
- For compliance cost reasons, where the head company with a SAP chooses to consolidate the group from the first day of its next income year beginning after 1 July 2003, access to the grouping provisions will be extended to the date of consolidation.

Grouping provisions

The existing grouping provisions cease for most groups on 1 July 2003. If a head company chooses to consolidate a group before that time the grouping provisions cease from the date of consolidation.

However, a fixed date of 1 July 2003 for the removal of the grouping provisions may result in additional compliance costs for those groups whose head company has a SAP. Therefore, a limited extension of the grouping provisions is allowed for SAP groups up until the date of consolidation where the head company chooses to consolidate the group from the first day of its next income year that begins after 1 July 2003.

The relevant grouping provisions are:

- CGT rollover relief for asset transfers between companies that are part of the same wholly-owned group
- loss transfers between companies that are part of the same wholly-owned group
- the intercorporate dividend rebate for unfranked dividends paid between companies that are part of the same wholly-owned group
- transfers of excess foreign tax credits between companies that are part of the same wholly-owned group, and
- grouping provisions in the thin capitalisation regime.

Table 1: Dates from which current grouping provisions no longer apply

Consolidation date of head company	Date from which current grouping provisions no longer apply (all members)
Any date from 1 July 2002 to 30 June 2003	Date of consolidation
First day of SAP income year commencing after 30 June 2003	Date of consolidation
Any other date before or after first day of SAP income year commencing after 30 June 2003	1 July 2003
Group does not consolidate	1 July 2003

Source: Table 13.2 on page 292 of the Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002.

If a SAP group does not consolidate on the first day of the head company's next income year after 1 July 2003, the grouping provisions are not available from 1 July 2003. They will, however, be available up until 30 June 2003.

Loss transfers

Tax loss transfers

The use of tax loss transfer provisions requires an apportionment of the tax loss of the loss company and the taxable income of the income company. Only that part of the income year's tax loss attributed to the period prior to 1 July 2003 and that part of the income year's taxable income attributed to the period prior to 1 July 2003 are taken into account in any tax loss transfer.

Net capital loss transfers

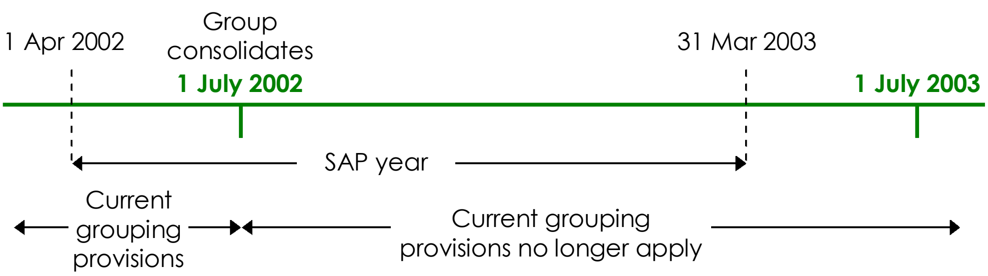
Net capital loss transfers are available only where the net capital loss would have arisen prior to 1 July 2003 and may only be transferred to a company that would have derived a net capital gain if its income year had ended on 30 June 2003.

Examples

Example 1

Head Company and its subsidiaries have a SAP ending 31 March in lieu of the following 30 June. The group consolidates on 1 July 2002.

Figure 1: SAP ends 31 March, group consolidates 1 July 2002



Current grouping provisions

Access to the current grouping provisions is lost for the whole group from 1 July 2002.

Lodgment of returns

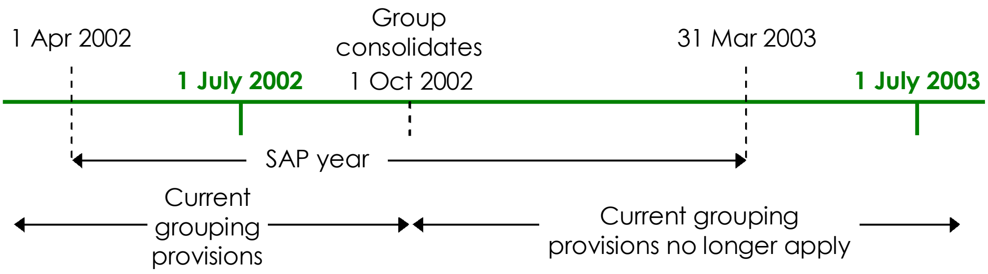
Head Company lodges its 2003 return for the 12-month period ending 31 March 2003. This return includes the assessable income and allowable deductions for the consolidated group from 1 July 2002.

The subsidiary members each lodge their 2003 return for the 12-month period ending 31 March 2003. Effectively, only the assessable income and allowable deductions for the period prior to consolidation – that is, from 1 April 2002 to 30 June 2002 – are included in these returns.

Example 2

Head Company and its subsidiaries have a SAP ending 31 March in lieu of the following 30 June. The group consolidates on 1 October 2002.

Figure 2: SAP ends 31 March, group consolidates 1 October 2002



Current grouping provisions

Access to the current grouping provisions is lost for the whole group from 1 October 2002. Prior to this the group transfer provisions are available to group members but only in relation to the loss or income for the pre-consolidation period ending on 30 September 2002.

Lodgment of returns

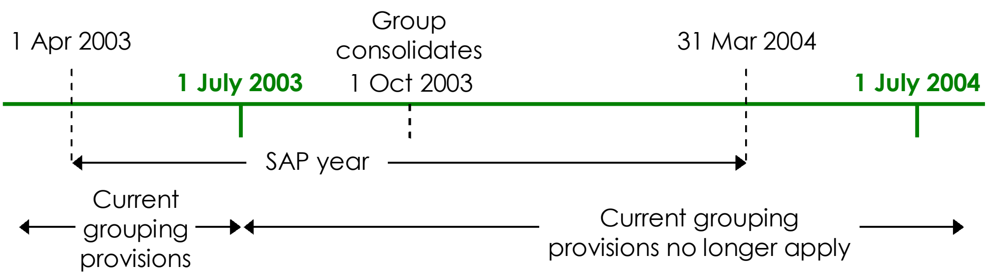
Head Company lodges its 2003 return for the 12-month period ending 31 March 2003. This return includes assessable income and allowable deductions for the consolidated group from 1 October 2002.

The subsidiary members each lodge their 2003 return for the 12-month period ending 31 March 2003. Effectively, only the assessable income and allowable deductions for the period prior to consolidation – that is, from 1 April 2002 to 30 September 2002 – are included in these returns.

Example 3

Head Company and its subsidiaries have a SAP ending 31 March in lieu of the following 30 June. The group consolidates on 1 October 2003.

Figure 3: SAP ends 31 March, group consolidates 1 October 2003



Current grouping provisions

As the group did not consolidate on the first day of Head Company's next income year after 1 July 2003, the current grouping provisions are not available from 1 July 2003. Using the tax loss transfer provisions requires an apportionment of the tax loss of the loss company and the taxable income of the income company. Only that part of the tax loss attributed to the period prior to 1 July 2003 and that part of the taxable income attributed to the period prior to 1 July 2003 are taken into account in any tax loss transfer.

Lodgment of returns

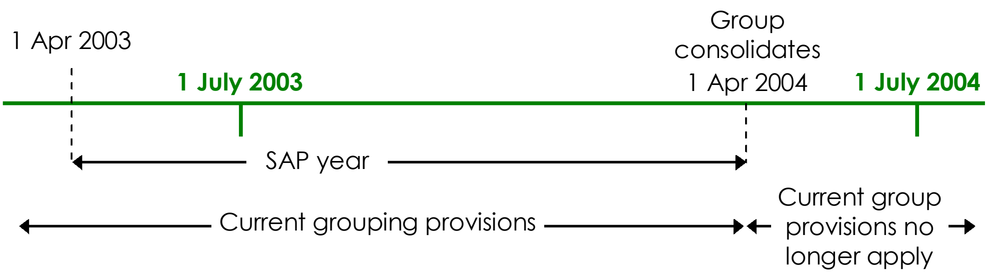
Head Company lodges its 2004 return for the 12-month period ending 31 March 2004. This return includes assessable income and allowable deductions for the consolidated group from 1 October 2003.

The subsidiary members lodge their 2004 returns for the 12-month period ending 31 March 2004. Effectively, only the assessable income and allowable deductions for the period prior to consolidation – that is, from 1 April 2003 to 30 September 2003 – are included in these returns

Example 4

Head Company and its subsidiaries have a SAP ending 31 March in lieu of the following 30 June. Head Company chooses to consolidate the group from the first day of its SAP year beginning after 30 June 2003, that is, 1 April 2004.

Figure 4: SAP ends 31 March, group consolidates 1 April 2004



Current grouping provisions

The current grouping provisions are available to the whole group until the day prior to the date of consolidation, that is, 31 March 2004.

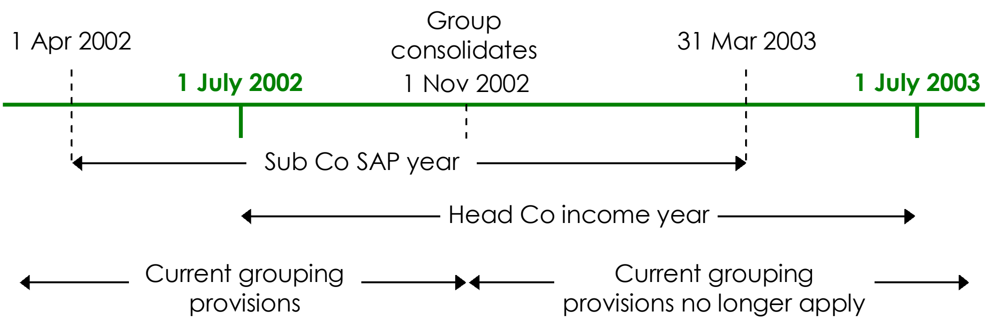
Lodgment of returns

The head company and individual subsidiaries each lodge their 2004 returns for the full 12-month period to 31 March 2004.

Example 5

Head Company is an ordinary balancing company with a subsidiary having a SAP ending 31 March in lieu of the following 30 June. Head Company chooses to consolidate the group from 1 November 2002.

Figure 5: Subsidiary SAP ends 31 March, head company year ends 30 June



Current grouping provisions

Access to the current grouping provisions is lost for the whole group from 1 November 2002. Prior to this the group transfer provisions are available to group members but only in relation to the loss or income for the pre-consolidation period ending on 31 October 2002.

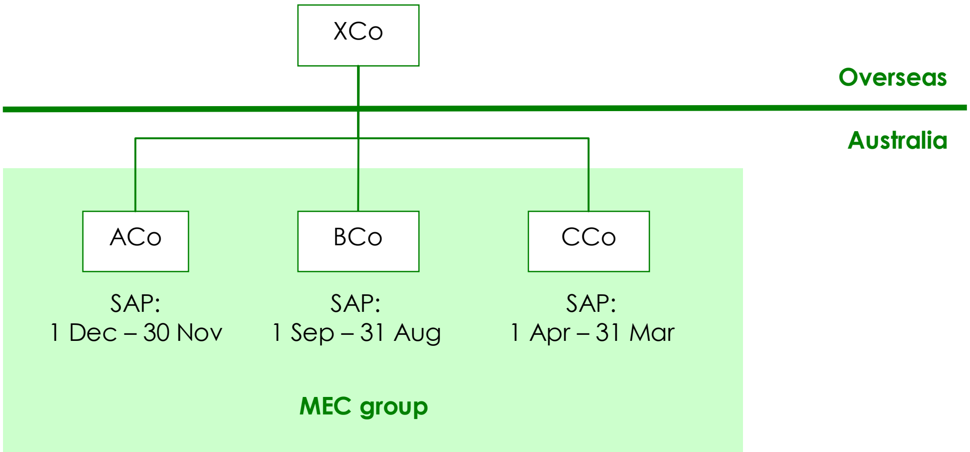
Lodgment of returns

Head Company lodges its 2003 return for the 12-month period to 30 June 2003. This return includes assessable income and allowable deductions for the consolidated group from 1 November 2002.

The subsidiary member with the SAP lodges its 2003 return for the 12-month period ending 31 March 2003. Effectively, only the assessable income and allowable deductions for the period from 1 April 2002 to 31 October 2002 are included in this return.

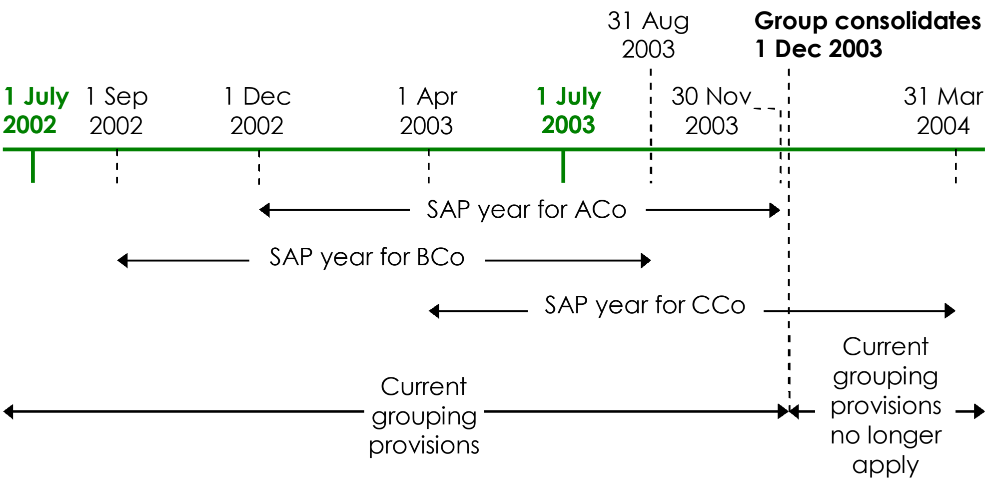
Example 6 A MEC group is formed in which the eligible tier-1 companies – ACo, BCo and CCo – have different SAPs (figure 6).

Figure 6: MEC group – eligible tier-1 companies with different SAPs



ACo, BCo and CCo jointly nominate ACo as the provisional head company of the MEC group. The group consolidates on 1 December 2003, which is the first day of ACo's next income year after 30 June 2003 (figure 7).

Figure 7: MEC group forms on provisional head company's first day of income year after 30 June 2003



Current grouping provisions

Access to the current grouping provisions is available until 30 November 2003 for the whole group, including BCo and CCo (even though they have a different SAP to the provisional head company, ACo).

Lodgment of returns

The head company (ACo) lodges the MEC group's 2004 return for the 12-month period from 1 December 2003 to 30 November 2004.

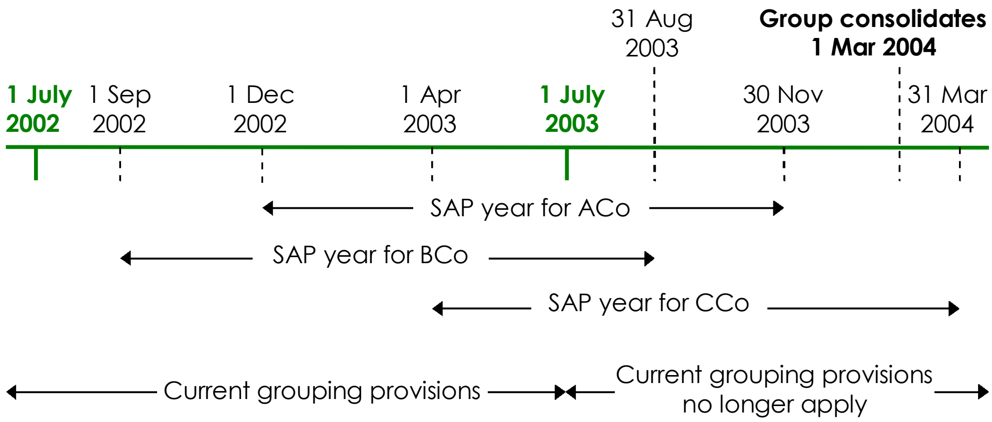
BCo lodges its 2004 return for the 12-month period ending 31 August 2004 but includes only the assessable income and allowable deductions for its non-membership period (1 September 2003 to 30 November 2003).

CCo lodges its 2004 return for the 12-month period ending 31 March 2004 but includes only the assessable income and allowable deductions for its non-membership period (1 April 2003 to 30 November 2003).

Example 7

The group described in example 6 decides to consolidate on 1 March 2004, which is not the first day of the provisional head company's (ACo's) income year after 30 June 2003 (figure 8).

Figure 8: MEC group forms on a day other than the provisional head company's first day of income year after 30 June 2003



Current grouping provisions

Access to the current grouping provisions is lost for the whole group from 1 July 2003 because the group has consolidated on 1 March 2004, which is not the first day of ACo's next income year beginning after 30 June 2003.

Lodgment of returns

The head company (ACo) lodges the MEC group's 2004 return for the 12-month period from 1 December 2003 to 30 November 2004. Effectively, the head company includes assessable income and allowable deductions for itself for the first three months (that is, from 1 December 2003 to 29 February 2004) and for the MEC group as a whole for the remaining nine months (that is, from 1 March 2004 to 30 November 2004).

The subsidiary members lodge their individual returns based on their non-membership periods: that is, BCo and CCo lodge their 2004 returns to cover their assessable income and allowable deductions up to 29 February 2004.

References

Income Tax Assessment Act 1997; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002*, (No. 68 of 2002), Schedule 3, Part 3, Divisions 1 and 2

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 13

Revision history

Section C9-4-110 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Calculating taxable income, income tax and losses for non-membership periods

Description

This example shows how to calculate an entity's income tax payable or loss when it has one or more periods during an income year in which it is not a subsidiary member of a consolidated group.

Commentary

An entity is required to calculate its income tax payable or sort of loss for each non-membership period in the income year. (A non-membership period is a period during an income year in which the entity is not a member of a consolidated group. Note that an entity will have more than one non-membership period in an income year if it leaves and then rejoins the same consolidated group or joins another consolidated group during that year.)

Total income tax payable for the financial year is the sum of tax payable for each period. Losses made in an earlier period are not offset. Any loss made in a non-membership period that ends on the last day of the income year is not offset against income made in an earlier period. However, the tax loss is carried forward.

For the purpose of determining whether a loss can be claimed by an entity for a period, that entity's non-membership period includes the time just after the end of the period. This ensures that any ownership changes occurring at that time (the end of the period) are taken into account in determining any loss claimable for the non-membership period. → subsections 701-30(3A) and 701-30(8)

Special rules apply under Division 716 of the *Income Tax Assessment Act 1997* (ITAA 1997) where income and deductions are 'brought to account' over a period rather than at a single moment. Subdivision 716A apportions, between the head company of a consolidated group and an entity that joins or leaves it in the year, the entity's assessable income and deductions that would have otherwise been brought to account over several income years. Subdivision 716B provides principles for the allocation of amounts to periods in which the head company and subsidiary member have different income years. It also provides for the grossing up of amounts for periods of less than 365 days.

The following steps are required to calculate the income tax payable, taxable income or losses of an entity that has one or more non-membership periods in the same income year:

Step 1: Identify each non-membership period during the income year.

→ paragraph 701-30(2)(b), ITAA 1997

Step 2: For each one of those periods, calculate separately the entity's taxable income and, where appropriate, the loss of each sort. Do this as if the start and end of each period were the start and end of the income year.

→ subsection 701-30(3)

Step 3: Calculate separately the income tax payable on each amount of taxable income identified for each period. → subsection 701-30(3)

Step 4: Add together each amount of taxable income identified at step 2 to calculate the entity's taxable income for the whole income year. → subsection 701-30(5)

Step 5: Add together each amount of income tax payable identified at step 3 to calculate the entity's income tax payable for the financial year. → subsection 701-30(4)

Step 6: If at step 2 a loss is calculated for any period, the entity has a loss of a particular sort for the income year only if it has a loss for a non-membership period ending at the end of the income year. → subsection 701-30(7)

The entity can only have a loss for the income year to the extent that it has a loss in the final period of the income year. This is because when an entity joins a consolidated group its losses are either transferred into the group in accordance with the loss transfer rules or they are cancelled and cannot be used by any entity. As the income tax payable is worked out separately for each period of the income year in which the entity is a taxpayer in its own right, losses in a later period of the income year cannot be used to offset income in an earlier period. → subsection 701-30(7)

These calculation rules apply also to partnerships and trusts, which have net income rather than taxable income. → subsection 701-65

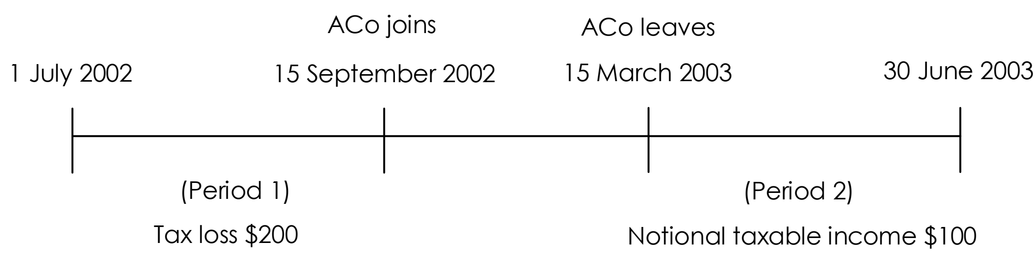
Example 1

Facts

ACo, a company, becomes a subsidiary member of a consolidated group on 15 September 2002 and leaves the group on 15 March 2003.

ACo makes a tax loss of $200 in the first part of the year in which it was not a member of the consolidated group (Period 1).

ACo has notional taxable income of $100 in the other part of the year in which it was not a member of the consolidated group (Period 2).



Calculation

Notional income tax liability:	Period 1	Nil
Notional income tax liability:	Period 2 ($100 x 30% tax rate)	$30
Income tax liability:		$30

ACo's 2002–03 income tax liability of $30 is based on the notional taxable income made in the second part of the year in which it was not a member of the consolidated group (Period 2).

The $200 tax loss made by ACo in Period 1 is either transferred to the consolidated group or cancelled and not able to be used by any entity.

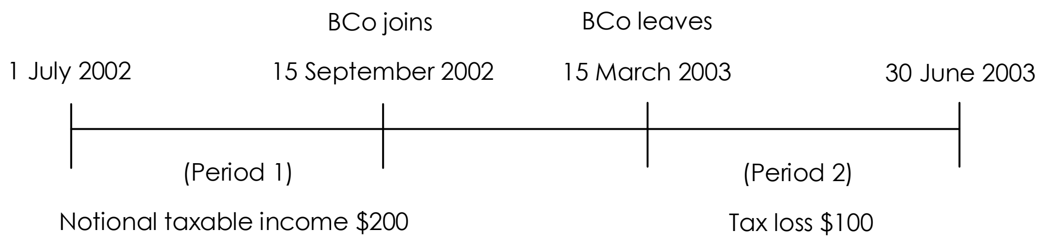
Example 2

Facts

BCo, a company, becomes a subsidiary member of a consolidated group on 15 September 2002 and leaves the group on 15 March 2003.

BCo has notional taxable income of $200 in the first part of the year in which it was not a member of the consolidated group (Period 1).

BCo makes a tax loss of $100 in the other part of the year in which it was not a member of the consolidated group (Period 2).



Calculation

Notional income tax liability:	Period 1 ($200 x 30% tax rate)	$60
Notional income tax liability:	Period 2	Nil
Income tax liability:		$60

BCo's 2002–03 income tax liability of $60 is based on the notional taxable income made in the first part of the year in which was not a member of the consolidated group (Period 1).

The $100 tax loss made by BCo in Period 2 becomes BCo's loss for the 2002–03 income year and is available to be carried forward to 2003–04.

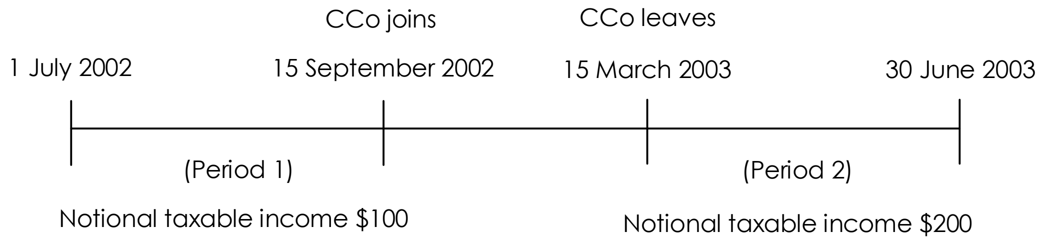
Example 3

Facts

CCo, a company, becomes a subsidiary member of a consolidated group on 15 September 2002 and leaves the group on 15 March 2003.

CCo has notional taxable income of $100 in the first part of the year in which it was not a member of the consolidated group (Period 1).

CCo has notional taxable income of $200 in the other part of the year in which it was not a member of the consolidated group (Period 2).



Calculation

Notional income tax liability:	Period 1 ($100 x 30% tax rate)	$30
Notional income tax liability:	Period 2 ($200 x 30% tax rate)	$60
Income tax liability:		$90

CCo's 2002–03 taxable income is $300 and is calculated by adding the notional taxable income derived in the two periods in which it was not a member of the consolidated group.

CCo's 2002–03 income tax liability is $90 and is calculated by adding the notional income tax liabilities calculated for the two periods in which it was not a member of the consolidated group.

References

Income Tax Assessment Act 1997, Division 716; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 1

Income Tax Assessment Act 1997, section 701-30; as amended by

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 1
- *New Business Tax System (Consolidation and Other Measures) Act 2003 (No. 16 of 2003)*, Schedule 19

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (no 2) 2002*,* Paragraphs 6.13 to 6.21

Income Tax Assessment Act 1997, section 701-65; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002

Revision history

Section C9-5-110 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Partners and partnerships – applying the part-year provisions

Description

This example shows how a head company and an entity that joins a consolidated group part-way through its income year work out their respective shares of income or a loss from a partnership.

The example also shows how a partnership with a non-membership period works out its net income for the income year.

Commentary

Under the partnerships provisions in Part III, Division 5 of the *Income Tax Assessment Act 1936* (ITAA 1936), resident partners include in their assessable income their individual interests in the net income of the partnership for the income year. If the partnership incurs a loss for the income year, resident partners are entitled to deductions equal to their individual interests in the partnership loss.

However, special provisions apply when an entity joins or leaves a consolidated group part-way through its income year and when it would, but for consolidation, have included its share of the net income or loss of a partnership in its tax return.

Under these special provisions, the amounts a partner includes in its tax return are worked out as its share of the partnership's assessable income and deductions that are attributable to the partner's non-membership period. The head company also includes these amounts in its tax return for any period when a partner was a member of the group but the partnership was not.

These provisions apportion assessable income and deductions instead of net income so that the amount returned by the partner for its non-membership period (or returned by the head company for the partner's membership period) properly reflects the income and deductions position of the partnership for that particular period in the income year. If the apportionment were made on the basis of the partnership's net income or loss, the income or loss would effectively be spread evenly over the whole income year. This is unlikely to reflect the partner's true contribution and entitlement for a particular period within the income year.

The following example shows how a partnership's assessable income and deductions for an income year are apportioned between the partners (including the period when a partner is taken to be part of the head company) under sections 716-80 and 716-85 of the *Income Tax Assessment Act 1997* (ITAA 1997). It also shows how a partnership with a non-membership period works out its net income under section 701-30 of the ITAA 1997 so that it can include this information in its tax return for the income year in which it joins or leaves a consolidated group.

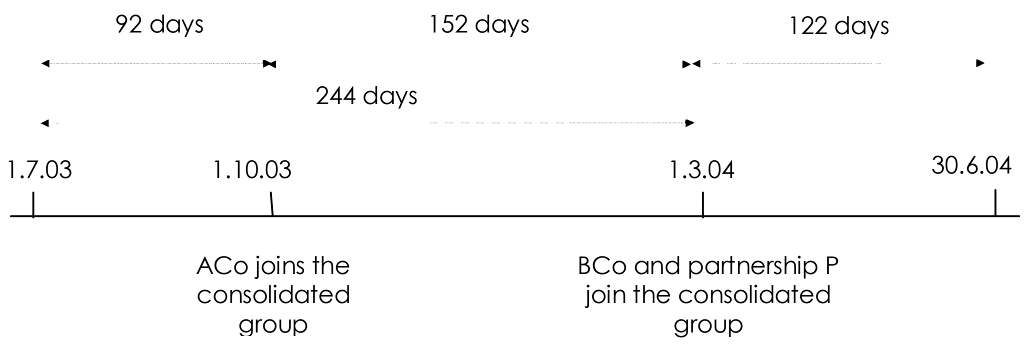
Example

Facts ACo and BCo each hold a 50% interest in partnership P.

On 1 October 2003, HCo, the head company of a consolidated group, acquires all the shares in ACo, which thus becomes a subsidiary member of the group.

On 1 March 2004, HCo acquires all the shares in BCo. By acquiring all the membership interests in BCo, HCo also acquires the remaining 50 per cent interest in partnership P, which means both BCo and partnership P become subsidiary members of the consolidated group.

Figure 1: Membership changes in HCo's consolidated group



Partnership P's assessable income and deductions for the relevant periods are shown in table 1.

The partnership's net income for the 2003–04 income year does not include amounts that relate to its period of membership in the consolidated group. During this period, partnership P is considered part of HCo for income tax purposes and HCo therefore includes in its return any assessable income and deductions that arise from partnership P's contribution to the group's income-producing activities.

Partnership P incurred borrowing expenses in the previous income year which it is required to deduct over 5 years → section 25-25, ITAA 1997. The deductible part of the borrowing expenses for the 2003–04 income year ($600) is not attributable to a particular period within the year.

Table 1: Partnership P's income and deductions – 2003–04 income year

Attributable to the period	Assessable income ($)	Deductions ($)
1.7.03 to 30.9.03 (92 days)	5000	(3000)
1.10.03 to 28.2.04 (152 days)	6000	(6400)
1.3.04 to 30.6.04 (122 days)	n/a	n/a
no particular period		(600)

Calculation of ACo's taxable income

As ACo is a subsidiary member of the consolidated group, its 2003–04 income tax return will only reflect the income and deductions attributable to the period before it joined the group. Section 701-30 in conjunction with Subdivision 716-A will determine the taxable income for that period and the tax payable for the 2003–04 financial year. → section 701-30, ITAA 1997; 'Calculating taxable income, income tax and losses for non-membership periods', C9-5-110

As a partner in partnership P, ACo normally includes its share in the net income or loss of the partnership → section 92, ITAA 1997. However, specific provisions apply when a partner or the beneficiary of a trust was a member of a consolidated group for part of an income year. → sections 716-75 to 716-100, ITAA 1997

Under section 716-85, ACo works out how much of partnership P's *assessable income* it must include in its own assessable income and how much of partnership P's *deductions* it is entitled to deduct for its non-membership period.

Note

Partnership P only has assessable income or deductions while it remains outside the consolidated group; it loses its individual identity on entry into the group and is treated as part of the head company.

ACo's share is 50%. → section 716-90, ITAA 1997

ACo includes its share of partnership P's assessable income that is reasonably attributable to its non-membership period (1 July 2003–30 September 2003) plus a proportion of any amounts that are not reasonably attributable to a particular period in the income year. → subsection 716-85(1), ITAA 1997

ACo therefore includes in its assessable income:

50% x $5,000 = $2,500

ACo is entitled to deduct its share of partnership P's deductions that are reasonably attributable to its non-membership period plus its share of a proportion of any amounts that are not reasonably attributable to a particular period. → subsection 716-85(2), ITAA 1997

Partnership P's deductions that are reasonably attributable to ACo's non-membership period are $3,000.

In addition, ACo can deduct its share of a proportion of the borrowing expenses that are not reasonably attributable to a particular period in the income year.

The proportion is worked out under subsection 716-85(3) as follows:

$$\$600 \times \frac{92 \text{ (days in both the non-membership period and the spreading period)}}{366 \text{ (days in the spreading period)}}$$

= $150

(Since ACo was a partner in partnership P for the whole of the 2003–04 income year, the spreading period is 366 days. → section 716-100, ITAA 1997)

ACo is entitled to deduct under subsection 716-85(2):

50% x ($3,000 + 150) = $1,575

Calculation of BCo's taxable income

BCo's 2003–04 income tax return will only reflect the income and deductions attributable to its non-membership period. Section 701-30 in conjunction with Subdivision 716-A will determine the taxable income for that period and the tax payable for the 2003 –04 financial year. → section 701-30, ITAA 1997; C9-5-110

Like ACo, BCo is a partner in partnership P and has a non-membership period. BCo must apply the specific provisions in Subdivision 716-A to work out how much of partnership P's *assessable income* it must include in its return and how much of partnership P's *deductions* it is entitled to deduct.

BCo's share is 50%. → section 716-90, ITAA 1997

BCo includes its share of partnership P's assessable income that is reasonably attributable to its non-membership period (1 July 2003–28 February 2004) plus a proportion of any amounts that are not reasonably attributable to a particular period in the income year. → subsection 716-85(1), ITAA 1997

BCo therefore includes in its assessable income:

50% x $11,000 = $5,500

BCo is entitled to deduct its share of partnership P's deductions that are reasonably attributable to its non-membership period plus its share of a proportion of any amounts that are not reasonably attributable to a particular period. → subsection 716-85(2), ITAA 1997

Partnership P's deductions that are reasonably attributable to BCo's non-membership period are $9,400.

In addition, BCo can deduct its share of a proportion of the borrowing expenses that are not reasonably attributable to a particular period in the income year.

The proportion is worked out under subsection 716-85(3) as follows:

$$\$600 \quad \times \quad \frac{244 \text{ (days in both the non-membership period and the spreading period)}}{366 \text{ (days in the spreading period)}}$$

= $400

(Since BCo was a partner in partnership P for the whole of the 2003–04 income year, the spreading period is 366 days. → section 716-100, ITAA 1997)

BCo is entitled to deduct under subsection 716-85(2):

50% x ($9,400 + 400) = $4,900

Adjustment to HCo's assessable income and deductions

Head company HCo has entities in its consolidated group for part of the income year that would, but for consolidation, have included their share of a partnership's income or loss in their tax returns. → section 716-75, ITAA 1997

HCo must therefore apply section 716-80 to both the relevant entities.

HCo's share of ACo's partnership income

HCo must include in its assessable income ACo's share of partnership P's assessable income that is reasonably attributable to the period when ACo was a subsidiary member of the consolidated group but partnership P was *not*. HCo must also include ACo's share of a proportion of any assessable amounts that are not reasonably attributable to any particular period in the income year. → paragraph 716-80(1)(a)

HCo includes 50% of partnership P's assessable income for the period 1 October 2003 to 29 February 2004:

50% x $6,000 = $3,000

HCo is entitled to deduct ACo's share of partnership P's deductions that are reasonably attributable to the period when ACo was a subsidiary member of the consolidated group but partnership P was *not*. → subparagraph 716-80(1)(b)(i), ITAA 1997

The total of these amounts is $6,400.

HCo is also entitled to deduct ACo's share of a proportion of partnership P's deductions that are not reasonably attributable to any particular period in the income year. → subparagraph 716-80(1)(b)(ii), ITAA 1997

In this case, partnership P's deduction for borrowing expenses of $600 is not attributable to any particular period in the 2003–04 income year.

The proportion is worked out under subsection 716-80(2) as follows:

$$\$600 \quad \times \quad \frac{152 \text{ (days in the spreading period when ACo was a member but P was not)}}{366 \text{ (days in the spreading period)}}$$

= $249

(The spreading period is 366 days, since ACo was a partner for the whole of the 2003–04 income year.→ section 716-100, ITAA 1997)

HCo is therefore entitled to deduct under subsection 716-80(1)(b):

50% x ($6,400 + 249) = $3,325

HCo's share of BCo's partnership income

HCo must include in its assessable income BCo's share of partnership P's assessable income. It is also entitled to deduct BCo's share of partnership P's deductions that relate to the period when BCo was a subsidiary member of the consolidated group but partnership P was *not*. → subsection 716-80(1)

Since there is no period when BCo was a subsidiary member of the consolidated group but partnership P was not, there are no amounts of assessable income or deductions that HCo must include or can deduct.

HCo's share of partnership P's borrowing expenses

Since partnership P has a non-membership period and, but for consolidation, would have been entitled to a deduction for borrowing expenses spread over two or more income years under a provision of the Act, special provisions apply to apportion the deduction between partnership P and HCo. → section 716-25, ITAA 1997

HCo's deduction is a proportion of the amount partnership P could have deducted if it had not joined the group (or that HCo could have deducted if partnership P had been a member of the group for the whole income year). The proportion of the $600 amount that is deductible by HCo is worked out under subsection 716-25(4):

$$\$600 \quad \times \quad \frac{122}{366}$$

122: (days in both the income year and the spreading period when P was in the group)

366: (days in both the income year and the spreading period)

= $200

HCo is therefore entitled to deduct $200 for the borrowing expenses under subsection 716-25(3).

Table 2: Allocation of borrowing expenses deductible over the full 2003–04 income year

Deductible by	Relevant period	Calculation	Deduction ($)
ACo	1.7.03 – 30.9.03	50% x $150	75
BCo	1.7.03 – 29.2.04	50% x $400	200
HCo (ACo is a member, P is not)	1.10.03 – 29.2.04	50% x $249	125
HCo (P is a member)	1.3.04 – 30.6.04	100% x $200	200
Total			**600**

HCo's income and deductions under the single entity rule

→ section 701-1, ITAA 1997

For the period 1 March–30 June 2004, partnership P is a subsidiary member of the consolidated group. It loses its individual identity on entry into the group and is treated as part of the head company. → section 701-1, ITAA 1997

From 1 March, HCo is taken to earn all assessable income and to incur all expenditure arising from partnership P's contribution to the group's income-producing activities.

Calculation of partnership P's net income

Partnership P joins the consolidated group on 1 March 2004, part-way through its income year. Because it has a non-membership period, it must work out its income tax position and lodge an income tax return for the 2003–04 income year. → section 701-30, ITAA 1997; C9-5-110

Section 701-65 modifies the operation of section 701-30 to allow it to apply to a partnership or a trust. → section 701-65, ITAA 1997

Partnership P must allocate each relevant item to either the non-membership period or to another period in the income year. Amounts that cannot be allocated are apportioned between periods. → paragraph 701-30(3)(c); 'Calculating taxable income, income tax and losses for non-membership periods', C9-5-110

On the facts provided, partnership P allocates a total of $11,000 in assessable income and $9,400 in deductions to its non-membership period. A further deduction of $600 must be apportioned between periods. A deduction that is spread over two or more income years by a provision of the Act (such as borrowing expenses under section 25-25) is apportioned between partnership P and HCo under a specific provision. → section 716-25, ITAA 1997

The proportion of the $600 amount that is deductible to partnership P is worked out under subsection 716-25(6):

$$\$600 \quad \times \quad \frac{244}{366} \quad \begin{matrix}\text{(days in both the non-membership period and the spreading period)} \\ \text{(days in both the income year and the spreading period)}\end{matrix}$$

$$= \$400$$

The net income of partnership P for the 2003–04 income year is its assessable income less deductions (with certain exceptions). → section 90, ITAA 1936:

$11,000 – ($9,400 + $400) = $1,200

Table 3: Reconciliation of taxable income or losses returned against the net income of partnership P

Entity	Assessable income ($)	Deductions ($)	Taxable income or loss included ($)
ACo	2,500	(1,575)	925
BCo	5,500	(4,900)	600
HCo	3,000	(3,325)	(325)
Total	**11,000**	**(9,800)**	**1,200**

References

Income Tax Assessment Act 1997, sections 25-25, 701-1, 701-30, 701-65, 716-25, 716-75 to 716-100, as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002); *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002)

Income Tax Assessment Act 1936 sections 90, 92

Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, paragraphs 4.27 to 4.39

Revision history

Section C9-5-120 first published 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on recent changes to consolidation rules.	Legislative amendments.
26.10.05	Note on recent changes deleted.	Legislative amendment.
	Change to figure 1.	For clarification.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Effect of entry history rule

Description

This example shows how the entry history rule may affect the future tax liabilities of a consolidated group when an entity joins the group.

Commentary

The entry history rule identifies the history that an entity takes with it into a consolidated group. This history can affect the future tax liabilities of the group.

For most purposes, a consolidated group inherits the tax history of its joining subsidiary members. Specifically, the entry history rule ensures that everything that happened in relation to an entity before joining a consolidated group is taken to have happened in relation to the head company for the purposes of calculating the head company's future income tax liability or tax losses. The entry history rule does not affect the joining entity's responsibility for taxation liabilities relating to pre-consolidation periods. → section 701-5, *Income Tax Assessment Act 1997* (ITAA 1997)

The entry history rule provides that a head company may be entitled to certain deductions for expenditure incurred by a joining entity before it joins, such as borrowing expenses, gift deductions (where the entitlement to the deduction is spread), the cost of connecting water, power and telephone lines, certain business-related costs and expenditure allocated to a project pool.

A head company may also be entitled to a deduction for a debt brought into a consolidated group that subsequently goes bad. → Subdivision 709-D; worked examples C9-5-350 to C9-5-352; paragraphs 6.30 – 6.55 of the Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 7) Bill 2004

Income is derived and therefore assessed when the services to which the payments relate are provided → *Arthur Murray (NSW) Pty Ltd v FC of T* (1965) 114 CLR 314. If such a period spans an entity joining, or the formation of, a consolidated group, the entry history rule requires a head company to include the relevant amounts as assessable income over the period in which the services are provided.

Where a specific provision of the Act requires that either income or deductions are spread over two or more periods, Division 716 of the ITTA 1997 operates to give effect to the spreading. The income tax history of the assessable income, or allowable deduction to be spread, is inherited under the entry history rule.

Other effects of the entry history rule include:

- The pre-CGT status of assets brought into a consolidated group by an entity that becomes a subsidiary member is inherited. (However, the pre-CGT status of the asset would be lost if any acquisition of membership interests in the entity resulted in the ultimate owners not continuing to hold majority underlying interests in the asset.)
- Private rulings about income tax issued to an entity before it joins a consolidated group may apply to the head company insofar as the relevant facts or arrangement associated with the ruling have not changed either by reason of consolidation (e.g. because they relate to intragroup transactions, which are ignored) or otherwise.

The following public rulings and determinations relate to the application of the entry history rule: Taxation Ruling TR 2007/2 and taxation determinations TD 2004/43, TD 2004/44, TD 2004/45, TD 2004/80, TD 2005/23 and TD 2008/29.

Situations where history is not inherited

For some purposes, specific provisions of the consolidation regime override the entry history rule. For example, the history in relation to the tax costs of a joining entity's assets is affected when those costs are set under the consolidation cost setting rules → 'Treatment of assets', C2-1; sections 701-10, 701-55 and 701-60, ITAA 1997. Other rules affect the amount of losses that can be brought into a consolidated group when an entity becomes a subsidiary member.
→ 'Treatment of losses', C3-1; Division 707, ITAA 1997.

Other provisions that modify the application of the entry history rule include:

- rules covering the entitlement to the R&D tax offset → section 73BABA, ITAA 1936, and the R&D incremental concession → section 73BAC, ITAA 1936
- a rule requiring that the entry history rule be ignored when determining a debt test period for the purpose of applying the consolidation bad debt rules → subsection 709-205(3), ITAA 1997.

The entry history rule is also modified by rules that permit the head company of a consolidated group to remake certain normally irrevocable elections or choices made by entities before they join the group → Subdivision 715-J, ITAA 1997. These fall into three categories:

1. Resettable elections

Where a joining entity was eligible to make a choice in this category (see list below) in relation to an income year starting before the joining time, or had, before the joining time, made such a choice which would have started to have effect for its first income year starting after the joining time if it had not joined the group, its choice (or absence of it) is ignored for the purposes of the head company's income tax affairs and the head company may make the choice, if it is eligible.

The head company has until the later of the time allowed under the choice provision and 90 days after it notifies the ATO that the entity has joined the group to make the choice. The Commissioner has discretion to extend this deadline.

Note that this rule came into effect on 21 March 2005. If the head company notified the ATO before 21 March 2005 that the entity had joined the group, the 90 day limit mentioned above is taken to be 90 days after 21 March 2005.

→ section 715-659, IT(TP)A 1997

The choice has effect from the joining time (or from the income year containing the joining time if the choice relates to a whole income year).

The choices in this category are:

- irrevocable declarations, elections, choices or selections provided for in Part X of the ITAA 1936 – about attribution of income in respect of controlled foreign companies (CFCs)
- the election to use a particular foreign currency to work out taxable income or a tax loss for an income year under item 1 of the table in subsection 960-60(1) of the ITAA 1997
- a fair value election, foreign exchange retranslation election, hedging financial arrangement election or election to rely on financial reports under section 230-210, 230-255, 230-315 or 230-395 of the ITAA 1997 respectively (about the treatment of gains and losses from Division 230 financial arrangements)
- elections provided for under other provisions that may be prescribed by regulation under this category in the future.

→ section 715-660, ITAA 1997; paragraphs 1.183 – 1.196 of the Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004; 'Effect of exit history rule', C9-5-810

Note

For income years before 2010-11, choices in this category also included:

- irrevocable declarations, elections, choices or selections provided for in former Part XI of the ITAA 1936 – about attribution of income in respect of foreign investment funds (FIFs) and foreign life policies (FLPs)
- the election to value all items of trading stock that were interests in a FIF at market value (rather than cost) under former section 70-70 of the ITAA 1997.

2. Limited resettable elections to overcome inconsistencies

Where a joining entity and another entity that was a member of the group at the joining time were both eligible to make a choice in this category (see list below) in relation to an income year starting before the joining time, and the choice was in effect just before the joining time for one entity but not the other, the choice (or absence of it) of the joining entity is ignored for the purposes of the head company's income tax affairs, and the head company may make the choice, if it is eligible.

The time limit for the head company to make the choice is the same as for resettable elections (see above). The choice has effect from the joining time (or from the income year containing the joining time if the choice relates to a whole income year).

The choices in this category are:

- the election under section 148 of the ITAA 1936 by a person carrying on a business of insurance in Australia who reinsures with a non-resident, in relation to reinsurance under contracts made at or after the joining time. (For contracts made before the joining time, the head company is taken to have made the same decision as the joining entity that was party to the contract to make or not make the election.)
- a fair value election, foreign exchange retranslation election, hedging financial arrangement election or election to rely on financial reports under section 230-210, 230-255, 230-315 or 230-395 of the ITAA 1997 respectively (about the treatment of gains and losses from Division 230 financial arrangements)
- the election under section 775-80 of the ITAA 1997 that sections 775-70 and 775-75 of that Act (concerning the tax consequences of certain short-term foreign exchange gains and losses) not apply
- elections provided for under other provisions that may be prescribed by regulation under this category in the future.

→ section 715-665, ITAA 1997; paragraphs 1.200 – 1.213 of the Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004; 'Effect of exit history rule', C9-5-810

3. Choices with ongoing effect

If a joining entity was eligible to make a choice in this category in relation to something that was its asset, right, liability or obligation until it became that of the head company because of the single entity rule, and the head company is similarly eligible under that rule, the head company is taken to have made the choice or not made the choice depending on whether the joining entity did or did not have that choice in effect at the joining time.

The only choice currently available in this category is the choice provided under section 775-150 of the ITAA 1997 regarding whether to apply rules about disregarding certain forex realisation gains and forex realisation losses.

Choices of this type are not affected by the fact of consolidation: that is, such a choice (or absence of a choice) continues to apply with respect to an asset, right, liability or obligation that, before consolidation, was held by an entity that had made the choice (or not made the choice).

→ section 715-670, ITAA 1997; paragraphs 1.220 – 1.224 of the Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004

However, if an entity has a particular choice in this category in effect at the time it joins a consolidated group and it is the first time that any entity with that choice in effect has joined the group, the head company may make an irrevocable choice that all assets, rights, liabilities or obligations it holds at that time, or subsequently when other entities later join the group, are covered by the choice. The head company must make the choice within 90 days of notifying the ATO that the entity has joined the group. The Commissioner has discretion to extend this time limit.

Note that this rule came into effect on 21 March 2005. If the head company notified the ATO before 21 March 2005 that the entity had joined the group, the 90 day limit mentioned above is taken to be 90 days after 21 March 2005.

→ section 715-659, IT(TP)A 1997

If the head company later becomes a subsidiary member of another consolidated group, this choice will itself be treated as a choice with ongoing effect in relation to that other consolidated group.

→ section 715-675, ITAA 1997; paragraphs 1.225 – 1.226 of the Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004'; 'Effect of exit history rule', C9-5-810

Example

Facts

- HCo has beneficially owned 100% of ACo since the companies were incorporated in 1996 and there has been no change in the group's ultimate owners.
- HCo chose to form a consolidated group with effect from 1 July 2002. ACo is the only subsidiary member of the group.
- ACo incurred $5,000 in borrowing expenses on 1 July 1999. The borrowing expenses have been deductible to ACo under section 25-25 of the ITAA 1997 at the rate of $1,000 per year (i.e. 1/5 of $5,000). The borrowed moneys continue to be used by ACo solely for income producing purposes.
- In 2000-01, ACo included in its assessable income $3,000 relating to an item of trading stock sold by it on a credit basis. In 2002-03 this debt was written off as bad by ACo.
- On 1 July 2001, ACo received an up-front payment of $4,000 under a contract to provide services to a customer for the period 1 July 2001 to 30 June 2003. ACo included $2,000 as assessable income in 2001-02 as the remaining $2,000 would not be earned until 2002-03.
- If the events in relation to ACo that occurred before consolidation are ignored, HCo's taxable income for the group would be $120,000 for 2002-03 and $100,000 for 2003-04.

Calculation of HCo's taxable income

Taking into account the entry history rule, HCo's 2002-03 and 2003-04 taxable income is calculated as follows:

	2002–03	2003–04
Taxable income before applying entry history rule:	$120,000	$100,000
Add further assessable amounts:		
income received in advance	$2,000	
Less further deductions:		
borrowing expenses	($1,000)	($1,000)
bad debt	($3,000)	
Taxable income after applying entry history rule:	$118,000	$99,000

References

Legislation

Income Tax Assessment Act 1997, section 701-5; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1 item 2; as amended by *Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Act 2005* (No. 147 of 2005), Schedule 1 item 105

Income Tax Assessment Act 1997, section 701-85; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1 item 2

Explanatory Memorandum to New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 2.7, 2.8, 2.13, 2.30 to 2.37, 2.47 and 2.81

Explanatory Memorandum to Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Bill 2005, paragraphs 3.14 to 3.19

Income Tax Assessment Act 1997, Subdivision 717-F; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 8 item 9

Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, paragraphs 7.65 to 7.69

Income Tax Assessment Act 1997, Division 716; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 1 item 3

Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, Ch 4.

Income Tax Assessment Act 1997, section 25-35

Income Tax Assessment Act 1997, Subdivision 715-J; as inserted by *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1, Part 10; as amended by *Tax Laws Amendment (Taxation of Financial Arrangements) Act*

2009 (No. 15 of 2009), Schedule 1, Part 2 and *Tax Laws Amendment (Foreign Source Income Deferral) Act (No. 1) 2010* (No. 114 of 2010), Schedule 1, Part 1

Explanatory Memorandum to Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008, paragraphs 5.63 to 5.67 and 12.38 – 12.63

Income Tax Assessment Act 1997, Subdivision 709-D; as inserted by *Tax Laws Amendment (2004 Measures No. 7) Act 2005* (No. 41 of 2005), Schedule 6, Part 4

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004, paragraphs 1.183 – 1.196, 1.200 – 1.213 & 1.220 – 1.226

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 7) Bill 2004, paragraphs 6.30 – 6.55

Income Tax Assessment Act 1936, section 73BABA; as inserted by the *Taxation Laws Amendment (No. 2) Act 2004* (No. 20 of 2004), Schedule 8 item 10

Income Tax Assessment Act 1936, section 73BAC; as amended by the *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 11 item 7; as amended by *Tax Laws Amendment (2007 Measures No. 5) Act 2007* (No. 164 of 2007), Schedule 11, items 11, 12

Taxation ruling

TR 2007/2 – Income tax: application of the same business test to consolidated and MEC groups – principally, the interaction between section 165-210 and section 701-1 of the *Income Tax Assessment Act 1997*

Taxation determinations

TD 2004/43 – Income tax: consolidation: capital gains: for the purposes of the capital gains tax provisions in Parts 3-1 and 3-3 of the *Income Tax Assessment Act 1997*, is the head company of a consolidated group taken to have acquired an asset, which a subsidiary member brings to the group, at the same time that the subsidiary member acquired it?

TD 2004/44 – Income tax: consolidation: capital gains: does the transfer of an asset between members of a consolidated group affect the ownership period of the head company for the purposes of applying the small business 15 year exemption in Subdivision 152-B of the *Income Tax Assessment Act 1997* ?

TD 2004/45 – Income tax: consolidation: capital gains: how does the controlling individual condition in paragraph 152-110(1)(c) of the *Income Tax Assessment Act 1997* (one of the conditions for the small business 15 year exemption in Subdivision 152-B) apply to the head company of a consolidated group in respect of the sale of an asset brought into the group by a subsidiary member?

TD 2004/80 – Income tax: consolidation: capital gains: does an entity permanently lose its status as an 'originating company', in respect of a deferral event in subsection 170-255(1) of the *Income Tax Assessment Act 1997*, when the entity becomes a subsidiary member of a consolidated group?

TD 2005/23 – Income tax: consolidation: can the head company of a consolidated group satisfy subsection 25-35(1) of the *Income Tax Assessment Act 1997* in relation to a debt that is written off as bad by a subsidiary member, where the debt is in respect of money lent by the subsidiary in the ordinary course of its business of lending money before it became a member of the consolidated group?

TD 2008/29 – Income tax: consolidation: capital gains: do the core consolidation rules in Division 701 of the *Income Tax Assessment Act 1997* modify the effect of the CGT contract rules if an entity contracts to buy or sell a CGT asset and the contract settles after the entity becomes, or ceases to be, a member of a consolidated group?

Revision history

Section C9-5-150 first published 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
27.10.03	Minor change to description of calculation.	To clarify.
14.7.04	Note on proposed changes to consolidation rules.	Proposed legislative amendments.
	Reference to rules relating to R&D tax offset and R&D incremental concession as modifying the application of the entry history rule, p. 2.	Legislative amendments.
26.10.05	Changes and new material in Commentary on rules that modify the entry history rule.	Legislative amendments.
6.5.11	Changes to the list of irrevocable elections made by a joining entity that may be remade by the head company despite the entry history rule.	Legislative amendments.
	Updated references to legislative amendments and public rulings.	Legislative amendments, new public rulings.
	Other minor changes to Commentary.	For clarification.

Worked example

Aligning income/deductions with services – arrangements between prospective fellow members

Description

This example shows the process for aligning, at the joining time:

- the income and deductions arising from an ongoing arrangement between two entities that subsequently become members of the same consolidated group, with
- the services actually provided or received up to that time.

Commentary

Ongoing arrangements of various kinds involving income and expenditure can exist between two entities before they become members of a consolidated group (or, alternatively, between a consolidated group and another entity before that entity joins the group). Examples of such arrangements include loans subject to interest, provision of property under a lease, or prepayment for the future provision of goods or services including insurance.

After entities in an ongoing arrangement become members of the same consolidated group, payments between them will not be recognised for income tax purposes – each subsidiary member is treated under the single entity principle as a part of the head company. This means that any difference between the proportion of services actually provided and the assessable income the providing entity has derived – when compared to the whole arrangement – will become frozen once the entities become members of the same consolidated group. Similarly, for the recipient of the services, any difference between the proportion of services received and its allowable deductions will likewise become frozen. → section 701-70, *Income Tax Assessment Act 1997*.

The purpose of section 701-70 is to align each entity's tax position at the joining time with the proportion of services it has actually provided or received. The provision ensures that assessable income and deductions are brought to account in respect of the amount of service provided under such arrangements before the entities become members of the same consolidated group.

Note that section 701-75 operates in similar fashion to section 701-70 where an ongoing arrangement exists between two members of the same consolidated group and one (or both) *ceases* to be a member of the group.

Example

Facts

Entity A becomes a wholly-owned subsidiary of holding company HC on 1 July 2002. Before that date Entity A was totally unrelated to HC.

Entity A executed a car lease with HC, effective 1 July 1998, under which Entity A is obliged to pay HC $100 monthly for 5 years in return for the lease of a car.

At 30 June 2002, Entity A is two months in arrears on the car lease payments. At that time Entity A accounts for its tax affairs on a cash basis. HC has at all times been an accruals taxpayer.

HC chooses to consolidate with all its wholly-owned subsidiaries with effect from 1 July 2002.

Calculation

As there is an arrangement in place that satisfies section 701-70(1), HC and Entity A must each apply the provision to their own tax positions at the consolidated group's formation time (1 July 2002).

Adjustment for disproportionate deductibility – Entity A

Subsection 701-70(3) requires Entity A to compare its total allowable deductions on the lease up to the time of consolidation with the proportion of allowable deductions for the whole of the lease arrangement that are attributable to this period. If there is any difference, Entity A is entitled to deduct the amount or must include it in its assessable income.

The adjustment is calculated in the following steps:

Step 1

The 'pre-joining time proportion of total arrangement deductions' is worked out as follows → subsection 701-70(4):

(A)		(B)
Pre-joining time services proportion	x	Total arrangement deductions

In this example:

$$\textbf{A}\text{ is } \frac{\overset{\text{lease period before the joining time}}{\textbf{4 years}}}{\underset{\text{total period of lease}}{\textbf{5 years}}} = 0.8$$

B is $1200 x 5 years = $6000

Therefore, the step 1 outcome is 0.8 x $6000 = **$4800**

Step 2

Calculate the sum of:

- lease payments deductible to Entity A for the year ending 30 June 2002 (the amount incurred by Entity A in the income year ending at the joining time) → paragraph 701-70(3)(a): that is, $1000 (10 months' payments made by Entity A before falling into arrears)

and

- total lease payments deductible to Entity A for all earlier years of income → paragraph 701-70(3)(b): that is,

1998-99	$1200
1999-2000	$1200
2000-01	<u>$1200</u>
Total to 30 June 2001	$3600

The step 2 outcome is **$4600.**

Step 3

Compare the amount calculated under step 1 with the amount calculated under step 2:

- If step 1 outcome > step 2 outcome, deduct the difference in these figures from assessable income in Entity A's return for 2001-02.

  → paragraph 701-70(3)(c)

- If step 1 outcome < step 2 outcome, include the difference in these figures in assessable income in Entity A's return for 2001-02.

  → paragraph 701-70(3)(d)

The step 3 outcome is that the **s**tep 1 outcome > step 2 outcome by $200 – therefore Entity A is entitled to deduct an amount of $200 in its 2001-02 income tax return. → paragraph 701-70(3)(c)

Adjustment for disproportionate assessability – HC

As lessor, HC must include in its assessable income any income it derives on the car lease.

Subsection 701-70(5) requires HC to compare the total assessable income it has derived on the car lease up to the time of consolidation with the proportion of assessable income it will derive over the whole of the lease arrangement that is attributable to this period. If there is any difference, HC is entitled to deduct the amount or must include it in its assessable income.

The adjustment is calculated in the following steps:

Step 1

Work out the pre-joining time proportion of total arrangement assessable income → subsection 701-70(6):

(A)		(B)
Pre-joining time services proportion	x	Total arrangement assessable income

In this example:

$$\textbf{A} \text{ is } \frac{\overset{\text{lease period before the joining time}}{\textbf{4 years}}}{\underset{\text{total period of lease}}{\textbf{5 years}}} = 0.8$$

B is \$1200 x 5 = \$6000

Therefore the step 1 outcome is 0.8 x \$6000 = **\$4800**

Step 2

Calculate the sum of:

- lease payments included in HC's assessable income for the year ended 30 June 2002 (i.e. the amount derived by HC in the income year ending at the joining time): that is, \$1200 (because HC accounts for income on an accruals basis)

and

- total lease payments included in HC's assessable income for all earlier years of income: that is,

1998-99	\$1200
1999-2000	\$1200
2000-01	<u>\$1200</u>
Total to 30 June 2001	\$3600

→ subsection 701-70(5)

Step 2 outcome is **\$4800**.

Step 3

Compare the amount calculated under step 1 with the amount calculated under step 2:

- If step 1 outcome > step 2 outcome, include the difference in these figures in HC's assessable income in its return for 2001-02.
  → paragraph 701-70(5)(a)

- If step 1 outcome < step 2 outcome, deduct the difference in these figures from HC's assessable income in its return for 2001-02.

  → paragraph 701-70(5)(b)

The step 3 outcome is that the step 1 outcome = step 2 outcome – that is, the two amounts are both $4800. Therefore, there is no adjustment to the taxable income of HC.

References

Income Tax Assessment Act 1997, section 701-70; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2

Income Tax Assessment Act 1997, section 701-75; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (68 of 2002), Schedule 1

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 2.69-74

Explanatory Memorandum to the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, paragraphs 1.22-24

Revision history

Section C9-5-210 first published 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
30.6.09	Changes to the Example to reflect the replacement of the simplified tax system by the small business entity provisions.	Legislative amendments.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Single entity treatment – deductibility of interest

Description

This example shows how, under the single entity rule, the basis of deductibility of interest paid by a holding company for funds on-lent to a subsidiary may differ from the situation applying outside consolidation (although the result may be the same).

Commentary

When a consolidated group is formed, the group is treated as a single entity for income tax purposes → section 701-1 ITAA 1997. Broadly, this means that on joining a consolidated group the subsidiary members lose their individual income tax identities and are treated as parts of the head company of the consolidated group (rather than as separate entities) for the purposes of determining the head company's income tax liability.

In effect, the consolidated group is treated as if it were a single divisional company. Intragroup assets and liabilities and intragroup transactions have no income tax consequences. The head company is the only entity the income tax law recognises for the purposes of working out the group's income tax liability or losses. → 'Single entity treatment', C9-1-110

Where a holding company borrows money to lend to a subsidiary, the basis of deductibility of interest paid by the holding company differs in consolidated and non-consolidated situations, although the result may be the same. In a consolidated group, intragroup transactions have no income tax consequences. The deductibility of interest paid to a non-member is determined by looking at the economic substance for the group as a whole of the purpose of the loan and the use to which it is put – that is, income tax law applies to the interest as if the head company was a single company undertaking the borrowing.

→ Taxation Determination TD 2004/36

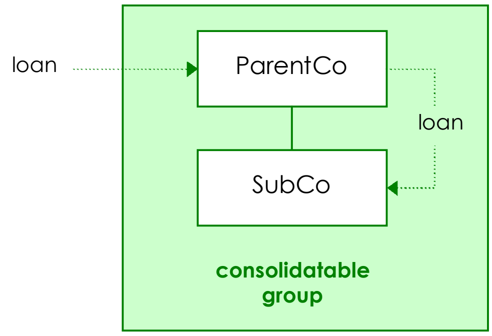
Example

Facts

ParentCo and its wholly-owned subsidiary, SubCo, form a consolidatable group (figure 1). Prior to consolidation, ParentCo borrows money to make a loan to SubCo for the purpose of making SubCo commercially feasible and promoting generation of income by SubCo – and thence ultimately by ParentCo through the receipt of dividends from SubCo.

The group subsequently consolidates.

Figure 1: Funds on-lent by ParentCo to SubCo



Analysis

Prior to consolidation, the interest paid by ParentCo on the monies loaned is deductible to ParentCo under section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) as it is incurred in producing ParentCo's assessable income and carrying on its business.

Following consolidation, the single entity rule means the loan between ParentCo (as head company) and SubCo is ignored for the purposes of working out ParentCo's income tax position. The interest paid by ParentCo on the loan is therefore no longer deductible on the basis that the monies are loaned to its subsidiary for the purposes of making the latter commercially feasible and promoting the ultimate generation of income by ParentCo through dividends to be received from SubCo.

Under the single entity rule, SubCo is treated as a part, or division, of ParentCo. The deductibility of the interest paid by ParentCo is therefore determined according to the normal principles applying to a single company. The use to which SubCo puts the loaned funds is attributed to ParentCo – that is, the relevant transactions are treated according to their economic substance for the group as a whole.

The deductibility of the interest payments is determined under the tests in section 8-1 on this basis. The interest is deductible if the borrowed monies are used in gaining or producing assessable income, or necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income *for the group* (represented by the head company).

References

Income Tax Assessment Act 1997, section 8-1

Income Tax Assessment Act 1997 – as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), section 701-1

Taxation Determination TD 2004/36 – Income tax: consolidation; can the head company of a consolidated group claim a deduction under section 8-1 of the *Income Tax Assessment Act 1997* for the interest paid on funds borrowed before consolidation and on-lent interest-free to a subsidiary member of the consolidated group?

Revision history

Section C9-5-220 first published 3 December 2003.

Further revisions are described below.

Date	Amendment	Reason
26.10.05	Reference to new tax determination.	
	Changes to 'Example'.	For clarification.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Single entity treatment – sale of intragroup asset to non-member

Description

This example shows how the sale of an intragroup asset to an entity outside the consolidated group is treated according to the transaction's economic substance for the group as a whole. Examples are given for the sale of an option, interest stream and debt.

Commentary

When a consolidated group is formed, the group is treated as a single entity for income tax purposes → section 701-1 ITAA 1997. Broadly, this means that on joining a consolidated group the subsidiary members lose their individual income tax identities and are treated as parts of the head company of the consolidated group (rather than as separate entities) for the purposes of determining the head company's income tax liability.

In effect, the consolidated group is treated as if it were a single divisional company. Intragroup assets and liabilities and intragroup transactions have no income tax consequences. The head company is the only entity the income tax law recognises for the purposes of working out the group's income tax liability or losses. → 'Single entity treatment', C9-1-110

A transaction between group members may give rise to an 'intragroup asset', such as an option, interest stream or debt.

When an intragroup asset is sold or assigned to an entity outside the consolidated group, there are no income tax consequences from the transaction that gave rise to the intragroup asset but the transaction with the outside party is recognised for the purposes of working out the head company's income tax.

The transaction with the outside party is treated according to its economic substance for the group as a whole, without regard to internal transactions. Transactions where intragroup assets are transferred to a non-group entity are recognised as a transfer by the head company. For example, the disposal of an intragroup CGT asset will ordinarily result in CGT event A1 (section 104-10 of the ITAA 1997) happening to the head company. The cost base of the asset in such a case will only be incidental costs incurred by the group to non-group members in relation to the transfer. However, in the case of the transfer of an intragroup debt, because the transfer is in substance equivalent to borrowing money or obtaining credit from another entity, no CGT event happens (see Taxation Determination TD 2004/33).

The asset may therefore be treated (for the purposes of working out the head company's income tax) as something different from its legal form.

The Tax Office has issued Taxation Ruling TR 2004/11 and the following taxation determinations related to this topic: TD 2004/35, TD 2004/39, TD 2004/45, TD 2004/46, TD 2004/83, TD 2004/84, TD 2004/85.

Note

Sale of membership interests

Special rules apply where membership interests in a subsidiary member are sold to a non-member by the head company. The Tax Office has issued the following taxation determinations related to this topic: TD 2004/40, TD 2004/41, TD 2004/47.

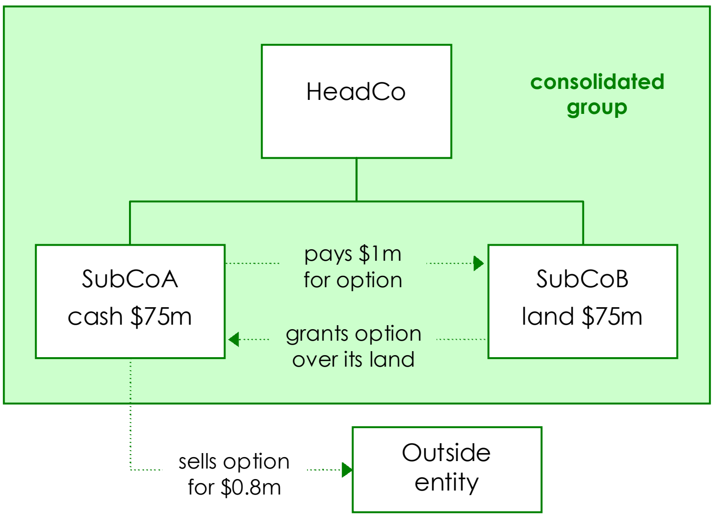
Example – sale of option

Facts

SubCoA and SubCoB are subsidiary members of a consolidated group, of which HeadCo is the head company (figure 1). At the time of consolidation:

- SubCoA's only asset is $75 million cash, and
- SubCoB's only asset is land, with a cost base of $75 million and market value of $75 million.

Figure 1: Sale of intragroup option outside group



SubCoB grants SubCoA a call option over the land for $1 million. There are no income tax consequences of this transaction, as the granting of the option is not recognised for HeadCo's income tax purposes.

As a result:

- SubCoA has cash on hand of $74 million and an option with a market value of $1 million, and
- SubCoB has cash of $1 million and land with a cost base of $75 million.

No cost has flowed outside the group. (Assume that the group has incurred no costs in relation to the transfer.)

SubCoA later sells the option to an entity outside the consolidated group for $0.8 million (the value of the option has fallen as a result of a fall in the market value of the land).

Assume that the group as a whole has incurred no costs in relation to the transfer.

Calculation

In legal form, SubCoA has sold an option. The transaction with the outside party is treated according to its economic substance for the group as a whole, without regard to internal transactions. The sale of the intragroup asset to a non-group entity is recognised as a CGT event A1 (section 104-10 of the ITAA 1997) happening to the head company. The cost base will only be incidental costs incurred by the group to non-group members in relation to the transfer.

Thus, while the sale price to the third party is less than the purchase price to SubCoA, the consolidated group has not made an economic loss from the assignment of the option to the third party for market value:

- The head company has sold an option to an entity outside the group.
- The group has received capital proceeds of $0.8 million from the transaction.
- CGT event A1[230] (disposal of a CGT asset) is triggered, resulting in a capital gain of $0.8million – the difference between the amount received for the option ($0.8 million) and the incidental costs incurred by the group (nil).
- The cost base for the land remains $75 million, which will be available on disposal of the land (if the option is exercised or otherwise).

This treatment is in accordance with single entity principle set out in section 701-1. → 'Treatment of assets', C2-1

→ Taxation Determination TD 2004/34

[230] Section 104-10, ITAA 1997.

Example – sale of interest stream

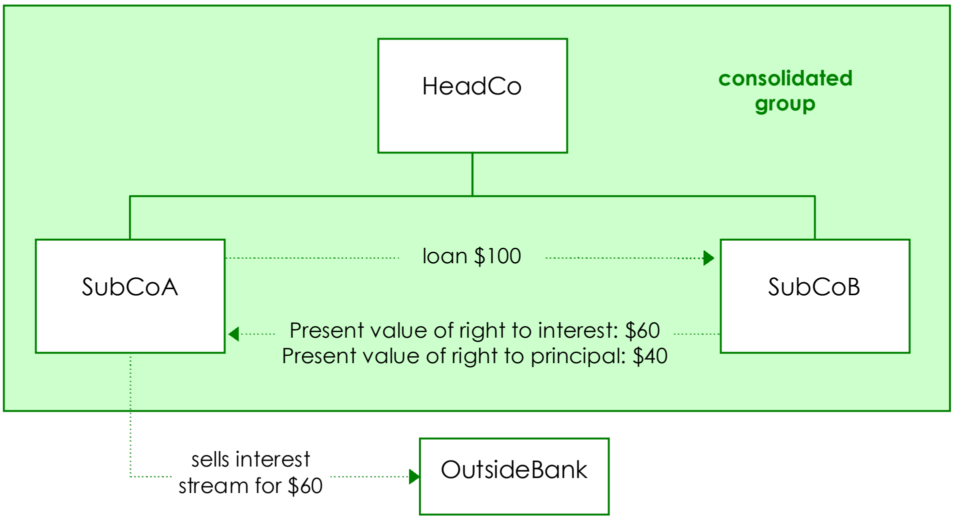
Facts

SubCoA and SubCoB are subsidiary members of a consolidated group of which HeadCo is the head company (figure 2).

SubCoA lends $100 to SubCoB in an interest-only loan at 10% for 10 years. For the purposes of working out HeadCo's income tax position, the intragroup debt is ignored. No deductions are allowed for interest payments by SubCoB to SubCoA, and no income is returned by SubCoA in respect of such payments.

The present value of the right to interest payments is $60 and the present value of the right to repayment of principal is $40. SubCoA then sells the interest stream to OutsideBank for $60.

Figure 2: Sale of intragroup income stream outside group



Calculation

In legal terms, SubCoB is making interest payments on a loan, with the entitlement to receive the payments assigned by SubCoA to OutsideBank. In terms of the consolidated entity, however, the group has received $60 from OutsideBank and will make 10 payments of $10.

In terms of the consolidated entity, the transaction has the substance of a *credit foncier* (blended payments) loan (a single receipt of $60 and an obligation to make 10 payments of $10 to end the liability to the person paying $60 to the consolidated entity). Thus, applying the single entity model, the transaction would be treated as a *credit foncier* loan and each payment would be dissected into interest and principal components for tax purposes.

Example – sale of debt

Facts

SubCoA and SubCoB are subsidiaries of HeadCo. Before the group consolidates, SubCoA lends SubCoB $25 million (figure 3).

On 1 July 2002 the group consolidates, with HeadCo as head company. For the purposes of working out HeadCo's income tax position, the intragroup debt is ignored. No deductions will be allowed for interest payments by SubCoB to SubCoA, and no income will be returned by SubCoA in respect of such payments.

As a result of a rise in market interest rates, the market value of the debt falls. On 1 September 2003 SubCoA sells the debt to OutsideCo for $20 million.

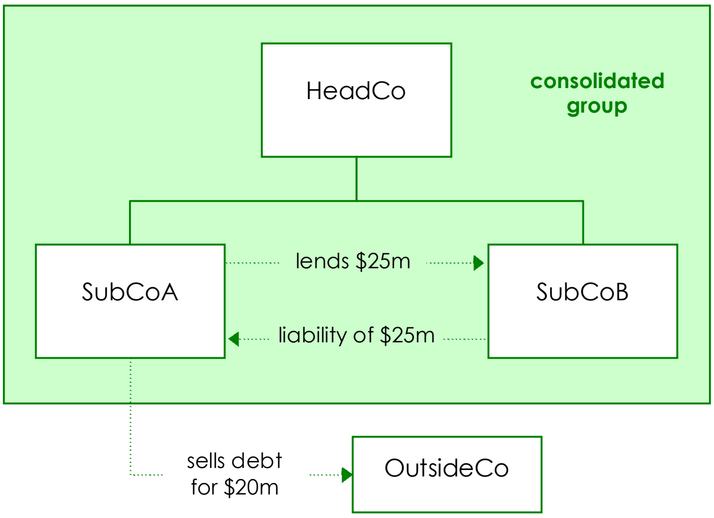


Figure 3: Sale of debt outside group

Calculation

The assignment of the intragroup debt is treated, in accordance with its economic substance for the group, as if HeadCo is entering into a new loan. This does not constitute a CGT event[231] → Taxation Determination TD 2004/33. Therefore there are no income tax consequences for the group as a result of the transaction. This accords with the income tax treatment of a single company undertaking the same transaction and is consistent with the single entity rule.

From the group (single entity) point of view, the economic substance of the transaction is receipt of $20 million in consideration for an obligation to repay an amount of $25 million.

231 Sections 104-35(5)(a) and 104-155(5)(a), ITAA 1997.

HeadCo is treated as having an obligation to repay $20 million principal on the loan. The $5 million difference between the amount received and amount to be repaid is treated as an interest expense. Division 16E of the ITAA 1936 applies, and this amount will be recognised over the life of the loan.

References

Income Tax Assessment Act 1936, Division 16E

Income Tax Assessment Act 1997, section 8-1

Income Tax Assessment Act 1997 – as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), section 701-1

Taxation Ruling TR 2004/11 – Income tax: consolidation: the meaning and application of the single entity rule in Part 3-90 of the Income Tax Assessment Act 1997

Taxation determinations

TD 2004/33 – Income tax: consolidation: capital gains: does a CGT event happen to the head company of a consolidated group if a debt is created within the consolidated group and later transferred to a non-group entity?

TD 2004/34 – Income tax: consolidation: capital gains: does section 104-10 (CGT event A1) of the *Income Tax Assessment Act 1997* apply to the head company of a consolidated group where an option granted within the consolidated group is later transferred to a non-group entity?

TD 2004/35 – Income tax: consolidation and capital gains tax: does section 104-10 (CGT event A1) of the *Income Tax Assessment Act 1997* apply to the head company of a consolidated group where a licence granted within the consolidated group is later transferred to a non-group entity for no capital proceeds?

TD 2004/36 – Income tax: consolidation: can the head company of a consolidated group claim a deduction under section 8-1 of the *Income Tax Assessment Act 1997* for the interest paid on funds borrowed before consolidation and on-lent interest-free to a subsidiary member of the consolidated group?

TD 2004/37 – Income tax: consolidation: are intra-group money lending transactions or dealings taken into account in determining if the head company of a consolidated group is carrying on business as a money lender?

TD 2004/39 – Income tax: consolidation: capital gains: does CGT event A1 in section 104-10 of the *Income Tax Assessment Act 1997* happen to the head company of a consolidated group if an asset is sold by a subsidiary member to an entity outside the group?

TD 2004/40 – Income tax: consolidation: capital gains: does CGT event A1 in section 104-10 of the *Income Tax Assessment Act 1997* happen to the head company of a consolidated group when a contract is made to sell a membership interest in a subsidiary member of the group to a purchaser outside the group?

TD 2004/41 – Income tax: consolidation: capital gains: can membership interests in a subsidiary member of a consolidated group be recognised for the purpose of applying the market value substitution rule in section 116-30 of the *Income Tax Assessment Act 1997* if CGT event A1 happens to the group's head company when a contract is entered into to dispose of the interests?

TD 2004/42 – Income tax: consolidation: capital gains: does the single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* affect the application of CGT event I1 in section 104-160 if a company which is a subsidiary member of a consolidated group stops being an Australian resident?

TD 2004/43 – Income tax: consolidation: capital gains: for the purposes of the capital gains tax provisions in Parts 3-1 and 3-3 of the *Income Tax Assessment Act 1997*, is the head company of a consolidated group taken to have acquired an asset, which a subsidiary member brings to the group, at the same time that the subsidiary member acquired it?

TD 2004/44 – Income tax: consolidation: capital gains: does the transfer of an asset between members of a consolidated group affect the ownership period of the head company for the purposes of applying the small business 15 year exemption in Subdivision 152-B of the *Income Tax Assessment Act 1997*?

TD 2004/45 – Income tax: consolidation: capital gains: how does the controlling individual condition in paragraph 152-110(1)(c) of the *Income Tax Assessment Act 1997* (one of the conditions for the small business 15 year exemption in Subdivision 152-B) apply to the head company of a consolidated group in respect of the sale of an asset brought into the group by a subsidiary member?

TD 2004/46 – Income tax: consolidation: capital gains: is the controlling individual condition in paragraph 152-305(2)(b) of the *Income Tax Assessment Act 1997* (one of the conditions for the small business retirement exemption) applied to the head company of a consolidated group?

TD 2004/47 – Income tax: consolidation: capital gains: does the single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* affect the application of the controlling individual test in paragraph 152-10(2)(a) when a CGT event happens to a share or trust interest that is a membership interest in a subsidiary member (company or trust) of a consolidated group?

TD 2004/48 – Income tax: consolidation: capital gains: for the purposes of Subdivision 125-C of the *Income Tax Assessment Act 1997*, can the head company of a consolidated group meet the requirements of a demerging entity in subsection 125-70(7) where a subsidiary member is demerged from the group?

TD 2004/49 – Income tax: consolidation: capital gains: does the single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* apply in determining whether the consequences in Subdivision 125-C of the *Income Tax Assessment Act 1997* apply to the head company of a consolidated group where one or more subsidiary members hold ownership interests in an entity outside the group that is being demerged?

TD 2004/50 – Income tax: consolidation: capital gains: if a subsidiary member of a consolidated group acquires shares in a company outside the group (the original company) under a scrip for scrip arrangement, is the single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* relevant in determining the eligibility for rollover of shareholders in the original company?

TD 2004/51 – Income tax: consolidation: capital gains: does section 124-784 of the *Income Tax Assessment Act 1997* apply to determine the cost base of equity or debt issued by an acquiring entity to its ultimate holding company as part of a scrip for scrip arrangement if those companies are members of a consolidated group?

TD 2004/68 – Income tax: consolidation: Division 7A: if a private company that is a head company or subsidiary member of a consolidated group makes a payment or a loan, or forgives a debt to a shareholder (or shareholder's associate) external to the consolidated group, does the single entity rule apply to the calculation of the distributable surplus under section 109Y of the *Income Tax Assessment Act 1936*?

TD 2004/69 – Income tax: consolidation: Division 7A: if a private company, as a member of a consolidated group, makes a payment, a loan or forgives a debt to a shareholder (or shareholder's associate), that is also a member of the consolidated group, does the single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* prevent the application of Division 7A of the *Income Tax Assessment Act 1936* to the transaction?

TD 2004/79 – Income tax: consolidation: capital gains: if an entity makes a capital gain prior to becoming a subsidiary member of a consolidated group, can it choose to apply the small business replacement asset roll-over under Subdivision 152-E of the *Income Tax Assessment Act 1997* if it acquires a replacement asset after it has become a member of the group?

TD 2004/81 – Income tax: consolidation: capital gains: does the deregistration of a subsidiary member of a consolidated group cause a 'new event' to happen under paragraph 170-275(1)(a) of the *Income Tax Assessment Act 1997* if, before the subsidiary joined that group, a transfer of shares in it was a 'deferral event' under section 170-255 and the group's head company is the 'originating company' for the deferral event?

TD 2004/82 – Income tax: consolidation: capital gains: can the exemption in section 152-125 of the *Income Tax Assessment Act 1997* apply to a payment made by the head company of a consolidated group to a CGT concession stakeholder of the head company in respect of a capital gain made on the disposal of an asset legally owned by a subsidiary member of the group for which disposal the head company obtained the small business 15 year exemption?

TD 2004/83 – Income tax: can the assignment of an intra-group debt or income stream to an entity that is not a member of the consolidated group give rise to a debt interest for the head company of the group under Division 974 of the *Income Tax Assessment Act 1997*?

TD 2004/84 – Income tax: can Division 16E of Part III of the *Income Tax Assessment Act 1936* apply to a head company of a consolidated group where the principal of an intra-group loan is assigned by a member of the group to a non-member?

TD 2004/85 – Income tax: can Division 16E of Part III of the *Income Tax Assessment Act 1936* apply to a head company of a consolidated group where an intra-group income stream is assigned by a member of the group to a non-member?

Revision history

Section C9-5-230 first published 3 December 2003.

Further revisions are described below.

Date	Amendment	Reason
26.10.05	References to new taxation determinations.	
	Change to figure 3.	To correct error.
16.12.05	Revisions to Commentary and to Calculation (p. 3).	New tax determinations.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Capital benefit paid in substitution for dividends

Description

This section shows how section 45B of the *Income Tax Assessment Act 1936* (ITAA 1936) applies where a member of a consolidated or multiple entry consolidated (MEC) group makes certain payments, allocations or distributions in substitution for dividends to recipients who are not members of the group.

Commentary

The purpose of section 45B of the ITAA 1936 is to ensure that any part of certain payments, allocations and distributions made in substitution for a dividend is treated as a dividend for tax purposes.

Under subsection 45B(3), the Commissioner may make a determination with the effect that the whole or part of a 'capital benefit' becomes a dividend that is fully assessable, or subject to withholding tax, in the hands of the recipient → section 45C(1), ITAA 1936. Having made such a determination, the Commissioner may also make a further determination under subsection 45C(3) with the consequence that a class C franking debit may also arise in relation to the capital benefit.[232]

In a consolidated or MEC group it is possible in some circumstances for the head company and certain subsidiary members to make payments, allocations and distributions that are subject to section 45B. For example, membership interests in the following subsidiary members can be held directly by shareholders who are not members of the group → 'Eligibility tests and rules', C1-1:

- an eligible tier-1 (ET-1) company that is a member of a MEC group but is not its head company → section 719-15, *Income Tax Assessment Act 1997* (ITAA 1997),
- a company that is treated as a wholly-owned subsidiary due to employee shares being disregarded → section 703-35, ITAA 1997, or
- a company that is a transitional foreign-held subsidiary → section 703-45, ITAA 1997, and sections 701C-10 and 701C-15, *Income Tax (Transitional Provisions) Act 1997*.

The single entity rule (section 701-1, ITAA 1997) does not apply in determining, for the purposes of applying section 45B of the ITAA 1936, whether there is a scheme under which a person has been provided with a capital benefit by a company.

The reason for this is that the single entity rule applies only for the core purposes set out in section 701-1 – i.e. for working out the income tax liability or tax losses of the members of a consolidated group → 'Single entity treatment',

[232] Subsection 45C(3) currently provides for a 'class C franking debit' to arise as a consequence of a determination made under that provision. However, under the Simplified Imputation System, which applies from 1 July 2002, debits arising in a franking account are now termed 'franking debits'. The Government has proposed amendments, with effect from 1 July 2002, which will include changing the reference made to class C franking debit in subsection 45C(3).

C9-1-110. Where a member of a consolidated or MEC group provides a capital benefit to a person (the external shareholder), section 45B is relevant to working out the income tax liability or tax losses of the external shareholder but not that of the members of the group.

Accordingly, as the single entity rule has no application, the issue of whether an external shareholder has been provided with a capital benefit is determined on the basis that each member of a consolidated or MEC group retains its status as a separate entity.

Retaining this status as a separate identity may be relevant in considering threshold section 45B matters such as:

- whether there is a scheme under which a person is provided with a capital benefit by the subsidiary member → paragraph 45B(2)(a), ITAA 1997, and
- the 'relevant circumstances' of the scheme, having regard to various matters or amounts attributable to not only the subsidiary member that provided the benefit but also to associates of that company (within the meaning of section 318 of the ITAA 1936) → paragraph 45B(2)(c) and subsection 45B(8), ITAA 1997.

Associates of a consolidated or MEC group member include the other members of the group. As such, the relevant circumstances of the scheme under which a person is provided with a capital benefit include matters and amounts that relate to the other members of the consolidated or MEC group.

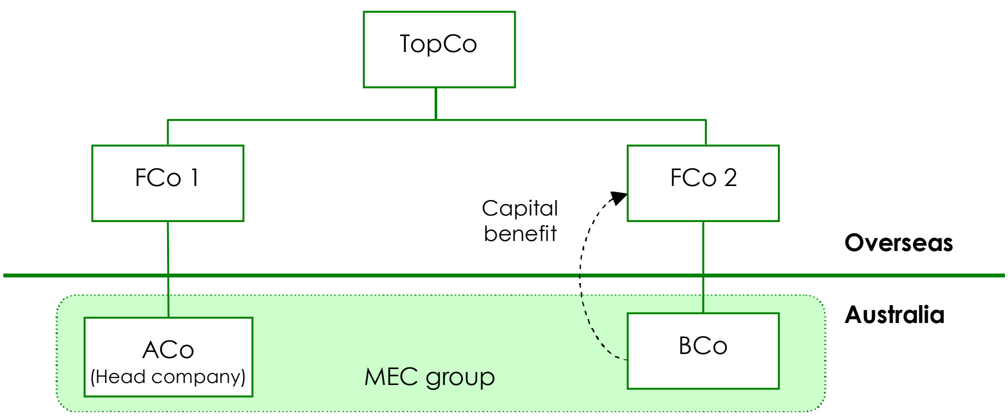
Example

ACo and BCo are ET-1 companies of TopCo and are members of a MEC group for which ACo is the head company (Figure 1).

Foreign-resident company FCo 1 is interposed between TopCo and ACo. Foreign-resident company FCo 2 is interposed between TopCo and BCo.

Pursuant to a share capital reduction, BCo makes a payment to its shareholder FCo 2 such that FCo 2 is taken to have been provided with a capital benefit in terms of subsection 45B(5) of the ITAA 1936.

Figure 1: Capital benefit paid outside MEC group



The single entity rule does not apply in determining whether section 45B applies to the capital benefit. This has been provided by BCo as a separate entity, and the application of section 45B must be determined on that basis.

The relevant circumstances of any scheme under which the capital benefit is provided by BCo to FCo 2 include any matters and amounts that relate to the associates of BCo, including ACo, the other member of the MEC group.

References

Income Tax Assessment Act 1936, sections 45B, 45C and 318

Income Tax Assessment Act 1997, sections 701-1, 703-35, 703-45 and 719-15

Income Tax (Transitional Provisions) Act 1997, sections 701C-10 and 701C-15

Taxation Ruling 2003/8 – Income tax: distributions of property by companies to shareholders – amount to be included as an assessable dividend

Taxation Ruling 2004/11 – Income tax: consolidation: the meaning and the application of the single entity rule in Part 3-90 of the *Income Tax Assessment Act 1997*

PS LA 2005/21, Application of section 45B of the *Income Tax Assessment Act 1936* to demergers

Revision history

Section C9-5-240 first published 12 September 2006.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Capital allowances – *with* accelerated depreciation

Description

This example shows how an accelerated depreciation asset brought into a consolidated group by a joining subsidiary is treated for capital allowances purposes.

Commentary

When an entity becomes a member of a consolidated group the tax costs of its assets are set under the cost setting rules (other than when the transitional option of retaining existing tax values has been applied).

When the tax cost of a depreciating asset is set, certain capital allowances provisions[233] apply as if certain things had happened in relation to the asset's date of acquisition and cost at that date, the method used for working out the asset's decline in value, and its effective life. → paragraphs 701-55(2)(a), (b) and (e), *Income Tax Assessment Act 1997* (ITAA 1997)

These deemed occurrences override the entry history rule. → 'Introduction to consolidation', B0-2

Under the capital allowances provisions, accelerated depreciation may be used where a depreciating asset was acquired before 11:45 am, ACT time, on 21 September 1999. However, this basic requirement is no longer met where a depreciating asset is taken to have been acquired by the head company at the joining time. The core rules therefore contain an exception to allow the head company to preserve accelerated depreciation under the following conditions:

- the asset was acquired by the joining entity at or before 11:45 am, ACT time, on 21 September 1999, and
- the asset's tax cost setting amount is not more than its terminating value.

→ section 701-80, ITAA 1997

Where the tax cost setting amount is more than the terminating value of the asset, the cost setting rules allow the head company to choose a tax cost setting amount equal to the terminating value. This means that the head company is able to bring the asset within the accelerated depreciation exception in the core rules. However, the head company must forfeit the excess from the original tax cost setting amount and cannot reallocate it among other assets. → section 705-45, ITAA 1997

Note: Where a head company chooses the transitional option for a transitional entity, the tax costs of the entity's assets are not reset under the cost setting rules. Because of the entry history rule, the head company is taken to have done everything in relation to the entity's depreciating assets that the entity did.

[233] Subdivisions 40-A to 40-D, sections 40-425 to 40-445 and Subdivision 328-D, ITAA 1997

A depreciating asset's date of acquisition, method of working out decline in value, effective life and adjustable value will be the same for the head company just after the joining time as they were for the joining entity just before the joining time, with the result that any accelerated depreciation is not lost. The following treatment does *not* apply to such assets.

Note

Changes to consolidation rules

Changes to the treatment of allowable capital expenditure (ACE), transport capital expenditure (TCE) and exploration and prospecting assets allow taxpayers to retain accelerated depreciation concessions available for ACE and TCE before 1 July 2001. → *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1, Part 4, 'Expenditure relating to mining or quarrying'; paragraphs 1.49 – 1.92, Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004

Example

Facts

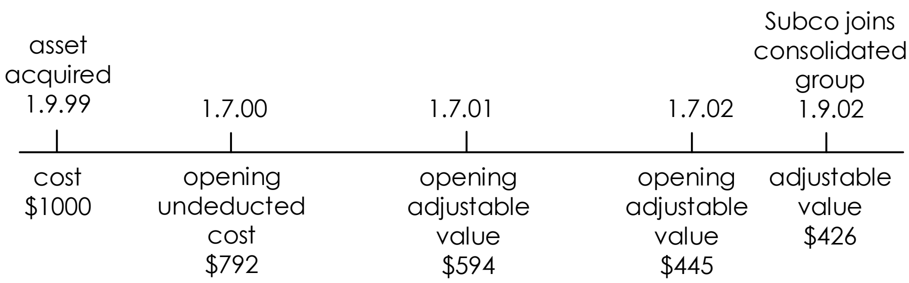
SubCo, a 90%-owned subsidiary of HeadCo, acquires depreciating Asset A on 1 September 1999 at a cost of $1000. The effective life of the asset is 10 years. SubCo chooses to depreciate the asset using the diminishing value method and applies the accelerated depreciation rate of 25%.

HeadCo chooses to consolidate on 1 July 2002.

On 1 September 2002, HeadCo acquires the remaining 10% of SubCo's shares, bringing SubCo into the consolidated group.

The adjustable value of Asset A in SubCo's hands just before it joins the consolidated group is $426. → figure 1

Figure 1



The adjustable value just before the joining time is Asset A's terminating value. → subsection 705-30(3), ITAA 1997

HeadCo calculates a tax cost setting amount for Asset A of $440 under Division 705.

Capital allowances treatment

When HeadCo sets the tax cost of Asset A, the capital allowances provisions operate as if:

- HeadCo acquired Asset A on 1 September 2002 for a payment equal to its tax cost setting amount of $440
- the diminishing value method were chosen, and
- Asset A's effective life were the same as in the hands of SubCo – 10 years.

→ paragraphs 701-55(2)(a), (b) and (e), ITAA 1997

Accelerated depreciation

For HeadCo to preserve accelerated depreciation for Asset A, the section 701-80 exception conditions must be met (→ p. 1); that is:

- the asset must have been acquired by the joining entity at or before 11:45 am, ACT time, on 21 September 1999, and
- the asset's tax cost setting amount must not exceed its terminating value.

In the case of Asset A, the first condition is met.

The second condition is not met because Asset A's tax cost setting amount of $440 is more than its terminating value of $426.

Even though the second condition is not met initially, HeadCo can choose under section 705-45 of the ITAA 1997 to limit Asset A's tax cost setting amount to its terminating value.

Scenario 1

HeadCo chooses to apply section 705-45 and limit the tax cost setting amount for Asset A to $426. The excess of $14 from the original tax cost setting amount of $440 is forfeited and cannot be reallocated to other assets.

Because both of its conditions are now met, the exception at section 701-80 applies. Under this provision, the component of the formula in subsection 40-70(1) of the ITAA 1997 that includes the asset's effective life is substituted with the accelerated depreciation rate used by SubCo.

For the 2003 income year, HeadCo will work out Asset A's decline in value under the formula in subsection 40-70(1), modified to include the accelerated depreciation rate of 25% and based on the reduced tax cost setting amount:

$$\$426 \quad \text{x} \; \frac{303 \text{ days}}{365 \text{ days}} \; \text{x} \quad 25\% \quad = \quad \$88 \; \textit{rounded}$$

Scenario 2

HeadCo does not choose to apply section 705-45. The original tax cost setting amount of $440 for Asset A is retained.

The conditions for the exception at section 701-80 are not met and HeadCo cannot apply accelerated depreciation to Asset A.

For the 2003 income year, HeadCo will work out Asset A's decline in value under subsection 40-70(1) based on the original tax cost setting amount of $440 and an effective life of 10 years as follows:

$$\$440 \times \frac{303 \text{ days}}{365 \text{ days}} \times \frac{150\%}{10 \text{ years}} = \$55 \textit{ rounded}$$

References

Income Tax Assessment Act 1997, Subdivisions 40-A to 40-D, sections 40-425 to 40-445, Subdivision 328-D

Income Tax Assessment Act 1997, sections 701-5, 701-10; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (68 of 2002), Schedule 1

Income Tax Assessment Act 1997, sections 701-55, 701-80, 705-30, 705-45; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 2.53, 2.78–80

Income Tax (Transitional Provisions) Act 1997, section 701-15; as amended by *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 7

Income Tax (Transitional Provisions) Act 1997, Subdivision 705-E; as inserted by *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1, Part 4

Income Tax (Transitional Provisions) Act 1997, Subdivision 712-E; as inserted by *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1, Part 4

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004, paragraphs 1.49 – 1.92

Revision history

Section C9-5-310 first published 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on proposed changes to consolidation rules, p. 2.	Proposed legislative amendments.
26.10.05	Update of note on changes to consolidation rules, p. 2.	Legislative amendments.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Capital allowances – *without* accelerated depreciation

Description

This example illustrates the treatment for capital allowances purposes of a depreciating asset brought into a consolidated group by a joining subsidiary and to which accelerated depreciation *does not* apply.

Commentary

When an entity becomes a member of a consolidated group the tax costs of its assets are set under the cost setting rules (other than when the transitional option of retaining existing tax values has been applied).

When the tax cost of a depreciating asset is set, certain capital allowances provisions[234] apply as if certain things had happened in relation to the asset's date of acquisition and cost at that date, the method used for working out the asset's decline in value, and its effective life. → paragraphs 701-55(2)(a), (b) and (e), *Income Tax Assessment Act 1997* (ITAA 1997).

These deemed occurrences override the entry history rule. → 'Introduction to consolidation', B0-2

Note

Where a head company chooses the transitional option for a transitional entity, the tax costs of the entity's assets are not reset under the cost setting rules. Because of the entry history rule, the head company is taken to have done everything in relation to the entity's depreciating assets that the entity did. A depreciating asset's date of acquisition, method of working out decline in value, effective life and adjustable value will be the same for the head company just after the joining time as they were for the joining entity just before the joining time. The following treatment does *not* apply to such assets.

Example

Facts

SubCo, a 90%-owned subsidiary of HeadCo, acquires depreciating Asset B on 1 July 2001 at a cost of $1000. SubCo chooses to use the Commissioner's determination of effective life of 10 years and also chooses to work out the asset's decline in value using the prime cost method.

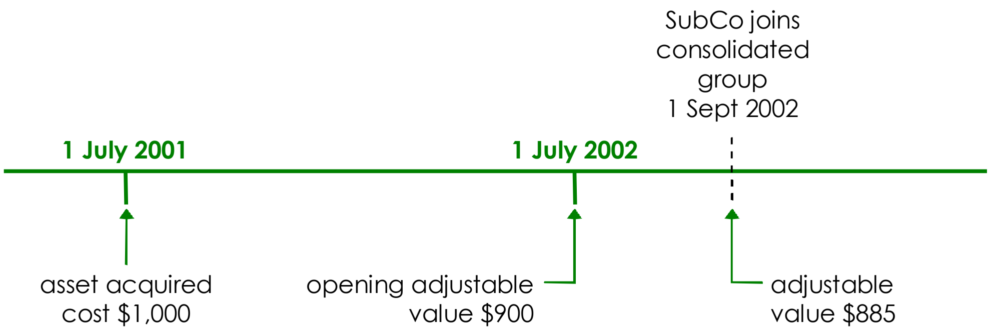
HeadCo chooses to consolidate on 1 July 2002.

On 1 September 2002, HeadCo acquires the remaining 10% of SubCo's shares, bringing SubCo into the consolidated group.

The adjustable value of Asset B in SubCo's hands just before it joins the consolidated group is $885. → figure 1

[234] Subdivisions 40-A to 40-D, sections 40-425 to 40-445 and Subdivision 328-D, ITAA 1997

Figure 1



The adjustable value just before the joining time is Asset B's terminating value.

→ subsection 705-30(3), ITAA 1997

HeadCo works out a tax cost setting amount for Asset B of $880 under Division 705 of the ITAA 1997.

Capital allowances treatment

When HeadCo sets the tax cost of Asset B the capital allowances provisions operate as if:

- HeadCo acquired Asset B on 1 September 2002 for a payment equal to its tax cost setting amount of $880
- the prime cost method were chosen, and
- an effective life were chosen equal to Asset B's remaining effective life at the joining time, i.e. 8.83 years (because Asset B's tax cost setting amount does not exceed its terminating value).

→ paragraphs 701-55(2)(a), (b) and (c), ITAA 1997

For the 2003 income year, HeadCo will calculate Asset B's decline in value under subsection 40-75(1) of the ITAA 1997 as follows:

$$\$880 \times \frac{303 \text{ days}}{365 \text{ days}} \times \frac{100\%}{8.83 \text{ years}} = \$83 \textit{ rounded}$$

Variation on the facts

Assume the same facts as above, except that HeadCo works out a tax cost setting amount for Asset B of $890.

As the tax cost setting amount for Asset B exceeds its terminating value of $885, paragraph 701-55(2)(d) applies.

Paragraph 701-55(2)(d) requires HeadCo to make a choice about the effective life for Asset B under subsections 40-95(1) and (3).

Under subsection 40-95(1) of the ITAA 1997, taxpayers can choose to use an effective life determined by the Commissioner or, alternatively, work out an effective life for themselves under section 40-105 of the ITAA 1997.

If HeadCo chooses to use an effective life determined by the Commissioner, paragraph 701-55(2)(d) limits this to an effective life in force at the joining time.

If HeadCo chooses to work out an effective life for itself, it may decide on a longer or shorter period than the remaining effective life, depending on its view of the factors in section 40-105.

References

Income Tax Assessment Act 1997, sections 40-75, 40-95, 40-105

Income Tax Assessment Act 1997, sections 701-5, 701-10; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Income Tax Assessment Act 1997, sections 701-55, 701-80, 705-30, 705-45; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2
- *Taxation Laws Amendment Act (No 8) 2003* (No. 107 of 2003), Schedule 2, item 1.

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 2.53, 2.78–80

Income Tax (Transitional Provisions) Act 1997, section 701-15; as amended by *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 7

Income Tax Assessment Act 1936, section 318

Revision history

Section C9-5-315 first published 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
23.12.03	Clarification of the rules on effective life including removal of the unexpected consequences of choosing effective life.	Reflects amendments to ITAA 1997, paragraph 701-55(2)(d), by *Taxation Laws Amendment Act (No. 8) 2002* (No. 107 of 2003).

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Treatment of trading stock brought into the group

Description

This worked example shows the income tax treatment for trading stock brought into a consolidated group by a joining entity.

Note

The examples assume that an asset's character as trading stock does not change merely because the single entity rule starts to apply. However, in some circumstances this can occur. → 'Single entity treatment', C9-1-110

Commentary

When an entity holds trading stock and joins a consolidated group, the treatment of its trading stock will depend on whether or not the entity is a continuing majority-owned entity or a chosen transitional entity, as shown in the following table:

Entity characteristics	Treatment of trading stock
Continuing majority-owned entity (A 'continuing majority-owned entity' is an entity that was majority owned at all times by a person or persons from the start of 27 June 2002 until the entity became a subsidiary member of a consolidated group. (This period includes the joining date.) → paragraph 701A-1, IT(TP)A 1997; Taxation Determination TD 2004/88	Trading stock brought into a group by a continuing majority-owned entity under these provisions is treated as a retained cost base asset with its tax cost setting amount equal to the joining entity's terminating value for the trading stock. → section 701A-5, IT(TP)A 1997; worked example 'Applying the continuing majority-owned entity test to multi-tiered structures', C2-4-855 The purpose of this integrity measure is to prevent the trading stock receiving an uplift in tax value resulting in a deferral of tax for the group. → EM to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, paragraphs 1.123 – 1.130
Basic case (not a continuing majority-owned entity)	The ordinary cost setting rules apply. The head company treats trading stock as a reset cost base asset. The tax cost setting amount for trading stock (as well as depreciating assets and revenue assets) is subject to a limit – it cannot exceed the greater of the asset's market value or the joining entity's terminating value for the asset. → section 705-40, ITAA 1997 The joining entity, on the other hand, must value the trading stock at a tax-neutral amount just before the joining time, so that no income tax consequences arise merely because the entity becomes a subsidiary member of the group. → section 701-35, ITAA 1997
Chosen transitional entity (transitional option) (The head company can use this option on the group's formation provided the entity is wholly owned on or before 30 June 2003 (and once wholly owned after 1 July 2002 it must remain so until the group consolidates). → Division 701, IT(TP)A 1997	The joining entity's assets, including trading stock, are brought into the group at their existing tax values and the cost setting rules do not apply. → Division 701, IT(TP)A 1997 The choice to treat an entity as a chosen transitional entity takes precedence over the continuing majority-owned entity rules. The head company inherits the history of the trading stock, including its tax value, under the entry history rule. → section 701-5, ITAA 1997

Example 1: continuing majority-owned entity

Facts

TradingCo is a subsidiary member of HeadCo's consolidatable group. All of TradingCo's shares have been held by the group since 1996.

At 30 June 2002, TradingCo has no trading stock on hand.

A year later, at 30 June 2003, TradingCo holds 1,000 units of trading stock that it produced during the income year at a cost of $5 per unit. Each item has a market selling value of $10 and a replacement value of $6 at that time.

HeadCo chooses to consolidate the group with effect from 1 July 2003, and it does not choose to treat TradingCo as a chosen transitional entity.

All of the units of trading stock are sold during the 2003-04 income year for $10 each. HeadCo has no other trading stock to account for during the year.

TradingCo's 2002–03 return

Since TradingCo was majority-owned by the group from the start of 27 June 2002 up to the date it joined the consolidated group, it is a continuing majority-owned entity and special transitional provisions apply to its trading stock on entry. → Division 701A, IT(TP)A 1997

TradingCo is free to elect a value for its stock on hand at 30 June 2003 in accordance with the rules for valuing closing stock set out in Division 70. It may elect to value each item at cost, replacement value or market selling value.
→ subsection 701A-5(2), IT(TP) Act 1997; section 70-45, ITAA 1997

Assume that TradingCo elects to value each of the 1,000 units of its stock on hand at its replacement value of $6.

In respect of the trading stock, TradingCo is entitled to deduct its cost of production of $5 per unit, i.e. an amount of $5,000. Under section 70-35, TradingCo is required to include in its assessable income the amount of $6,000, being the excess of the value of closing stock over opening stock. The net effect for TradingCo is that its taxable income for the 2002-03 income year is increased by $1,000.

HeadCo's 2003–04 return

HeadCo is taken to hold the trading stock from 1 July 2003 under the single entity rule.

Since TradingCo is a continuing majority-owned entity, HeadCo must treat each unit of the trading stock as a retained cost base asset with a tax cost setting amount equal to the value used by TradingCo at 30 June 2003.
→ subsection 701A-5(3), IT(TP)A 1997

The tax cost setting amount for each unit is therefore $6.

HeadCo includes in its stock on hand at the start of its income year a value equal to the tax cost setting amount of $6,000. → subsection 701-55(3), ITAA 1997

As the trading stock is sold for its market value of $10 per unit during the year, HeadCo must include sales revenue of $10,000 in its assessable income. For the purposes of section 70-35, the value of stock on hand at the start of the income year is $6,000 and the value of stock on hand at the end of the income year is nil.

Applying section 70-35, HeadCo can deduct the amount of $6,000, being the excess of the value of opening stock over closing stock.

The net result is that HeadCo's taxable income is increased by $4,000.

Example 2: basic cost setting case

Facts

TradingCo holds 1,000 units of trading stock at 31 July 2004, 500 of which were included in its stock on hand at 1 July 2004 at a value of $5 each and 500 of which were manufactured during July 2004 at a cost of $5.50 each.

On 1 August 2004, all of TradingCo's shares are acquired by the HeadCo consolidated group. TradingCo also meets all the other eligibility requirements and becomes a subsidiary member of the consolidated group.

The market value of TradingCo's trading stock at 31 July 2004 is $8,000, i.e. the price that would be negotiated for the trading stock if TradingCo's business was sold at arm's length in an open and unrestricted market. TradingCo did not adopt the short cut option for market valuing trading stock.
→ 'Valuation short cut 3' in 'Market valuation guidelines', C4-1

All the units of trading stock are sold between 1 August 2004 and 30 June 2005 for $10 each. No further trading stock is manufactured during the year.

TradingCo's 2004–05 return

TradingCo is a subsidiary member of the consolidated group for some but not all of the income year. It must therefore lodge an income tax return for the 2004-05 income year. However, TradingCo includes only taxable income that is attributable to the non-membership period 1 July to 31 July 2004 and treats those dates as if they were the start and end of an income year.
→ section 701-30, ITAA 1997

As TradingCo is not a continuing majority-owned entity, its items of trading stock have their tax costs determined under the ordinary cost setting rules.

For the purpose of working out its taxable income and income tax, or a loss, for the period 1 July to 31 July 2004, TradingCo is required to value its trading stock at 31 July 2004 at a tax neutral amount. → section 701-35, ITAA 1997

The tax neutral amount is as follows:

- for each of the 500 items that was stock on hand at the start of the income year: its value at that time of $5 ($2,500 in total) → paragraph 701-35(4)(a)

- for each of the 500 items produced between 1 July 2004 to 31 July 2004: the amount of the outgoing incurred in connection with its acquisition, $5.50 ($2,750 in total) → paragraph 701-35(4)(c)

The total value of stock on hand at 31 July 2004 is therefore $5,250.

Applying section 70-35 as if the non-membership period 1 July to 31 July 2004 were an income year, TradingCo includes the excess of $2,750 (stock on hand at 31 July 2004 less stock on hand at 1 July 2004) in its assessable income for that period.

In addition, TradingCo is entitled to deduct the outgoings of $2,750 incurred in manufacturing the trading stock in July 2004.

The result is tax-neutral for TradingCo.

Note:

The choice to consolidate from the start of an income year may be made at any time up to the date of lodgement of the head company's return for that year. If a subsidiary member did not use tax-neutral values for trading stock in its return for the period up to the joining time, it may be required to amend that return to give effect to section 701-35(4).

HeadCo's 2004–05 return

Since TradingCo is not a continuing majority-owned entity, HeadCo applies the ordinary cost setting rules to its assets, including trading stock (subject to the ceiling rules for revenue-like assets). Items of trading stock are treated as reset cost base assets.

Assume that HeadCo initially works out a tax cost setting amount of $7 for each item of TradingCo's trading stock. As this amount is less than the greater of the market value of each item ($8) and TradingCo's terminating value for each item ($5 and $5.50, respectively), it becomes the tax cost setting amount.
→ section 705-40, ITAA 1997

HeadCo includes in its stock on hand at the start of its income year a value equal to the tax cost setting amount of $7,000. → subsection 701-55(3), ITAA 1997

As the trading stock is sold for $10 per unit during the year, HeadCo must include sales revenue of $10,000 in its assessable income. Under section 70-35, the value of stock on hand at the start of the income year, 1 July 2004, is $7,000 and the value of stock on hand at the end of the income year, 30 June 2005, is nil.

Applying section 70-35, HeadCo can deduct the amount of $7,000, being the excess of the value of opening stock over closing stock.

The net result is that HeadCo's taxable income is increased by $3,000.

Example 3: chosen transitional entity

Facts

TradingCo is a subsidiary member of HeadCo's consolidatable group. All of TradingCo's shares have been held by the group since 1996.

At 30 June 2002, TradingCo has no trading stock on hand.

A year later, at 30 June 2003, TradingCo holds 1,000 units of trading stock that it manufactured during the income year at a cost of $5 per unit. Each item has a market selling value of $7 and a replacement value of $4 at that time.

HeadCo chooses to consolidate the group with effect from 1 July 2003 and also chooses to treat TradingCo as a chosen transitional entity.

All of the units of trading stock are sold during the course of the 2003-04 income year for $7 each. No other units of trading stock are manufactured.

TradingCo's 2002–03 return

As TradingCo is a chosen transitional entity, section 701-10 does not apply to reset the tax cost of its assets. Also, subsection 701-35(4), which requires a joining entity to choose a tax-neutral value for its trading stock just before the joining time, does not apply → section 701-15, IT(TP)A. Therefore, TradingCo is free to elect a value for its stock on hand at 30 June 2003 in accordance with the closing stock provisions. It may elect to value each item at cost, replacement value or market selling value. → section 70-45, ITAA 1997

Assume TradingCo elects to value its trading stock at replacement value of $4. Under section 70-35, it includes in its assessable income the amount of $4,000, since the value of stock on hand at 1 July 2002 was nil and the value chosen for stock on hand at 30 June 2003 is $4,000.

In addition, TradingCo can deduct the outgoings of $5,000 incurred in manufacturing the trading stock during the income year.

The net effect in relation to the trading stock is that TradingCo's taxable income is reduced by $1,000.

HeadCo's 2003–04 return

As HeadCo has chosen to treat TradingCo as a chosen transitional entity, its assets do not have their tax costs reset. HeadCo inherits the tax cost of each asset (and other history) under the entry history rule. → section 701-5, ITAA 1997

Applying the trading stock provisions, HeadCo includes in the value of its stock on hand at 1 July 2003 the value it inherits as the elected value at 30 June 2003, the end of the last income year. In this case, that elected value for each item is the replacement value of $4, giving a total opening value of $4,000 for the trading stock brought into the group by TradingCo. → section 70-40, ITAA 1997

HeadCo includes the sale proceeds of $7,000 in its assessable income.

Applying section 70-35, HeadCo can deduct the amount of $4,000, being the excess of the value of opening stock over closing stock.

The net effect for HeadCo is that its taxable income is increased by $3,000 in respect of the trading stock brought into the group by TradingCo.

References

Income Tax Assessment Act 1997, sections 70-35, 70-40, 70-45, 701-5, 701-55; as amended by:

- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2
- *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 23
- *Taxation Laws Amendment Act (No. 8) 2003*, (No. 107 of 2003) Schedule 2

Income Tax (Transitional Provisions) Act 1997, sections 701-15, 701A-5; as amended by:

- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 7
- *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 1
- *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 9

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, paragraphs 1.123 to 1.130

Taxation Determination TD 2004/88 – Income tax: consolidation: does the continuing majority-owned entity test in subsections 701A-1(1) and 701A-1(2) of the *Income Tax (Transitional Provisions) Act 1997* require tracing through interposed entities to the ultimate beneficial owners to determine whether there has been a change in the majority ownership of an entity during the period from 27 June 2002 until the entity becomes a subsidiary member of a consolidated group?

Revision history

Section C9-5-320 first published 8 June 2004. Further revisions are described below.

Date	Amendment	Reason
27.1.05	Changes to example 2.	For clarification and to correct errors.
26.10.05	Reference to new tax determination.	

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Prepayment transitional rules – group consolidates 1 July 2002

Description

This example shows how the prepayment transitional rules interact with the single entity rule and entry history rule.

It applies to a situation where a head company and all of its relevant subsidiaries share the same balance date for income tax and consolidate on the first day of their income year that includes 21 September 2002 (in most cases, a consolidation date of 1 July 2002). Post-consolidation prepayments subject to the transitional rules are made by members of the consolidated group.

Note

Part-year membership

This example does not examine the Subdivision 716-A rules applying to deductions spread over two or more income years where an entity is a subsidiary member of a consolidated group for only some of the income year.

Commentary

When the '13-month rule' allowing full deductibility of certain prepaid expenditure was withdrawn, transitional rules were introduced to phase out its benefits.

The transitional rules allow a taxpayer to deduct, in the expenditure year, some of the expenditure that relates to services not provided until the following income year. Such expenditure is called the 'later year amount'.

Under the transitional rules, 80% of the later year amount is deductible for an expenditure year including 21 September 1999 (for most taxpayers, the 1999–2000 income year). Similar transitional deductions are available in each of the next three income years, but with different percentages of the later year amounts deductible in the expenditure year. For the income year including 21 September 2002 (for most taxpayers, the 2002–03 income year) the percentage is 20%. → subsection 82KZMB(5), ITAA 1936

There is a limit on the amount eligible for transitional treatment in each of the income years subsequent to the income year that includes 21 September 1999. This limit is referred to as the 'cap'. The cap is the total of all later year amounts subject to the transitional rules in the income year including 21 September 1999. → section 82KZMC, ITAA 1936

If the later year amount for one of the subsequent income years exceeds the cap, the later year amount subject to the transitional rules in that year is limited to the amount of the cap. The amount by which a later year amount exceeds the cap is allowed as a deduction proportionately over the eligible service period that occurs after the expenditure year. → subsection 82KZMB(6), section 82KZMC, ITAA 1936

When the head company of a consolidated group works out the sum of its later year amounts for the 2002–03 income year, it applies the single entity rule and the entry history rule:

- The effect of the single entity rule is that eligible prepaid expenditure incurred by subsidiary members of the group is taken to have been incurred by the head company. The later year amounts attributable to this expenditure are therefore the later year amounts of the head company for the purpose of working out its deductions under the transitional prepayment rules. → section 701-1, ITAA 1997
- The effect of the entry history rule is that the head company's prepayment cap is the sum of the prepayment caps of all members of the consolidated group. → section 701-5, ITAA 1997

Example

Facts

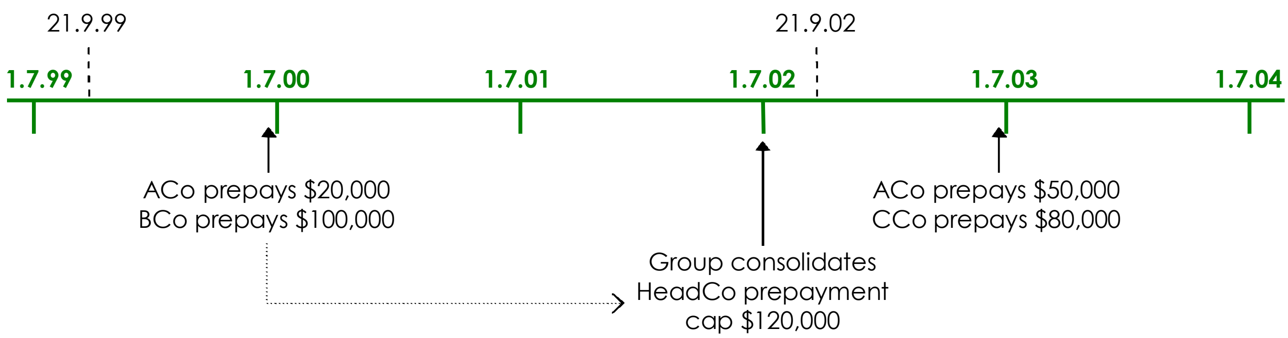
ACo, BCo and CCo are wholly-owned subsidiaries of HeadCo. All companies are 30 June balancers.

On 30 June 2000, ACo incurs prepaid expenditure of $20,000 and BCo incurs prepaid expenditure of $100,000 for services to be provided from 1 July 2000 to 30 June 2001. Neither CCo nor HeadCo incurs any prepaid expenditure for this period.

HeadCo chooses to consolidate with effect from 1 July 2002.

On 30 June 2003, ACo incurs expenditure of $50,000 and CCo incurs expenditure of $80,000 for services to be provided from 1 July 2003 to 30 June 2004. Neither BCo nor HeadCo incurs any prepaid expenditure for this period.

Figure 1: HeadCo group prepayments timeline



Calculation

Establishing the prepayment cap for HeadCo

To work out the sum of its later year amounts for the 1999–2000 income year, HeadCo applies the entry history rule. The effect is that, for the head company core purposes, everything that happened to ACo, BCo and CCo before they became subsidiary members of the consolidated group is taken to have happened to HeadCo. HeadCo is taken to have made the prepayments actually made by ACo and BCo on 30 June 2000 and to have had their later year amounts for the 1999–2000 income year. → section 701-5, ITAA 1997

The later year amounts of ACo and BCo for the 1999–2000 income year were \$20,000 and \$100,000 respectively. The sum of these amounts establishes a cap of \$120,000, which is used to calculate HeadCo's deduction for the remaining income years of the transitional period. → subsections 82KZMB(6) and 82KZMC(3), ITAA 1936

Applying the provisions to expenditure prepaid in the 2002–03 year

Since the group consolidates with effect from 1 July 2002, the single entity rule applies for the core purposes.

For the purposes of working out HeadCo's income tax liability, ACo, BCo and CCo are taken to be parts of HeadCo and not separate entities. HeadCo is taken to have incurred the prepaid expenditure actually incurred by ACo and CCo under their service agreements.

The later year amount under ACo's service agreement is \$50,000, because no part of the eligible service period falls within the 2002–03 income year. Similarly, the later year amount under CCo's service agreement is \$80,000. For HeadCo, the sum of its later year amounts is therefore \$130,000.

The amount that HeadCo is entitled to deduct in the 2002–03 income year is based on its cap of \$120,000, established in the 1999–2000 income year. → subsection 82KZMC(1), ITAA 1936

(Note that HeadCo can claim a deduction for prepaid expenditure incurred by CCo in the 2002–03 income year even though CCo did not incur prepaid expenditure in the income year when the cap was established.)

In the 2002–03 income year, HeadCo is entitled to deduct 20% of its later year amounts, subject to its prepayment cap of \$120,000:

\$120,000 x 20% = \$24,000

→ subsection 82KZMB(5), table item 4, column 2

The amount that HeadCo is entitled to deduct in the 2003–04 income year consists of two elements:

- First, HeadCo is entitled to deduct the remaining 80% of the 2002–03 later year amount, up to the limit of the cap:

  \$120,000 x 80% = \$96,000

  → subsection 82KZMB(5), table item 4, column 3

- Second, HeadCo is entitled to claim the excess of the 2002–03 later year amount over the cap:

  $130,000 – $120,000 = $10,000

  → subsections 82KZMC(4) to (6)

HeadCo's total deduction for the 2003–04 income year in respect of the prepaid expenditure incurred on 30 June 2003 is:

$96,000 + $10,000 = $106,000

References

Income Tax Assessment Act 1997 – as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002) and *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), sections 701-1, 701-5

Income Tax Assessment Act 1936, sections 82KZMB, 82KZMC

Revision history

Section C9-5-330 first published 3 December 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Consumables brought into a group (transitional option)

Description

This example illustrates how the head company treats consumables that are brought into the group by a joining entity under the transitional option in Division 701 of the *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A 1997).

The example assumes that a consumable was acquired after 7:30 pm on 13 May 1997.

Commentary

The income tax treatment of assets commonly referred to as 'consumables' is not expressly provided for by the Income Tax Assessment Act (ITAA). True consumables are things that are destroyed or cease to exist as soon as they are used, such as fuel. They are not depreciating assets as defined in subsection 40-30(1). They are also distinguished from trading stock, which includes raw materials and other assets, such as parts, that are incorporated into a final product. While consumables fall within the definition of CGT assets, expenditure on them is often of a revenue nature.

It has been the Commissioner's practice, as espoused in *Taxation Ruling* IT 333, to allow a deduction for consumables on either an incurred basis or a usage basis, depending on the circumstances. Where consumables are acquired to meet current needs, deductions may be claimed in the income year in which the expenditure was incurred (typically this will be where they have a relatively short life, e.g. 3 months, or where the quantity held is sufficient only to enable the business to be carried on efficiently). Where the taxpayer builds up a store or stockpile of consumables in excess of normal requirements, deductions may be claimed only as the consumables are used up. → Taxation Ruling IT 333

Apart from the transitional option under Division 701 of the IT(TP)A 1997, an asset of a joining entity has its tax cost reset at the joining time at the asset's tax cost setting amount. The setting of the tax cost at the tax cost setting amount has different implications for different purposes under the Act.
→ section 701-55, ITAA 1997

When a consumable is brought into a consolidated group and has its tax cost reset, for deductibility purposes this means its cost is equal to its tax cost setting amount. → subsection 701-55(6), section 701-56, ITAA 1997

For CGT purposes, setting the consumable's tax cost means that its cost base or reduced cost base is increased or reduced at the joining time to an amount equal to its tax cost setting amount. → subsection 701-55(5), ITAA 1997

Where a head company chooses to treat a transitional entity as a chosen transitional entity under Division 701 of the IT(TP)A 1997, all the entity's assets are brought into the group at their existing tax values. This is because section 701-10, which resets the tax cost of assets, does not apply.
→ section 701-15, IT(TP)A 1997

By virtue of the entry history rule, consumables of a chosen transitional entity retain their existing tax costs on becoming assets of the head company under the single entity rule.

Note

The rules in section 701-55, which override the entry history rule in relation to tax cost, have no application unless an asset's tax cost is set at its tax cost setting amount.

Incurred basis

Under the entry history rule, for the head company core purposes, everything that happened to the joining entity before the joining time is taken to have happened to the head company. → section 701-5, ITAA 1997

This means that a consumable on hand at the joining time is taken to have been acquired by the head company at its original acquisition time and for the same cost. Any deduction claimed by the joining entity is likewise taken to have been claimed by the head company.

Where a joining entity has already deducted the cost of a consumable on the incurred basis, it follows that the head company is not entitled to claim any further deduction.

A consumable is also a CGT asset for CGT purposes. Under the CGT cost base provisions, its reduced cost base in the hands of the joining entity is reduced by the amount of the deduction claimed, resulting in a reduced cost base of nil. → sections 110-45 and 110-55, ITAA 1997

Note

Different rules apply to assets acquired at or before 7.30 pm on 13 May 1997. → section 110-40, ITAA

The head company inherits the reduced cost base of nil under the entry history rule. → section 701-5, ITAA 1997

When the asset is eventually used up, CGT event C1 produces no capital loss to the head company.

Usage basis

Where a joining entity has previously applied a usage basis to deducting the cost of consumables, the head company inherits this history.

The head company is entitled to a deduction for the cost of consumables as they are used.

Note

This is not an inherited deduction for the purposes of ACA step 7. Entitlement to the deduction does not arise until the consumable is used up.

There is no capital loss because the reduced cost base is accordingly reduced to nil as the consumables are used up. When the consumable is used up, CGT event C1 occurs. In applying the CGT provisions, the head company must reduce the reduced cost base of the consumable to the extent of any deduction to which it is entitled. → sections 110-45 and 110-55, ITAA 1997

Example 1: incurred basis

Facts

Subco is a wholly-owned subsidiary of Headco. The two entities are a consolidatable group.

On 1 June 2003, Subco acquires a quantity of fuel for use in its transport business for $10,000. It deducts its expenditure on fuel on an incurred basis.

One quarter of the fuel remains unused at the joining time. The cost to Subco of that fuel was $2,500 (one quarter of $10,000).

Headco consolidates the group with effect from 1 July 2003 and chooses to apply the transitional option to Subco so that Subco's assets are brought into the group at their existing tax costs.

Subco's 2002-03 income tax return

In completing its income tax return for the 2002-03 income year, Subco is entitled to claim a deduction of $10,000 for its expenditure on the fuel.

Headco's 2003-04 income tax return

Under the entry history rule, Headco is taken to have bought the fuel on hand at 1 July 2003 for $2,500 on 1 June 2003 and to have deducted $2,500 in respect of it.

It follows that Headco is not entitled to any further deduction.

Any CGT implications that might arise from the consumption of the asset are neutralised by its revenue treatment. Its reduced cost base at the joining time is nil and the capital proceeds from CGT event C1 are also nil.

Example 2: usage basis

Facts

Subco is a wholly-owned subsidiary of Headco. The two entities are a consolidatable group.

On 21 June 2003, Subco acquires a consumable at a fire sale for $500 and stockpiles it for use in its business. This expenditure is deductible on a usage basis.

Headco chooses to consolidate with effect from 1 July 2003 and applies the transitional option to Subco so that Subco's assets are brought into the group at their existing tax costs.

All of the consumable remains stockpiled at the joining time.

The consumable is used up in the 2003-04 income year.

Subco's 2002-03 income tax return

As Subco is not entitled to claim a deduction for the expenditure until the consumable is used up, the expenditure is not deductible to Subco.

Headco's 2003-04 income tax return

Under the entry history rule, Headco is taken to have acquired the consumable on 21 June 2003 at a cost of $500 and to have held it up to the joining time as a consumable deductible on a usage basis. For deductibility purposes, the tax cost of the consumable to Headco remains at $500.

When the consumable is used, its tax cost is deductible to Headco. Headco is entitled to a deduction of $500.

Any CGT implications that might arise from the consumption of the asset are neutralised by its revenue treatment. Its reduced cost base is reduced to nil in the hands of Headco because of the deduction; the capital proceeds from CGT event C1 are also nil.

References

Income Tax Assessment Act 1997, sections 110-45, 110-55

Income Tax Assessment Act 1997, sections 701-5, 701-55, 705-40; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2
- *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 11
- *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 23

Income Tax Assessment Act 1997, sections 701-55 and 701-56; as amended by *Tax Laws Amendment (2010 Measures No.1) Act 2010* (No. 56 of 2010), Schedule 5, Part 1

Income Tax (Transitional Provisions) Act 1997, section 701-15; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 7
- *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 9

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No.1) Bill 2010, Chapter 5

Revision history

Section C9-5-341 first published 9 December 2003.

Further revisions are described below.

Date	Amendment	Reason
12.9.06	Major changes to Commentary, including deletion of references to 'Consumables brought into a group (cost setting case)', C9-5-340 (which has been withdrawn).	Withdrawal of draft taxation determinations TD 2004/D74 and TD 2004/D75 in light of proposed legislative amendments.
3.5.07	Deletion of note and changes to text under 'Usage basis' in Commentary.	New draft tax determination TD2006/D46.
6.5.11	Addition of legislative reference in Commentary.	Legislative amendment.
	Minor edit to note in Commentary.	Pre-existing law and legislative amendment.

Worked example

Deducting a bad debt – company that is owed debt becomes member of consolidated group

Description

This example shows how the consolidation bad debt rules apply to the head company of a consolidated group that claims a bad debt deduction for a debt that was originally owed to another company before that company became a subsidiary member of the consolidated group.

Specifically, it shows how the continuity of ownership test (COT) in section 165-123 of the *Income Tax Assessment Act 1997* (ITAA 1997) is modified in such circumstances.

Commentary

The consolidation bad debt rules are contained in Subdivision 709-D of the ITAA 1997.

Subdivision 709-D applies when determining whether an entity (the claimant) can deduct a bad debt where the debt has been owed:

- to an entity (whether the claimant or another entity) for a period (the debt test period) when the entity was a member of a consolidated group, and
- to an entity (whether the claimant or another entity) for a period (which is also a debt test period) when the entity was not a member of that consolidated group.

In determining each of the debt test periods the entry and exit history rules are ignored.[235] Each debt test period is identified as the period in which the entity is taken to be owed the debt for tax purposes. In some cases the debt is taken to be owed to the entity because of the single entity rule.

Effectively, Subdivision 709-D looks at each entity that is owed the debt to determine (based on certain assumptions) whether that entity would have been able to claim a bad debt deduction. The claimant is only able to deduct the debt if, for each debt test period, the entity that was owed the debt could have deducted it for the relevant 'debt test income year', assuming the debt was written off as bad at the end of the debt test period.

Example

Facts

On 1 December 2002, a $5,000 debt begins to be owed to a company, SubCo. The amount of the debt is brought to account by SubCo as assessable income in the income year ended 30 June 2003.

On 1 July 2004, a consolidated group is formed with HeadCo as the head company. SubCo joins the consolidated group at the time the group is formed.

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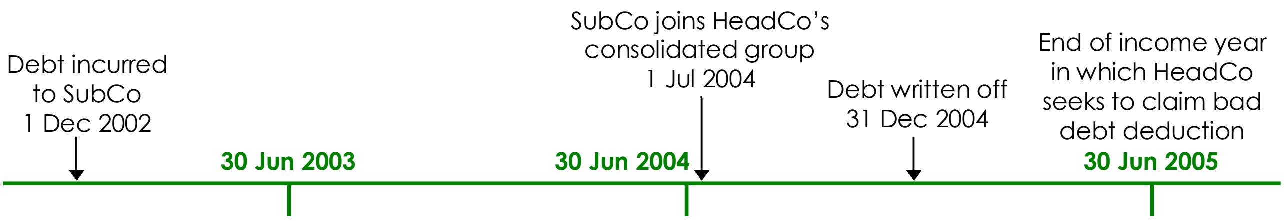
[235] Subsection 709-205(3).

On 31 December 2004, the $5,000 debt owed to SubCo is written off as bad in SubCo's books of account. HeadCo (as the head company of the consolidated group) seeks to claim a bad debt deduction for this debt in the year ended 30 June 2005.[236]

HeadCo (the claimant) can deduct the debt if the condition in subsection 709-205(2) is met for each debt test period – namely, that SubCo and HeadCo could have each deducted the debt for their respective debt test income years, based on certain assumptions.

Figure 1: Timeline of events



Calculation

To determine whether SubCo and HeadCo could have each deducted the debt for their relevant debt test income year it is necessary to identify, for each entity:

1. **The debt test period(s):** This is identified in section 709-205.
2. **The debt test income year(s):** This is identified in the table in subsection 709-215(3).
3. **The continuity periods:** To determine whether an entity has satisfied the COT in section 165-123 of the ITAA 1997, the continuity periods are identified under subsection 709-215(4) and not subsection 165-120(2). Note that subsection 709-215(2) modifies a number of the provisions that would normally apply in determining whether a company would be able to deduct a bad debt for the debt test income year if the company had written off the debt as bad at the end of the debt test period.

SubCo

Step 1: Identify the debt test period

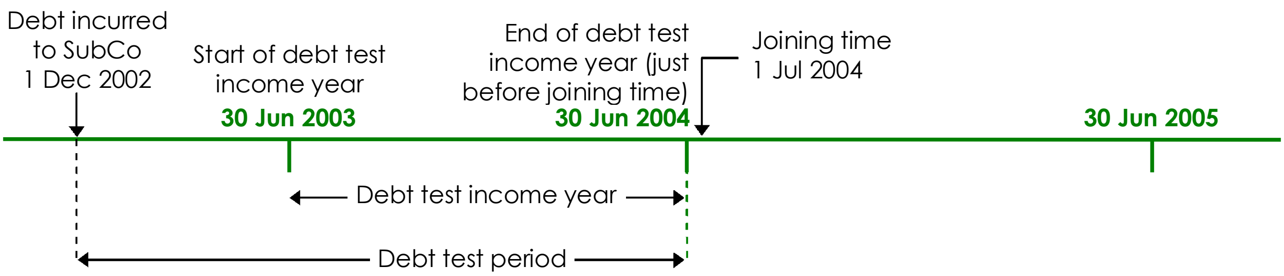
SubCo's debt test period is from 1 December 2002 to just before the time that SubCo joins the consolidated group on 1 July 2004. → section 709-205

[236] The entity that owes the debt is not an associate of SubCo or HeadCo for the period 1 December 2002 to 30 June 2005.

Step 2: Identify the debt test income year

Item 2 of the table in subsection 709-215(3) applies because SubCo is not the claimant. The start of the debt test income year is 12 months before the end of the debt test period (i.e. 30 June 2003). The end of the debt test income year is the end of the debt test period (i.e. just before the joining time on 1 July 2004).

Figure 2: SubCo's debt test period and debt test income year



Step 3: Identify the continuity periods

SubCo's first continuity period
Item 3 in the table in subsection 709-215(4) applies because SubCo's debt test period:

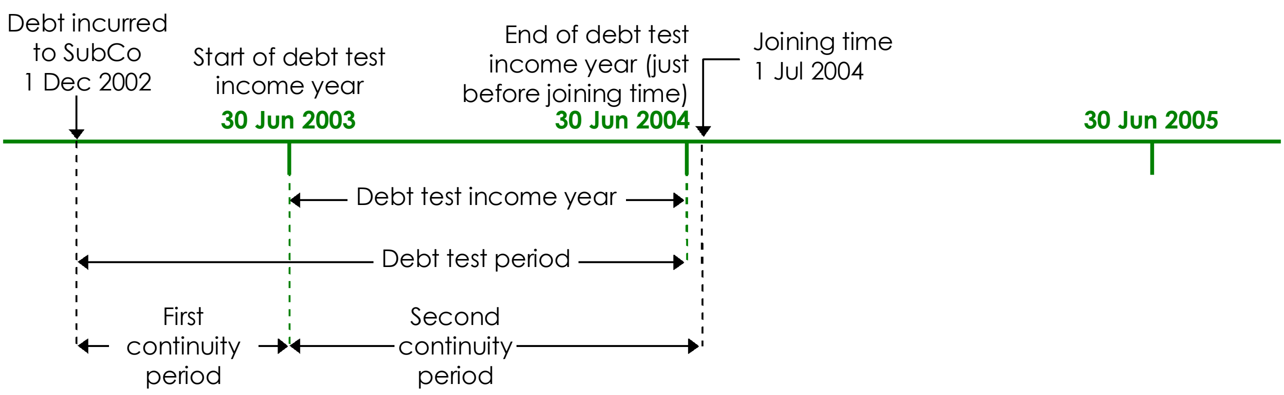
- does not start when SubCo ceases to be a member of a consolidated group, and
- ends when SubCo becomes a member of a consolidated group.

The start of the first continuity period is the start of the debt test period, which is 1 December 2002.

Paragraph 709-215(4)(a) identifies the end of the first continuity period as the start of the debt test income year (30 June 2003).

SubCo's second continuity period
The second continuity period starts at the start of the debt test income year (30 June 2003) and ends at the time identified in the table in subsection 709-215(4). Item 3 in this table identifies the end of the second continuity period as just after the end of the debt test period. As SubCo's debt test period ends just before the joining time, the second continuity period ends at the joining time on 1 July 2004.

Figure 3: SubCo's continuity periods for the purposes of the COT



To determine if SubCo has satisfied the COT its ownership is examined from the start of the first continuity period to the end of the second continuity period (i.e. from 1 December 2002 to the joining time on 1 July 2004).

If SubCo has not satisfied the COT for this period it would not be able to claim a bad debt deduction in the debt test income year unless it satisfies the same business test (SBT) in section 165-126.[237]

→ For an explanation of how the SBT applies to an entity seeking to deduct a bad debt where Subdivision 709-D applies see 'Deducting a bad debt – company that is owed debt experiences majority ownership change when it joins consolidated group', C9-5-351.

HeadCo

Step 1: Identify the debt test period

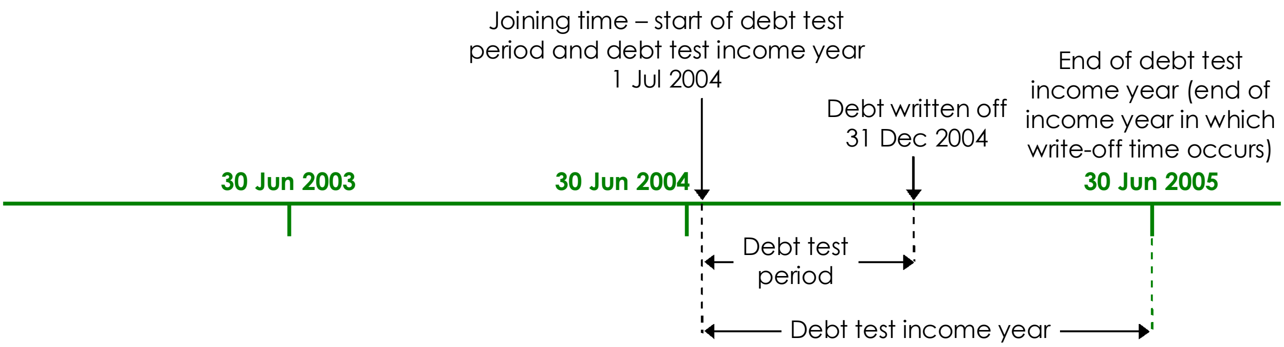
HeadCo's debt test period is from the time that SubCo joins the consolidated group (1 July 2004) to the time that HeadCo writes off the debt as bad (31 December 2004). → section 709-205

Step 2: Identify the debt test income year

Item 1 of the table in subsection 709-215(3) applies because HeadCo is the claimant and the debt test period ends when HeadCo actually writes off the debt. The start of the debt test income year is 1 July 2004 because this is both the start of the income year in which the write-off time occurs and the start of the debt test period (if these times did not coincide the debt test income year would start at the later of the two). The end of the debt test income year is the end of the income year in which the write-off time occurs (i.e. 30 June 2005).

[237] Assuming that the discretion in paragraph 165-120(1)(b) is not favourably exercised by the Commissioner of Taxation.

Figure 4: HeadCo's debt test period and debt test income year



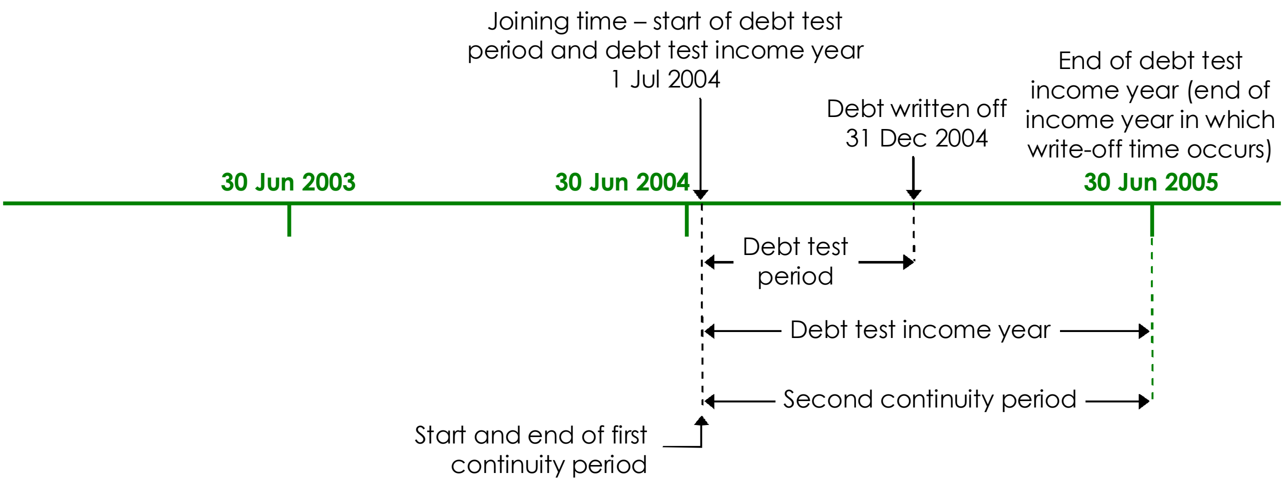
Step 3: Identify the continuity periods

HeadCo's first continuity period
Item 1 of the table in subsection 709-215(4) applies because HeadCo is the claimant, the debt test period ends when HeadCo actually writes off the debt and HeadCo is the head company of a consolidated group at the write-off time. The start of the first continuity period is the start of the debt test period (1 July 2004).

Paragraph 709-215(4)(a) identifies the end of the first continuity period as the start of the debt test income year (also 1 July 2004).

HeadCo's second continuity period
The second continuity period starts at the start of the debt test income year (1 July 2004) and ends at the time identified in the table in subsection 709-215(4). Item 1 in this table identifies the end of the second continuity period as the end of the income year in which the write-off time occurs (i.e. 30 June 2005).

Figure 5: HeadCo's continuity periods for the purposes of the COT



To determine if HeadCo has satisfied the COT its ownership is examined from the start of the first continuity period to the end of the second continuity period (i.e. from 1 July 2004 to 30 June 2005).

If HeadCo has not satisfied the COT for this period it would not be able to claim a bad debt deduction in the debt test income year unless it satisfies the SBT in section 165-126.[238]

→ For an explanation of how the SBT applies to an entity seeking to deduct a bad debt where Subdivision 709-D applies see 'Deducting a bad debt – company that is owed debt experiences majority ownership change when it joins consolidated group', C9-5-351.

Provided that both SubCo and HeadCo would have been able to deduct the debt for their respective debt test income years, HeadCo is able to claim a bad debt deduction for the debt that was written off on 31 December 2004.

References

Income Tax Assessment Act 1997, Subdivision 165-C

Income Tax Assessment Act 1997 – as amended by *Tax Laws Amendment (2004 Measures No. 7) Act 2005*, Schedule 6:

- Subdivision 709-D

Explanatory Memorandum to the Tax Laws Amendment (2004 Measures No. 7) Bill 2004, Chapter 6

Revision history

Section C9-5-350 first published 3 August 2005.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

[238] Assuming that the discretion in paragraph 165-120(1)(b) is not favourably exercised by the Commissioner of Taxation.

Worked example

Deducting a bad debt – company that is owed debt experiences majority ownership change when it joins consolidated group

Description

This example shows how the consolidation bad debt rules apply where the head company of a consolidated group claims a bad debt deduction for a debt that was originally owed to another company before that company became a subsidiary member of the consolidated group.

Specifically, it shows how the same business test (SBT) in section 165-126 of the *Income Tax Assessment Act 1997* (ITAA 1997) is affected by the operation of those rules.

Commentary

The consolidation bad debt rules are contained in Subdivision 709-D of the ITAA 1997.

Subdivision 709-D applies when determining whether an entity (the claimant) can deduct a bad debt where the debt has been owed:

- to an entity (whether the claimant or another entity) for a period (the debt test period) when the entity was a member of a consolidated group, and
- to an entity (whether the claimant or another entity) for a period (which is also a debt test period) when the entity was not a member of that consolidated group.

In determining each of the debt test periods the entry and exit history rules are ignored.[239] Each debt test period is identified as the period in which the entity is taken to be owed the debt for tax purposes. In some cases the debt is taken to be owed to the entity because of the single entity rule.

Effectively, Subdivision 709-D looks at each entity that is owed the debt to determine (based on certain assumptions) whether that entity would have been able to claim a bad debt deduction. The claimant is only able to deduct the debt if, for each debt test period, the entity that was owed the debt could have deducted it for the relevant 'debt test income year', assuming the debt was written off as bad at the end of the debt test period.

Example

Facts

On 8 September 2002, a $7,000 debt begins to be owed to a company, SubCo. The amount of the debt is brought to account by SubCo as assessable income in the income year ended 30 June 2003.

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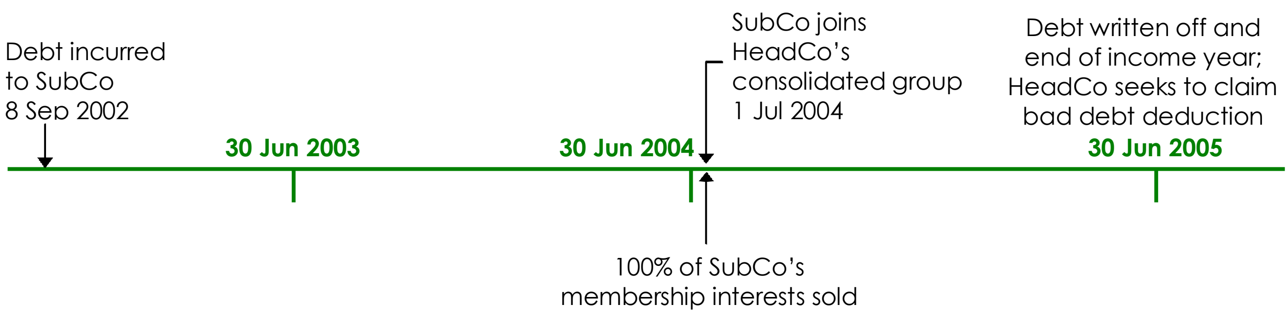
[239] Subsection 709-205(3).

On 1 July 2004, a consolidated group is formed with HeadCo as the head company. At the time the consolidated group is formed HeadCo acquires 100% of the membership interests in SubCo, which means SubCo becomes a member of the group at formation.

On 30 June 2005, the $7,000 debt owed to SubCo is written off as bad in SubCo's books of account. HeadCo (as the head company of the consolidated group) seeks to claim a bad debt deduction for this debt in the year ended 30 June 2005.[240]

HeadCo (the claimant) can deduct the debt if the condition in subsection 709-205(2) is met for each debt test period – namely, that SubCo and HeadCo could have each deducted the debt for their respective debt test income years, based on certain assumptions.

Figure 1: Timeline of events



Calculation

To determine whether SubCo and HeadCo could have each deducted the debt for their relevant debt test income year it is necessary to identify, for each entity:

1. **The debt test period(s):** This is identified in section 709-205.
2. **The debt test income year(s):** This is identified in the table in subsection 709-215(3).
3. **The continuity periods:** To determine whether an entity has satisfied the COT in section 165-123 of the ITAA 1997, the continuity periods are identified under subsection 709-215(4) and not subsection 165-120(2). Note that subsection 709-215(2) modifies a number of the provisions that would normally apply in determining whether a company would be able to deduct a bad debt for the debt test income year if the company had written off the debt as bad at the end of the debt test period.

[240] The entity that owes the debt is not an associate of SubCo or HeadCo for the period 8 September 2002 to 30 June 2005.

SubCo

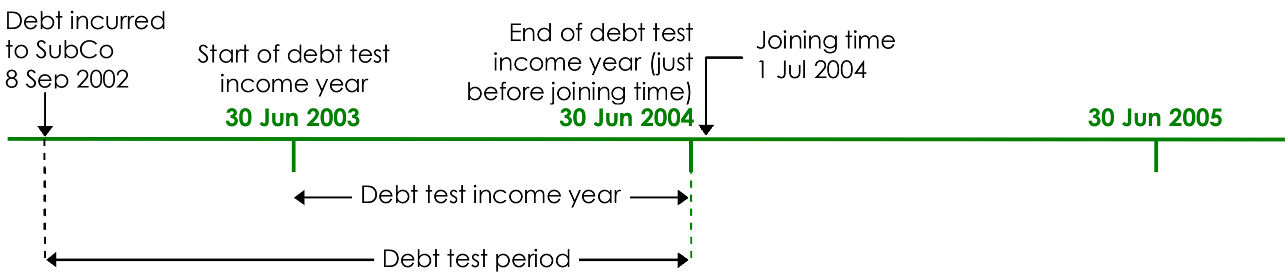
Step 1: Identify the debt test period

SubCo's debt test period is from 8 September 2002 to just before the time that SubCo joins the consolidated group on 1 July 2004. → section 709-205

Step 2: Identify the debt test income year

Item 2 of the table in subsection 709-215(3) applies because SubCo is not the claimant. The start of the debt test income year is 12 months before the end of the debt test period (i.e. 30 June 2003). The end of the debt test income year is the end of the debt test period (i.e. just before the joining time on 1 July 2004).

Figure 2: SubCo's debt test period and debt test income year



Step 3: Identify the continuity periods

SubCo's first continuity period
Item 3 in the table in subsection 709-215(4) applies because SubCo's debt test period:

- does not start when SubCo ceases to be a member of a consolidated group, and
- ends when SubCo becomes a member of a consolidated group.

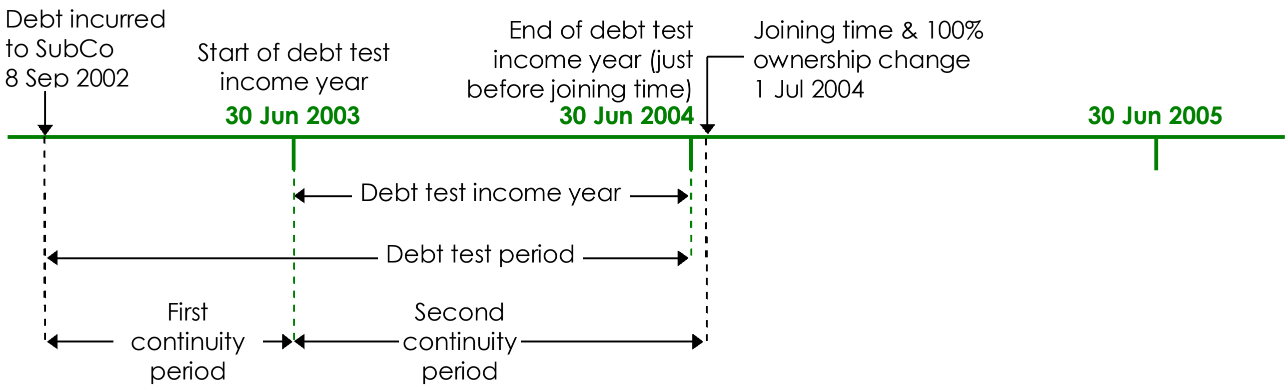
The start of the first continuity period is the start of the debt test period, which is 8 September 2002.

Paragraph 709-215(4)(a) identifies the end of the first continuity period as the start of the debt test income year (30 June 2003).

SubCo's second continuity period for COT purposes

The second continuity period for the purposes of the COT starts at the start of the debt test income year (30 June 2003) and ends at the time identified in the table in subsection 709-215(4). Item 3 in this table identifies the end of the second continuity period as just after the end of the debt test period. As SubCo's debt test period ends just before the joining time, the second continuity period ends at the joining time on 1 July 2004.

Figure 3: Subco's continuity periods for the purposes of the COT



To determine is SubCo has satisfied the COT its ownership is examined from the start of the first continuity period to the end of the second continuity period (i.e. from 8 September 2002 to the joining time on 1 July 2004).

SubCo does not satisfy the COT because there has been a majority ownership change at the joining time (1 July 2004). To be able to deduct the debt SubCo needs to satisfy the SBT in section 165-126.[241]

SubCo's second continuity period for SBT purposes

The second continuity period for the purposes of the SBT is the debt test income year (which is from 30 June 2003 to 30 June 2004). → paragraph 709-215(4)(b)

Test time for applying the SBT

Under subsection 709-215(6), the test time (to apply the SBT) is the later of:

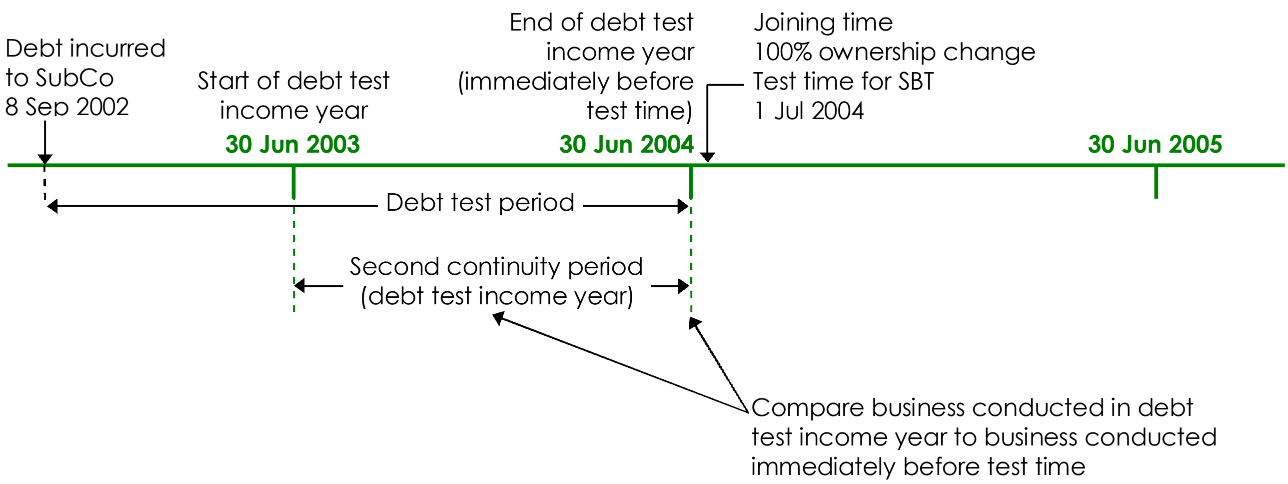
- the first time that it was not practicable to show that the company had met the conditions in section 165-123 (effectively, the first time that it could not be shown that it had maintained majority ownership), and
- the time just after the start of the debt test period.

In this instance, the later of these times is the joining time on 1 July 2004, which is the point when SubCo experiences a 100% change in its ownership.

Therefore, the SBT needs to be satisfied for the business conducted by SubCo in the debt test income year (the second continuity period) when compared to the business conducted by SubCo immediately before the test time (i.e. just before the joining time).

[241] Assuming that the discretion in paragraph 165-120(1)(b) is not favourably exercised by the Commissioner of Taxation.

Figure 4: Applying the SBT to SubCo



If SubCo satisfies the SBT (as applied above) and HeadCo is able to deduct the debt in its identified debt test income year, HeadCo will be able to deduct the debt.

HeadCo

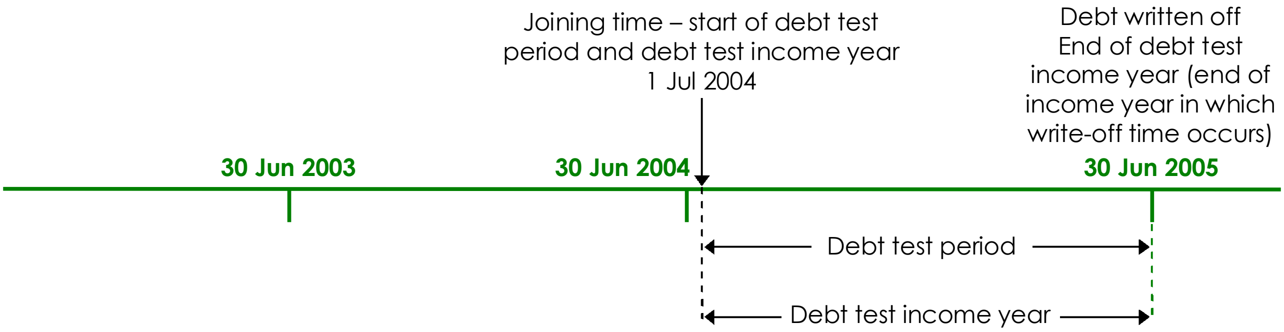
Step 1: Identify the debt test period

HeadCo's debt test period is from the time that SubCo joins the consolidated group (1 July 2004) to the time that HeadCo writes off the debt as bad (30 June 2005). → section 709-205

Step 2: Identify the debt test income year

Item 1 of the table in subsection 709-215(3) applies because HeadCo is the claimant and the debt test period ends when HeadCo actually writes off the debt. The start of the debt test income year is 1 July 2004 because this is both the start of the income year in which the write-off time occurs and the start of the debt test period (if these times did not coincide, the debt test income year would start at the later of the two). The end of the debt test income year is the end of the income year in which the write-off time occurs (i.e. 30 June 2005).

Figure 5: HeadCo's debt test period and debt test income year



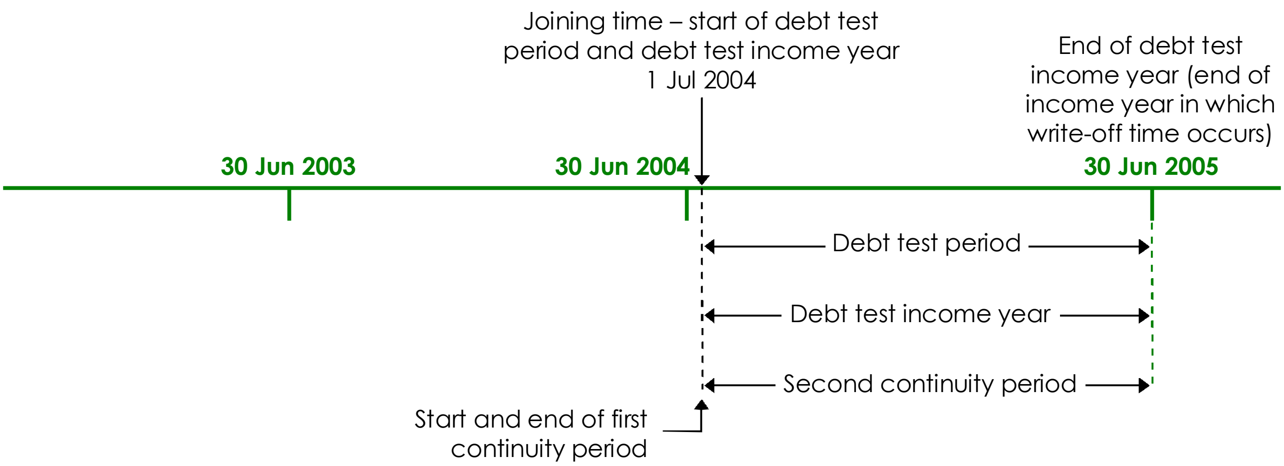
Step 3: Identify the continuity periods

HeadCo's first continuity period
Item 1 in the table in subsection 709-215(4) applies because HeadCo is the claimant, the debt test period ends when HeadCo actually writes off the debt and HeadCo is the head company of a consolidated group at the write-off time. The start of the first continuity period is the start of the debt test period (1 July 2004).

Paragraph 709-215(4)(a) identifies the end of the first continuity period as the start of the debt test income year (also 1 July 2004).

HeadCo's second continuity period
The second continuity period starts at the start of the debt test income year (i.e. 1 July 2004) and ends at the time identified in the table in subsection 709-215(4). Item 1 in this table identifies the end of the second continuity period as the end of the income year in which the write-off time occurs (i.e. 30 June 2005).

Figure 6: HeadCo's continuity periods for purposes of the COT



To determine if HeadCo has satisfied the COT its ownership is examined from the start of the first continuity period to the end of the second continuity period (i.e. from 1 July 2004 to 30 June 2005).

If HeadCo has not satisfied the COT in section 165-123 for this period it would not be able to claim a bad debt deduction in the debt test income year unless it satisfies the SBT in section 165-126 [242] (as illustrated above in respect of SubCo).

Provided that both SubCo and HeadCo would have been able to deduct the debt for their respective debt test income years, HeadCo is able to claim a bad debt deduction for the debt that was written off on 30 June 2005.

References

Income Tax Assessment Act 1997, Subdivision 165-C

Income Tax Assessment Act 1997 – as amended by *Tax Laws Amendment (2004 Measures No. 7) Act 2005*, Schedule 6:

- Subdivision 709-D

Explanatory Memorandum to the Tax Laws Amendment (2004 Measures No. 7) Bill 2004, Chapter 6

Revision history

Section C9-5-351 first published 3 August 2005.

Proposed changes to consolidation

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- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

[242] Assuming that the discretion in paragraph 165-120(1)(b) is not favourably exercised by the Commissioner of Taxation.

Worked example

Deducting a bad debt – company that is owed debt joins consolidated group that later ceases to exist

Description

This example shows how the consolidation bad debt rules apply where a company seeks to claim a bad debt deduction for a debt that was owed to the company before it became a subsidiary member of a consolidated group and the company later left that consolidated group when the group ceased to exist.

Specifically, it shows how the continuity of ownership test (COT) in section 165-123 of the *Income Tax Assessment Act 1997* (ITAA 1997) is modified so that the company is taken to be owed the debt for more than one period of time.

Commentary

The consolidation bad debt rules are contained in Subdivision 709-D of the ITAA 1997.

Subdivision 709-D applies when determining whether an entity (the claimant) can deduct a bad debt where the debt has been owed:

- to an entity (whether the claimant or another entity) for a period (the debt test period) when the entity was a member of a consolidated group, and
- to an entity (whether the claimant or another entity) for a period (which is also a debt test period) when the entity was not a member of that consolidated group.

In determining each of the debt test periods the entry and exit history rules are ignored.[243] Each debt test period is identified as the period in which the entity is taken to be owed the debt for tax purposes. In some cases the debt is taken to be owed to the entity because of the single entity rule.

Effectively, Subdivision 709-D looks at each entity that is owed the debt to determine (based on certain assumptions) whether that entity would have been able to claim a bad debt deduction. The claimant is only able to deduct the debt if, for each debt test period, the entity that was owed the debt could have deducted it for the relevant 'debt test income year', assuming the debt was written off as bad at the end of the debt test period.

Example

Facts

On 12 November 2001, an $8,500 debt begins to be owed to a company, SubCo. The amount of the debt is brought to account by SubCo as assessable income in the income year ended 30 June 2002.

On 1 July 2002, a consolidated group is formed with HeadCo as the head company. SubCo joins the consolidated group at the time the group is formed.

[243] Subsection 709-205(3).

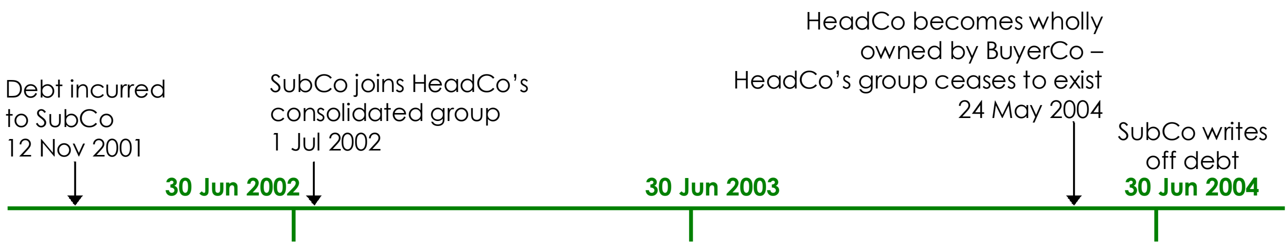
On 24 May 2004, HeadCo becomes a wholly-owned subsidiary of BuyerCo (an Australian resident company that is not a member of a consolidated group) as a result of BuyerCo acquiring 10% of HeadCo's membership interests.

HeadCo is therefore no longer eligible to be the head company of a consolidated group and the group ceases to exist. No new consolidated group is formed.

On 30 June 2004, the $8,500 debt that is owed to SubCo is written off as bad in SubCo's books of account. SubCo seeks to claim a bad debt deduction for this debt in the year ended 30 June 2004.[244]

SubCo (the claimant) can deduct the debt if the condition in subsection 709-205(2) is met for each debt test period – namely, that SubCo or HeadCo could have each deducted the debt for their respective debt test income years, based on certain assumptions.

Figure 1: Timeline of events



Calculation

In this example, SubCo has two debt test periods as it is taken to have been owed the debt for two different periods of time. Each debt test period has a separate debt test income year.

To determine whether SubCo and HeadCo could have each deducted the debt for their relevant debt test income year(s), it is necessary to identify, for each entity:

1. **The debt test period(s):** This is identified in section 709-205.
2. **The debt test income year(s):** This is identified in the table in subsection 709-215(3).
3. **The continuity periods:** To determine whether an entity has satisfied the COT in section 165-123 of the ITAA 1997, the continuity periods are identified under subsection 709-215(4) and not subsection 165-120(2). Note that subsection 709-215(2) modifies a number of the provisions that would normally apply in determining whether a company would be able to

244 The entity that owes the debt is not an associate of SubCo or HeadCo for the period 12 November 2001 to 30 June 2004.

deduct a bad debt for the debt test income year if the company had written off the debt as bad at the end of the debt test period.

SubCo prior to joining consolidated group

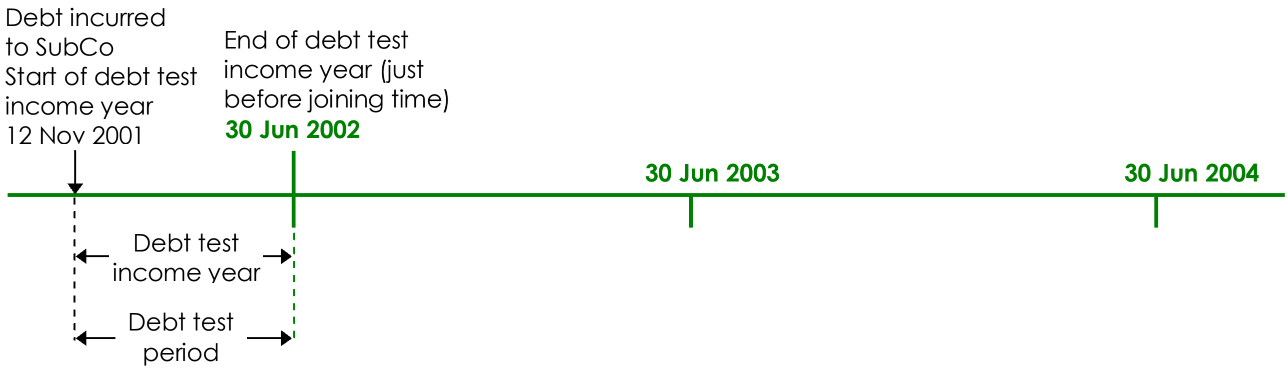
Step 1: Identify the debt test period

SubCo's debt test period is from 12 November 2001 to just before the time that SubCo joins the consolidated group on 1 July 2002. → section 709-205

Step 2: Identify the debt test income year

Item 2 of the table in subsection 709-215(3) applies because, while SubCo is the claimant, the debt test period ends before SubCo writes off the debt. The start of the debt test income year is 12 November 2001, which is the start of the debt test period (because this is later than 12 months before the end of the debt test period). The end of the debt test income year is the end of the debt test period, which is just before the joining time on 1 July 2002.

Figure 2: SubCo's debt test period and debt test income year (before SubCo joins HeadCo's consolidated group)



Step 3: Identify the continuity periods

SubCo's first continuity period
Item 3 in the table in subsection 709-215(4) applies because SubCo's debt test period:

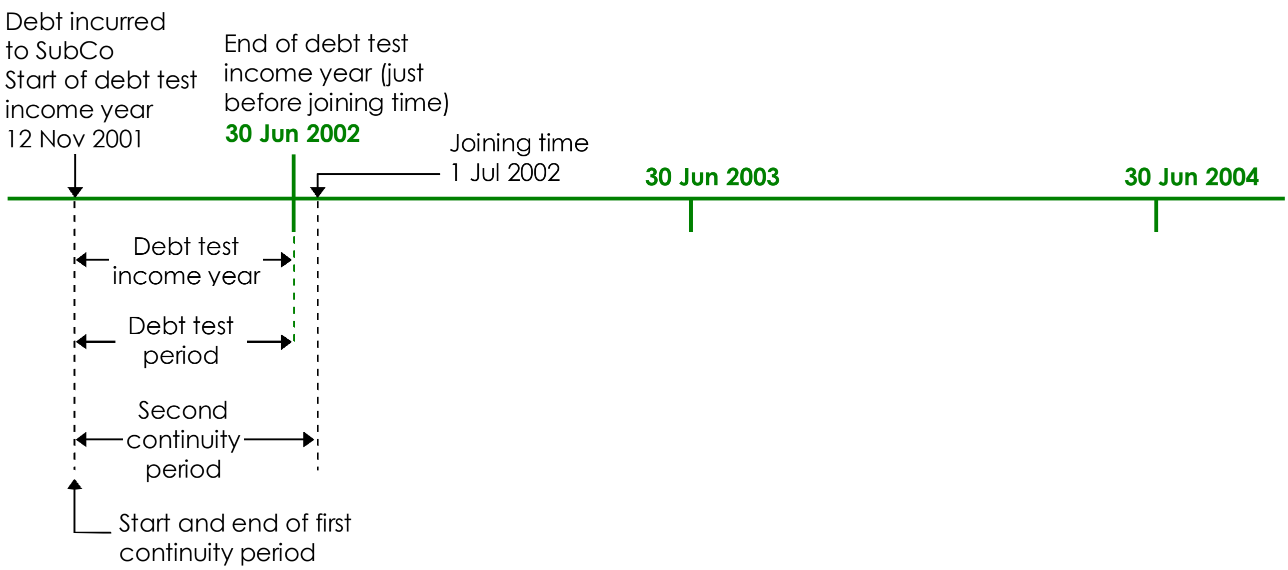
- does not start when SubCo ceases to be a member of a consolidated group, and
- ends when SubCo becomes a member of a consolidated group.

The start of the first continuity period is the start of the debt test period (12 November 2001). Paragraph 709-215(4)(a) identifies the end of the first continuity period as the start of the debt test income year (also 12 November 2001).

SubCo's second continuity period
The second continuity period starts at the start of the debt test income year (12 November 2001) and ends at the time identified in the table in subsection 709-215(4). Item 3 in this table identifies the end of the second continuity

period as just after the end of the debt test period. As SubCo's debt test period ends just before the joining time, the second continuity period ends at the joining time on 1 July 2002.

Figure 3: SubCo's continuity periods for the purposes of the COT (before SubCo joins HeadCo's consolidated group)



To determine if SubCo has satisfied the COT its ownership is examined from the start of the first continuity period to the end of the second continuity period (i.e. from 12 November 2001 to the joining time on 1 July 2002).

If SubCo has not satisfied the COT for this period it would not be able to claim a bad debt deduction in the debt test income year[245] unless it satisfies the same business test (SBT) in section 165-126.[246]

→ For an explanation of how the SBT applies to an entity seeking to deduct a bad debt where Subdivision 709-D applies see 'Deducting a bad debt – company that is owed debt experiences majority ownership change when it joins consolidated group', C9-5-351.

[245] Remembering that SubCo has two debt test periods as it is taken to have been owed the debt for two different periods of time.

[246] Assuming that the discretion in paragraph 165-120(1)(b) is not favourably exercised by the Commissioner of Taxation.

HeadCo

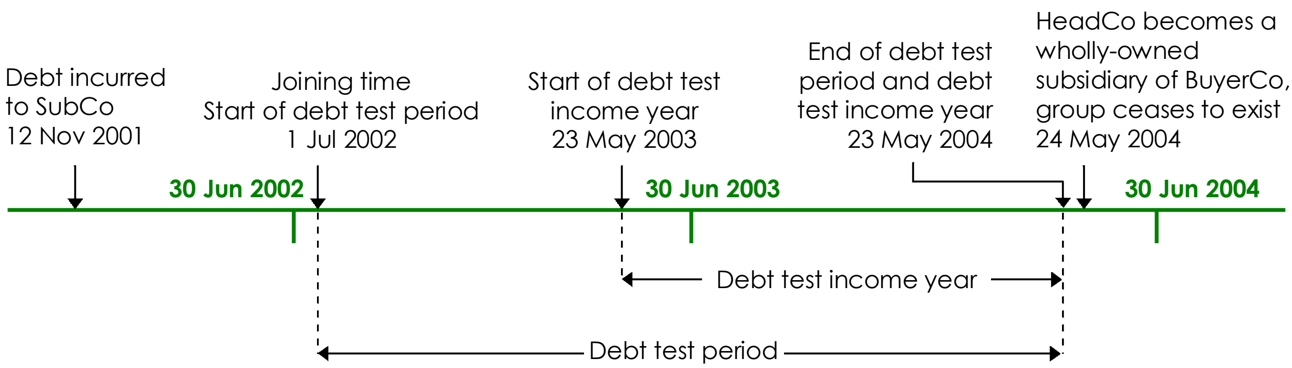
Step 1: Identify the debt test period

HeadCo's debt test period is from the time that SubCo joins the consolidated group (1 July 2002) to just before the time that the group ceases to exist (24 May 2004). → section 709-205

Step 2: Identify the debt test income year

Item 2 in the table in subsection 709-215(3) applies because HeadCo is not the claimant. The start of the debt test income year is 23 May 2003 (i.e. 12 months before the end of the debt test period) because this is later than the start of the debt test period. The end of the debt test income year is the end of the debt test period (which is just before the group ceases to exist on 24 May 2004).

Figure 4: HeadCo's debt test period and debt test income year



Step 3: Identify the continuity periods

HeadCo's first continuity period

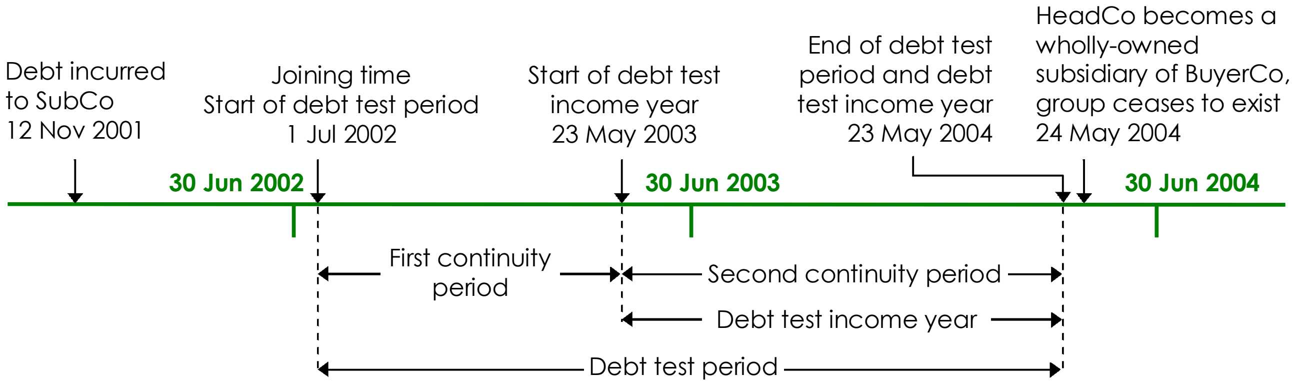
Item 4 of the table in subsection 709-215(4) applies because HeadCo is the head company of a consolidated group for the debt test period that ends when HeadCo ceases to be a member of the consolidated group without becoming a member of another consolidated group. The start of the first continuity period is the start of the debt test period (1 July 2002).

Paragraph 709-215(4)(a) identifies the end of the first continuity period as the start of the debt test income year (23 May 2003).

HeadCo's second continuity period

The second continuity period starts at the start of the debt test income year (23 May 2003) and ends at the time identified in the table in subsection 709-215(4). Item 4 in this table identifies the end of the second continuity period as the end of the debt test period (23 May 2004).

Figure 5: HeadCo's continuity periods for the purposes of the COT



To determine if HeadCo has satisfied the COT its ownership is examined from the start of the first continuity period to the end of the second continuity period (i.e. from 1 July 2002 to 23 May 2004).

If HeadCo has not satisfied the COT for this period it would not be able to claim a bad debt deduction in the debt test income year unless it satisfies the SBT.[247]

→ For an explanation of how the SBT applies to an entity seeking to deduct a bad debt where Subdivision 709-D applies see 'Deducting a bad debt – company that is owed debt experiences majority ownership change when it joins consolidated group', C9-5-351.

SubCo from when group ceases to exist

SubCo has a second debt test period for the time from when HeadCo's consolidated group ceases to exist. The steps need to be repeated for this period.

Step 1: Identify the debt test period

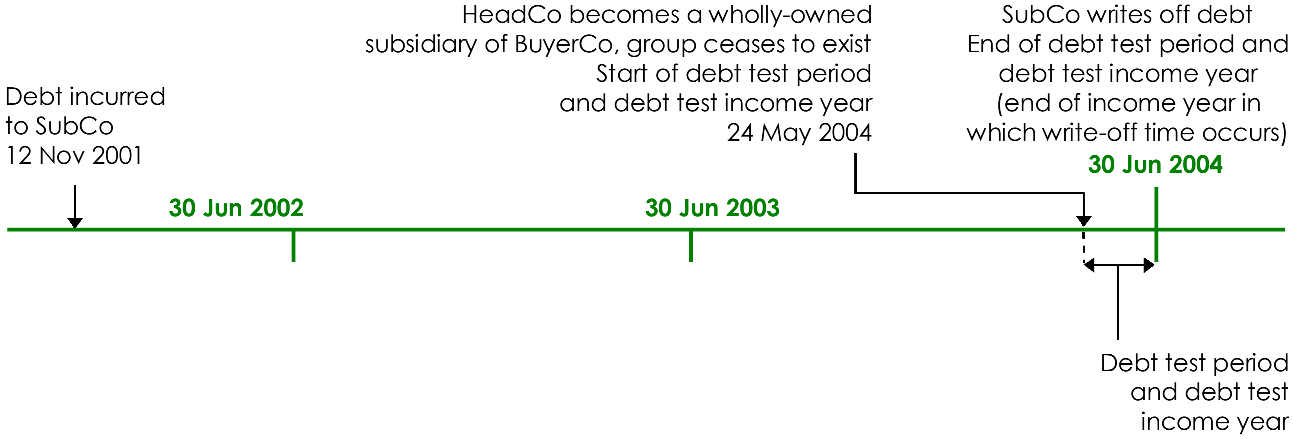
SubCo's debt test period is from the time that HeadCo's consolidated group ceases to exist (24 May 2004) to the time that SubCo writes off the debt as bad (30 June 2004). → section 709-205

Step 2: Identify the debt test income year

Item 1 of the table in subsection 709-215(3) applies because SubCo is the claimant and the debt test period ends when SubCo actually writes off the debt. The start of the debt test income year is 24 May 2004 because this is later than the start of the income year in which the write-off time occurs. The end of the debt test period is the end of the income year in which the write-off time occurs, which is 30 June 2004.

[247] Assuming that the discretion in paragraph 165-120(1)(b) is not favourably exercised by the Commissioner of Taxation.

Figure 6: SubCo's debt test period and debt test income year (from when HeadCo's group ceases to exist)



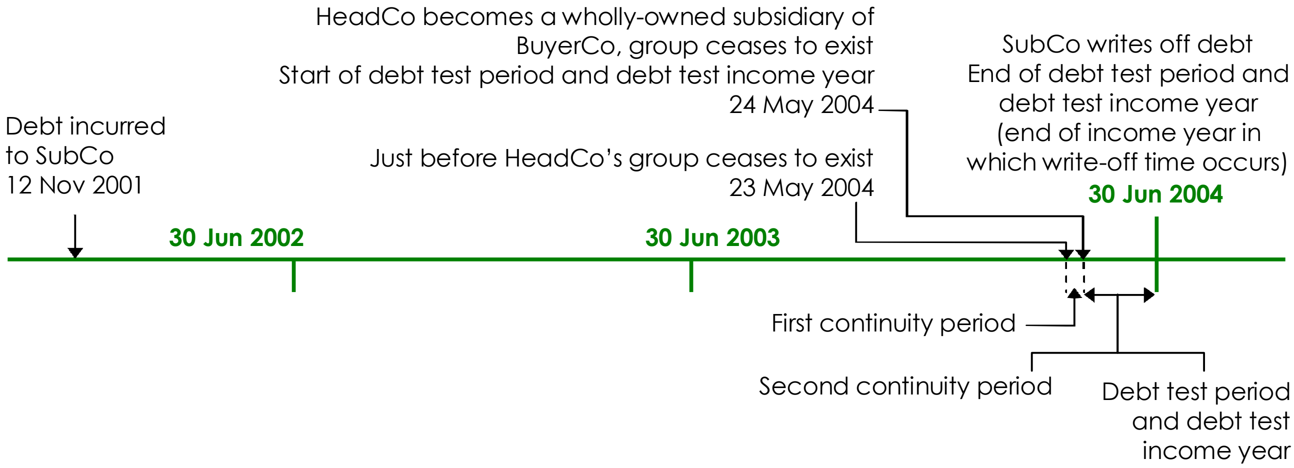
Step 3: Identify SubCo's continuity periods

SubCo's first continuity period
Item 2 of the table in subsection 709-215(4) applies because SubCo is the claimant, the debt test period ends when SubCo actually writes off the debt and SubCo is not the head company of a consolidated group at the write-off time. The start of the first continuity period is just before the start of the debt test period (which is just before the time that the group ceases to exist on 24 May 2004).

Paragraph 709-215(4)(a) identifies the end of the first continuity period as the start of the debt test income year (which is the time the group ceases to exist on 24 May 2004).

SubCo's second continuity period
The second continuity period starts at the start of the debt test income year (i.e. the time that the group ceases to exist on 24 May 2004) and ends at the time identified in the table in subsection 709-215(4). Item 2 in this table identifies the end of the second continuity period as the end of the income year in which the write-off time occurs (i.e. 30 June 2004).

Figure 7: SubCo's continuity periods for the purposes of the COT (from when HeadCo's group ceases to exist)



To determine if SubCo has satisfied the COT its ownership is examined from the start of the first continuity period to the end of the second continuity period (i.e. from 23 May 2004 to 30 June 2004). The 10% change in the membership interests of HeadCo on 24 May 2004 is relevant – because SubCo is a wholly-owned subsidiary of HeadCo – and needs to be taken into account in determining whether SubCo satisfies the COT.

If SubCo has not satisfied the COT for this period it would not be able to claim a bad debt deduction in the debt test income year unless it satisfies the SBT.[248]

→ For an explanation of how the SBT applies to an entity seeking to deduct a bad debt where Subdivision 709-D applies see 'Deducting a bad debt – company that is owed debt experiences majority ownership change when it joins consolidated group', C9-5-351.

Provided that both SubCo (for both the time before it becomes a member of HeadCo's consolidated group and for the time from when HeadCo's group ceases to exist) and HeadCo would have been able to deduct the debt for their respective debt test income years, SubCo is able to claim a bad debt deduction for the debt that was written off on 30 June 2004.

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248 Assuming that the discretion in paragraph 165-120(1)(b) is not favourably exercised by the Commissioner of Taxation.

References

Income Tax Assessment Act 1997, Subdivision 165-C

Income Tax Assessment Act 1997 – as amended by *Tax Laws Amendment (2004 Measures No. 7) Act 2005*, Schedule 6:

- Subdivision 709-D

Explanatory Memorandum to the Tax Laws Amendment (2004 Measures No. 7) Bill 2004, Chapter 6

Revision history

Section C9-5-352 first published 3 August 2005.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Effect of exit history rule

Description

This example shows how the exit history rule may affect the tax liabilities of an entity after it leaves a consolidated group.

Commentary

The exit history rule applies for the core purposes of working out an entity's income tax liability or loss for any period after it ceases to be a subsidiary member of a consolidated group. → subsection 701-40(1), *Income Tax Assessment Act 1997* (ITAA 1997)

The exit history rule applies to assets, liabilities or any business that becomes that of an entity when it ceases to be a subsidiary member of a group. Everything that happened in relation to those assets etc. while part of the consolidated group is taken to have happened to the assets etc. as if they had been assets etc. of the leaving entity. This includes any history that the head company may have inherited under the entry history rule. → subsection 701-40(3)

The history that is inherited by a leaving entity is the history relating to:

- any assets
- any liabilities, including anything that, in accordance with accounting principles, is a liability
- any businesses, and
- any registration under section 39J of the *Industry Research and Development Act 1986* for particular research and development activities,

that the entity takes when it leaves the group. To this extent, the exit history rule is more limited in scope than the entry history rule. → subsection 701-40(2)

The exit history rule provides that a leaving entity may be entitled to deductions for expenditure incurred by the head company in regard to assets, liabilities or businesses that leave the group with the entity. For example, the leaving entity may be entitled to deductions for borrowing expenses, gift deductions (where the entitlement to the deduction is spread), the cost of connecting water, power and telephone lines, certain business-related costs, and expenditure allocated to a project pool.

The leaving entity may also be entitled to a deduction for a debt it takes with it that subsequently goes bad. → Subdivision 709-D; worked examples, C9-5-350, C9-5-351, C9-5-352; paragraphs 6.30 – 6.55 of the Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 7) Bill 2004

An entity that has left a consolidated group may also need to include in its assessable income amounts relating to such things as prepayments made to the head company for services to be provided by the entity after it has left the group. An entity may also be assessable on amounts received as a recoupment of expenditure previously made by the head company. In addition, a former subsidiary would also need to include amounts in its assessable income where:

- the head company had previously elected to defer tax on the profit from the disposal or death of livestock or elected to defer the inclusion of the profit on a second wool clip, and
- the business that relates to these items left the group with the leaving entity.

Other effects of the exit history rule include:

- The pre-CGT status of assets that a leaving entity takes with it is inherited by that entity. (However, the pre-CGT status of the asset would be lost if any disposal of membership interests in the entity resulted in the ultimate owners not continuing to hold a majority underlying interest in the asset.)
- Private rulings about income tax issued to the head company may apply to the leaving entity where they relate to particular assets, liabilities or businesses that a leaving entity takes out of a group. A private ruling will apply to the leaving entity insofar as the relevant facts and arrangements have not changed either by reason of the entity ceasing to be a member of a consolidated group or otherwise.

Situations where history is not inherited

The leaving entity's tax costs for the assets that it takes with it are the head company's terminating values for those assets inherited under the exit history rule, except for certain assets whose costs are separately worked out at the leaving time because they were disregarded for income tax purposes before that time under the single entity rule. These are:

- any liabilities owed to the leaving entity by other members of the group → section 701-45, ITAA 1997; section 701-60, table item 3, ITAA 1997; Taxation Determination TD 2005/46
- any membership interests held by the leaving entity in any other subsidiary members that leave the group at the same time → section 701-50, ITAA 1997; section 701-60, table item 4, ITAA 1997.

Other provisions that modify the application of the exit history rule include:

- rules covering the treatment of franking credits and losses → section 701-85
- rules relating to the entitlement to the R&D tax offset → section 73BACA, ITAA1936, and the R&D incremental concession → section 73BAD, ITAA 1936
- a rule requiring that the exit history rule be ignored when determining a debt test period for the purpose of applying the consolidation bad debt rules → subsection 709-205(3), ITAA 1997.

The exit history rule is also modified by rules which permit an entity leaving a consolidated group to remake certain irrevocable elections or choices made by the head company after the entity became a member of the group → Subdivision 715-K, ITAA 1997. These fall into three categories:

1. Resettable elections

Where an entity leaves a consolidated group and the head company was eligible to make a choice in this category (see list below) in relation to an income year starting before the leaving time, the head company's choice (or absence of it) is ignored for the purposes of the leaving entity's income tax affairs for income years ending after the leaving time, and the leaving entity may make the choice, if it is eligible.

The leaving entity has until the later of the time allowed under the choice provision and 90 days after the leaving time to make the choice. The Commissioner has discretion to extend this deadline.

Note that this rule came into effect on 21 March 2005. If the entity left the group before that date, the 90 day limit mentioned above is taken to be 90 days after 21 March 2005. → section 715-699, IT(TP)A 1997

The choice has effect from the leaving time (or from the income year containing the leaving time if the choice relates to a whole income year).

The choices in this category are:

- irrevocable declarations, elections, choices or selections provided for in Part X of the ITAA 1936 (about attribution of income in respect of controlled foreign companies – CFCs)
- the election to use a particular foreign currency to work out taxable income or a tax loss for an income year under item 1 of the table in subsection 960-60(1) of the ITAA 1997
- a fair value election, foreign exchange retranslation election, hedging financial arrangement election or election to rely on financial reports under section 230-210, 230-255, 230-315 or 230-395 of the ITAA 1997 respectively (about the treatment of gains and losses from Division 230 financial arrangements)
- elections provided for under other provisions that may be prescribed by regulation under this category in the future.

→ section 715-700, ITAA 1997; paragraphs 1.197 – 1.199 of the Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004; 'Effect of entry history rule', C9-5-150

Note

For income years before 2010-11, choices in this category also included:

- irrevocable declarations, elections, choices or selections provided for in former Part XI of the ITAA 1936 – about attribution of income in respect of foreign investment funds (FIFs) and foreign life policies (FLPs)
- the election to value all items of trading stock that were interests in a FIF at market value (rather than cost) under former section 70-70 of the ITAA 1997.

2. Limited resettable elections to overcome inconsistencies

Where an entity leaves a consolidated group and there is an inconsistency because either:

- there was a choice in this category made by the entity that was in effect just before the entity joined the group and there was not such a choice by the head company having effect just before the leaving time, or
- the converse applied,

the choice (or absence of it) of the head company is ignored for the purposes of the leaving entity's income tax affairs, and the leaving entity may make the choice, if it is eligible.

The time limit for the leaving entity to make the choice is the same as for resettable elections (see above). The choice has effect from the leaving time (or from the income year containing the leaving time if the choice relates to a whole income year).

The choices in this category are:

- the election under section 148 of the ITAA 1936 by a person carrying on a business of insurance in Australia who reinsures with a non-resident, in relation to reinsurance under contracts made at or after the leaving time. (For contracts made before the leaving time, the leaving entity is taken to have made the same decision as the head company made – or was taken to have made – to make or not make the election.)
- a fair value election, foreign exchange retranslation election, hedging financial arrangement election or election to rely on financial reports under section 230-210, 230-255, 230-315 or 230-395 of the ITAA 1997 respectively (about the treatment of gains and losses from Division 230 financial arrangements
- the election under section 775-80 of the ITAA 1997 that sections 775-70 and 775-75 of that Act (concerning the tax consequences of certain short-term foreign exchange gains and losses) not apply
- elections provided for under other provisions that may be prescribed by regulation under this category in the future.

→ section 715-705, ITAA 1997; paragraphs 1.214 – 1.219 of the Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004; 'Effect of entry history rule', C9-5-150

3. Choices with ongoing effect

Where an entity leaves a consolidated group and there were, just before the leaving time, any choices in effect in this category in relation to any assets, rights, liabilities or obligations that the entity leaves with, those choices continue in effect. If a choice was made originally by the head company, the leaving entity will inherit the choice as per the normal exit history rule.

The only choice currently available in this category is that provided under section 775-150 of the ITAA 1997 regarding whether to apply rules about disregarding certain forex realisation gains and forex realisation losses.

→ paragraph 1.225 of the Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004; 'Effect of entry history rule', C9-5-150

Example

Facts

- ACo is a 100% subsidiary of HCo and operates a computer retail business.
- In the 2000-01 income year, ACo sells goods to one of its customers for $10,000 but does not receive payment. In its 2000-01 income tax return, ACo includes the amount of $10,000 in its assessable income.
- HCo forms a consolidated group on 1 July 2002. The subsidiary members include ACo and BCo.
- Under consolidation, HCo is taken to hold all the assets of ACo, including the debt.
- In May 2003 it becomes apparent that there is no likelihood of the debt being recovered. HCo writes off the $10,000 as a bad debt and claims a deduction of $10,000 under subsection 25-35 of the ITAA 1997 in the group's 2002-03 income tax return. (As a claimant, HCo will need to take into account the modifications to the bad debt rules contained in Subdivision 709-D, ITAA 1997, 'Deducting bad debts' → worked examples C9-5-350, C9-5-351, C9-5-352.)
- In July 2003, HCo restructures its operations and transfers the computer retail business to BCo. As part of the transfer agreement, BCo assumes responsibility for collecting all outstanding debts that are owing to ACo. Adjustments to the purchase price are made for these outstanding debts, but there is no adjustment made for the $10,000 bad debt as it has been written off.
- On 1 August 2003, HCo sells its shares in BCo, which ceases to be a member of the consolidated group. BCo continues to operate the computer retail business.
- On 1 December 2003, BCo unexpectedly receives a payment of $2500 in respect of the debt that had been written off as bad.

Because of the exit history rule in section 701-40, everything that happened in relation to the computer retail business in the hands of HCo is taken to have happened to it in the hands of BCo. This means that the bad debt claimed as a deduction by HCo in relation to the business is taken to have been claimed by BCo. Because BCo is taken to have claimed the deduction, the recoupment is assessable to BCo under Subdivision 20-A of the ITAA 1997.

In its 2003-04 tax return, BCo must include the amount of $2,500 in its assessable income.

References

Income Tax Assessment Act 1997, Subdivision 20-A

Income Tax Assessment Act 1997, Subdivision 170-D

Income Tax Assessment Act 1997, section 701-5; as amended by *Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Act 2005* (No. 147 of 2005), Schedule 1 item 105

Explanatory Memorandum to Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Bill 2005, paragraphs 3.14 to 3.19

Income Tax Assessment Act 1997, section 701-40; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (68 of 2002), Schedule 1, and *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, item 90

Income Tax Assessment Act 1997, section 701-85; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (68 of 2002), Schedule 1

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 2.7, 2.8, 2.11, 2.13, 2.30, 2.38 - 2.47 and 2.81

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.75, 5.76, 5.184, 5.237, 5.247

Income Tax Assessment Act 1997, sections 701-45, 701-50, 701-60; as amended by *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (No. 83 of 2004), Schedule 2, items 23 and 24; 25; 14, 26 and 27

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 2) Bill 2004, paragraphs 2.66 – 2.78, 2.246 – 2.264

Income Tax Assessment Act 1997, section 707-410; as inserted by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002*, Schedule 6, item 5

Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill 2002, paragraph 8.9

Income Tax Assessment Act 1997, Subdivision 717-G; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 8

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No 2) 2002, paragraphs 7.65 – 7.69

Income Tax Assessment Act 1997, section 25-25

Income Tax Assessment Act 1997, Subdivision 715-J; as amended by *Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009* (No. 15 of 2009), Schedule 1, Part 2, and *Tax Laws Amendment (Foreign Source Income Deferral) Act (No. 1) 2010* (No. 114 of 2010), Schedule 1, Part 1

Explanatory Memorandum to Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008, paragraphs 5.63, 12.38 – 12.63

Income Tax Assessment Act 1997, Subdivision 715-K; as inserted by *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1, Part 10

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004, paragraphs 1.197 – 1.199, 1.214 – 1.219 & 1.225

Income Tax Assessment Act 1997, Subdivision 709-D; as inserted by *Tax Laws Amendment (2004 Measures No. 7) Act 2005* (No. 41 of 2005), Schedule 6, Part 4

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 7) Bill 2004, paragraphs 6.30 – 6.55

Income Tax Assessment Act 1936, section 73BACA; as inserted by *Taxation Laws Amendment (No. 2) Act 2004* (No. 20 of 2004), Schedule 8, item 11

Income Tax Assessment Act 1936, section 73BAD; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No 1) 2002* (No. 117 of 2002), Schedule 11, item 7, and *Tax Laws Amendment (2007 Measures No. 5) Act 2007* (No. 164 of 2007), Schedule 11, items 14, 15

Taxation determinations

TD 2004/80 – Income tax: consolidation: capital gains: does an entity permanently lose its status as an 'originating company', in respect of a deferral event in subsection 170-255(1) of the *Income Tax Assessment Act 1997*, when the entity becomes a subsidiary member of a consolidated group?

TD 2005/46 – Income tax: consolidation: what is the tax cost of an asset of a leaving entity that is only recognised upon the entity ceasing to be a subsidiary member of a consolidated group when the single entity rule ceases to apply?

Revision history

Section C9-5-810 first published 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Reference to rules relating to R&D tax offset and R&D incremental concession as modifying application of the exit history rule, p. 2.	Legislative amendments.
26.10.05	Changes and new material in 'Commentary' on rules that modify the exit history rule.	Legislative amendments.
6.5.11	Update to list of irrevocable elections made by the head company that a leaving entity may remake, despite the exit history rule.	Legislative amendments.
	Changes to 'Situations where history is not inherited', p 2.	To clarify treatment of intragroup assets.

Treatment of life insurance companies

Special consolidation rules apply to consolidated groups that have life insurance company members to take into account the special taxation treatment of life insurance companies. These rules are designed to ensure that Division 320 of the *Income Tax Assessment Act 1997* (ITAA 1997), and other provisions of income tax law relating specifically to life insurance companies, continue to apply appropriately to the head company of the group (since it is the only recognised income tax payer in a consolidated group).

Head company is deemed to be a life insurance company

The head company of a consolidated group that has one or more subsidiary members that are life insurance companies at any time during the year is itself deemed to be a life insurance company for income tax purposes. This allows the special provisions in the income tax law that apply to life insurance companies to apply to the consolidated group.

Application of the single entity rule

The income tax treatment of a consolidated group is based on the single entity rule in section 701-1 of the ITAA 1997. This rule means that a subsidiary that is a life insurance company is treated as part of the head company as long as it is a subsidiary member of the group. The single entity rule, combined with the fact that the head company is deemed to be a life insurance company, allows the head company to:

- establish and maintain complying superannuation/first home saver account (FHSA) assets and segregated exempt assets for the group
- have access to the dividend imputation rules that apply to life insurance companies, and
- be taxed appropriately on its allocation of taxable income, namely the complying superannuation class and the ordinary class.

Note

In some circumstances, the single entity rule has caused practical difficulties for the head company in identifying the segregated asset income of each class. To overcome these difficulties, if a life insurance company is a member of the consolidated group, the single entity rule will be disregarded for the purposes of working out the segregated asset income of each class.

→ section 713-510A, ITAA 1997

Modification to the membership rules

When a group consolidates, all the head company's eligible wholly-owned subsidiaries must normally be included in the consolidated group – this is known as the 'one in, all in' rule. This rule does not apply to a consolidated group that has a member that is a life insurance company.

As a result of special tax provisions, life insurance companies often hold assets in wholly-owned unit trusts or wholly-owned companies. Consequently, the complying superannuation/FHSA assets and segregated exempt assets are the membership interests in those wholly-owned unit trusts or companies.

The application of the 'one in, all in' rule would cause these membership interests to cease to be recognised for income tax purposes. This would mean the practical mechanism used to determine income (including capital gains) that should be taxed at 15% or that should be exempt from tax would no longer be effective.

Therefore, a wholly-owned subsidiary of a life insurance company that has membership interests that, directly or indirectly, are a mixture of complying superannuation/FHSA assets, segregated exempt assets and/or ordinary assets, is precluded from being a member of the same consolidated group. The excluded subsidiary member can be a member of another consolidated group provided all the membership requirements in section 703-15 of the ITAA 1997 are satisfied.

→ 'Modified membership rules for consolidated groups that include a life insurance company', C9-6-510

Note

In certain circumstances, a life insurance company that joins a consolidated group will have access to transitional measures allowing the life insurance company to rearrange assets of the group so that a subsidiary entity can become a member of the group, without any immediate tax consequences.
→ *Income Tax (Transitional Provisions) Act 1997*, Subdivision 713-L

Modifications to the cost setting rules

When a life insurance company joins a consolidated group, the cost setting process that applies to a single entity joining a consolidated group (→ Figure 1: Cost setting process on formation and entry in 'Treatment of Assets', C2-1) applies. However, the basic rules are modified to ensure that the special taxing provisions that apply to life insurance companies continue to apply appropriately in a consolidated environment, and that assets and liabilities that relate to policyholders are not affected by the cost setting process. In particular, modifications need to be made when adding liabilities at step 2 of the entry allocable cost amount (ACA) calculation and when subtracting the value of retained cost base assets at step B of the cost setting process.

→ Taxation Determination TD2005/17

Modifications to step 2 of the entry ACA

The following policyholder liabilities have a prescribed value as distinct from the amount those liabilities are valued at in accordance with accounting standards:

- Complying superannuation/FHSA liabilities and exempt life insurance policy liabilities are valued at an amount worked out under sections 320-190 and 320-245 respectively at the joining time.
- Liabilities under the net investment component of ordinary life insurance policies (other than policies that provide for 'participating benefits' or 'discretionary benefits' under life insurance business carried on in Australia) are valued at an amount worked out for those liabilities under subsection 320-190(2) as if those liabilities were complying superannuation/FHSA liabilities.

Modifications to step B of the cost setting process

In addition to retained cost base assets, such as Australian currency, or an entitlement that is subject to a prepayment (see section 705-25 of the ITAA 1997), the following assets are treated as retained cost base assets in the cost setting process:

- Complying superannuation/FHSA assets and segregated exempt assets – as these assets relate to policyholders, this modification ensures that the tax cost of these assets is not reset under the entry cost setting process. The tax cost of these assets, for the purpose of working out the tax cost setting amounts of reset cost base assets (→ step C in Figure 1: Cost setting process on formation and entry, 'Treatment of Assets', C2-1), is the 'transfer value' of the assets just before joining time. Transfer value is defined as 'the amount that could be expected to be received from the disposal of the asset in an open market after deducting any costs expected to be incurred in respect of the disposal' → subsection 995-1(1), ITAA 1997. For all other purposes, the tax cost of these assets is the terminating value of the assets → section 705-30, ITAA 1997.
- Assets held by the life insurance company for the purpose of discharging its liabilities under the net investment component of ordinary life insurance policies (other than policies that provide for 'participating benefits' or 'discretionary benefits' under life insurance business carried on in Australia) – the purpose of this modification is to ensure that the value of assets held on behalf of ordinary policyholders is not reset under the entry cost setting process. The tax cost of these assets, for the purpose of working out the tax cost setting amounts of reset cost base assets (→ step C in figure 1: 'Cost setting process on formation and entry', C2-1), is the transfer value of the assets just before joining time. For all other purposes, the tax cost of these assets will be the terminating value of the assets → section 705-30.
- In certain circumstances, the goodwill asset of a joining entity that is a life insurance company that has demutualised. The tax cost of this asset is the 'embedded value' (under subsection 121AM(1) of the *Income Tax Assessment Act 1936* (ITAA 1936)) at the time of the demutualisation of the

life insurance company, less the net value of shareholders' assets held by the company on that day. This value equates to the goodwill component of the embedded value (as defined in AASB Accounting Standard 1038) of a life insurance company at the time of the demutualisation.

→ 'Modified cost setting rules for consolidated groups that include a life insurance company', C9-6-520

Note

Joining and leaving time are taken to be a valuation time for the purposes of Division 320. This means life insurance companies will be required to determine the transfer value of complying superannuation/FHSA assets and segregated exempt assets, and the value of associated liabilities, as required under sections 320-190 and 320-245, immediately before they join or leave a consolidated group. When the transfer value of the assets exceeds the value of their associated liabilities, assets with a transfer value equal to the excess must be transferred from the relevant segregated assets within 30 days of the valuation. When the transfer value of those assets is less than the value of their associated liabilities, assets with a transfer value equal to the shortfall may be transferred into the relevant segregated assets within 30 days of the valuation. This process ensures that the value of complying superannuation/FHSA assets and segregated exempt assets is aligned with the value of complying superannuation/FHSA liabilities and exempt life insurance policy liabilities.

Transfer of tax losses of the complying super/FHSA class on leaving a consolidated group

When a life insurance company ceases to be a member of a consolidated group in an income year, any tax losses of the complying superannuation/FHSA class and net capital losses from complying superannuation/FHSA assets become losses of the life insurance company just after the leaving time (provided that no other member of the group, at the leaving time, is a life insurance company that has a complying superannuation/FHSA pool).

As these losses are subject to loss quarantining rules, the head company would not be able to utilise the losses – it will not have any future income of the complying superannuation/FHSA class, or future capital gains from complying superannuation/FHSA assets, against which the losses can be applied.

References

Income Tax Assessment Act 1936, subsection 121AM(1)

Income Tax Assessment Act 1997, Division 320, as amended by *First Home Saver Accounts (Consequential Amendment) Act 2008*; and subsection 995-1(1)

Income Tax Assessment Act 1997, sections 701-1, 703-15, 705-25 and 705-30; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Income Tax Assessment Act 1997, Subdivision 713-L; as amended by:

- *New Business Tax System (Consolidation and Other Measures) Act (No. 2) 2002*, Schedule 6, Part 1
- *First Home Saver Accounts (Consequential Amendment) Act 2008*
- *Tax Laws Amendment (2010 Measures No.1) Act 2010*, Schedule 5, Part 19

Income Tax (Transitional Provisions) Act 1997, Subdivision 713-L; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 2) 2002*, Schedule 6, Part 3

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 1

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5

Taxation Determination TD 2005/17 – Income tax: consolidation: life insurance: do sections 705-75 and 705-80 of the *Income Tax Assessment Act 1997* apply to a policy liability that has been valued under section 713-520 for the purposes of working out step 2 of the allocable cost amount for a joining entity that is a life insurance company?

AASB 1038 Life Insurance Business

Revision history

Section C9-6-110 first published (excluding drafts) 2 December 2002 and updated 28 May 2003. Further revisions are described below.

Date	Amendment	Reason
14.7.04	Notes on proposed changes to consolidation rules, pp. 5, 6.	Proposed legislative amendments.
26.10.05	Reference to new taxation determination.	
6.5.11	Addition of note regarding application of single entity rule, p. 1.	Legislative amendment
	Removal of notes on proposed changes to consolidation rules, pp. 5, 6.	
	References to virtual PST assets and virtual PST liabilities replaced.	Enactment of *First Home Saver Accounts (Consequential Amendment) Act 2008*

Worked example

Modified membership rules for consolidated groups that include a life insurance company

Description

Under consolidation, the 'one in, all in' rule means that all eligible wholly-owned subsidiaries must be included in a consolidated group. This example shows an exception to that rule, in certain circumstances, when a life insurance company becomes a member of a consolidated group.

Commentary

Subdivision 713-L of the *Income Tax Assessment Act 1997* (ITAA 1997) modifies the 'one in, all in' rule to ensure that the special rules in Division 320, regarding the segregation of assets, apply appropriately to the head company of a consolidated group that includes a life insurance company. This preserves the mechanism used to determine income (including capital gains) that should be taxed at 15% or that should be exempt from tax.

Entities that are precluded from being subsidiary members of a consolidated group are listed in table 1.

Table 1: Entities precluded from being members of a consolidated group

Entity	Section excluded under	Reason
A wholly-owned company or unit trust where some but not all of the membership interests are complying superannuation/FHSA assets	Section 713-510	The income derived from the complying superannuation/FHSA asset pool is subject to tax at 15%
A wholly-owned company or unit trust where some but not all of the membership interests are segregated exempt assets	Section 713-510	The income derived from segregated exempt assets is exempt from tax

Example

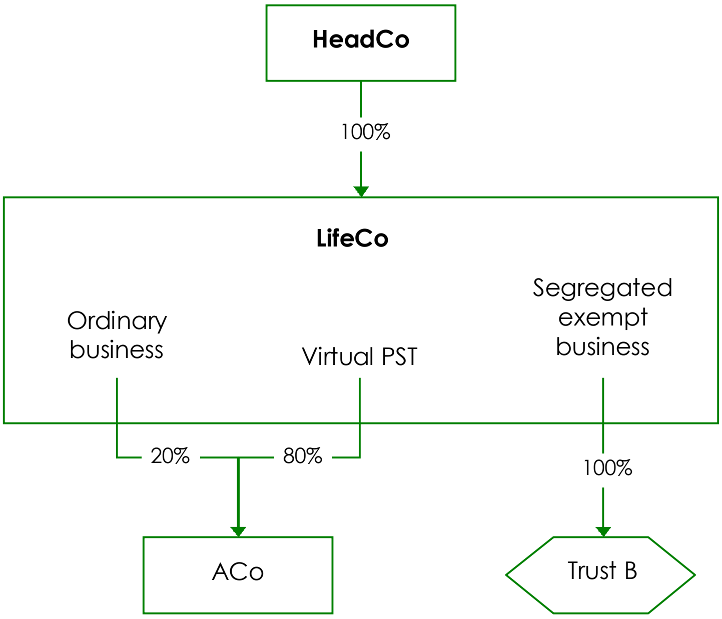
Facts

HeadCo beneficially owns 100% of the membership interests in LifeCo, both ordinary Australian-resident companies. LifeCo beneficially owns 100% of the membership interests in ACo (an ordinary Australian-resident company) and trust B (an Australian-resident fixed trust).

LifeCo holds 80% of the membership interests in ACo as complying superannuation/first home saver account (FHSA) assets and holds the remaining 20% of the membership interests as ordinary assets. All of its membership interests in trust B are segregated exempt assets.

Figure 1 shows the pre-consolidation group structure.

Figure 1: Group structure before consolidation



Eligibility

If HeadCo chooses to consolidate, which entities will be eligible to be members of the consolidated group?

Under the modified membership rules in subsection 713-510(1) for consolidated groups that include a life insurance company, the following entities will be subsidiary members of the consolidated group:

- LifeCo, which is 100% beneficially owned by HeadCo, and
- Trust B, which is 100% beneficially owned by LifeCo and whose membership interests are segregated exempt assets.

ACo will be precluded from becoming a member of the consolidated group as the membership interests held by LifeCo are a mixture of complying superannuation/FHSA and ordinary assets.

References

Income Tax Assessment Act 1997, Division 320; as amended by *First Home Saver Accounts (Consequential Amendment) Act 2008*

Income Tax Assessment Act 1997, Subdivision 713-L; as amended by:

- *New Business Tax System (Consolidation and Other Measures) Act (No. 2) 2002*, Schedule 6, Part 1
- *First Home Saver Accounts (Consequential Amendment) Act 2008*

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 1

Revision history

Section C9-6-510 first published 28 May 2003. Further revisions are described below.

Date	Amendment	Reason
6.5.11	Removal of notes on proposed changes to consolidation rules.	
	References to virtual PST and virtual PST assets replaced.	Enactment of *First Home Saver Accounts (Consequential Amendment) Act 2008*

Worked example

Modified membership rules for a joining life insurance company's wholly-owned subsidiary held indirectly through one or more interposed entities

Description

The 'one in, all in' rule, which provides that all eligible wholly-owned subsidiaries are included in a consolidated group, is modified in certain circumstances where the subsidiary is a life insurance company. This example shows how these modifications extend to a wholly-owned subsidiary of a joining life insurance company where the membership interests in the subsidiary are held indirectly through one or more interposed entities.

Commentary

Subdivision 713-L of the *Income Tax Assessment Act 1997* (ITAA 1997) modifies the 'one in, all in' rule to ensure that the special rules in Division 320, regarding the segregation of assets, apply appropriately to the head company of a consolidated group that includes a life insurance company. This preserves the mechanism used to determine income (including capital gains) that should be taxed at 15% or that should be exempt from tax.

Table 1: Entities precluded from being members of a consolidated group

Entity	Section excluded under	Reason
A wholly-owned company or unit trust where membership interests are held indirectly through one or more interposed entities by the life insurance company and some but not all of the key interests* are complying superannuation/FHSA assets	Section 713-510	The income derived from the complying superannuation/FHSA asset pool is subject to tax at 15%
A wholly-owned company or unit trust where membership interests are held indirectly through one or more interposed entities by the life insurance company and some but not all of the key interests* are segregated exempt assets	Section 713-510	The income derived from segregated exempt assets is exempt from tax

*The key interests are the membership interests the life insurance company owns directly in the entity or an interposed entity.

Example

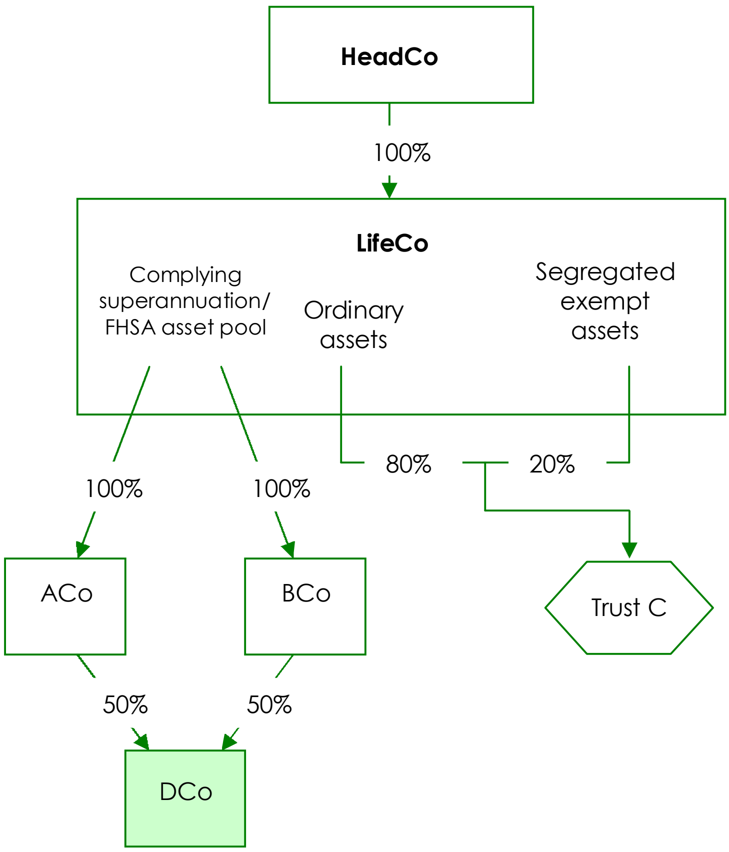
Facts

HeadCo beneficially owns 100% of the membership interests in LifeCo, both Australian-resident companies. LifeCo beneficially owns 100% of the membership interests in ACo and BCo (both Australian-resident companies) and trust C (an Australian-resident unit trust). All of the membership interests in DCo (an Australian-resident company) are held indirectly by LifeCo through two interposed entities (i.e. ACo and BCo).

LifeCo holds all of its membership interests in ACo and BCo as complying superannuation/first home saver account (FHSA) assets. LifeCo holds 80% of its membership interests in trust C as ordinary assets and holds the remaining 20% as segregated exempt assets.

Figure 1 shows the pre-consolidation group structure.

Figure 1: Group structure before consolidation



Eligibility

If HeadCo chooses to consolidate, which entities will be eligible to be members of the consolidated group?

Under the modified membership rules in subsection 713-510(1) for consolidated groups that include a life insurance company, the following entities will be subsidiary members of the consolidated group:

- ACo and BCo, which are 100% beneficially owned by LifeCo and whose membership interests are complying superannuation/FHSA assets
- DCo, which is 100% beneficially owned by LifeCo through two interposed entities (i.e. ACo and BCo) in which all the key interests are complying superannuation/FHSA assets of LifeCo, and
- Life Co.

Trust C will be precluded from becoming a member of the consolidated group as the membership interests held by LifeCo are a mixture of ordinary and segregated exempt assets.

References

Income Tax Assessment Act 1997, Division 320; as amended by *First Home Saver Accounts (Consequential Amendment) Act 2008*

Income Tax Assessment Act 1997, Subdivision 713-L; as amended by:

- Tax Laws Amendment (2004 measures No.7) Act 2004, Schedule 6, Part 5
- *First Home Saver Accounts (Consequential Amendment) Act 2008*

Explanatory Memorandum to Tax Laws Amendment (2004 measures No.7) Bill 2004, Chapter 6

Revision history

Section C9-6-512 first published 16 December 2005.

Further revisions are described below.

Date	Amendment	Reason
6.5.11	Removal of notes on proposed changes to consolidation rules.	
	References to virtual PST assets and virtual PST replaced.	Enactment of *First Home Saver Accounts (Consequential Amendment) Act 2008*

Worked example

Modified cost setting rules for consolidated groups that include a life insurance company

Description

When an entity joins a consolidated group, or a consolidated group is formed, the tax costs of the assets of each joining entity are aligned with the cost to the group of acquiring the entity (unless the head company chooses the transitional option of retaining existing tax values). The cost setting rules are used to obtain the tax cost of each asset → 'Treatment of assets', C2-1. The group's cost for each asset is worked out by allocating the ACA (allocable cost amount) for the joining entity among the entity's assets. This example shows how the cost setting rules are modified when a life insurance company joins a consolidated group.

Commentary

Subdivision 713-L of the *Income Tax Assessment Act 1997* (ITAA 1997) modifies the tax cost setting rules in Subdivision 705-A to specify:

- which assets of life insurance companies are to be treated as retained cost base assets (see table 1), and
- the basis of valuing life insurance policy liabilities for the purposes of working out the ACA (see table 2).

Table 1: Retained cost base assets of a life insurance company

Basic principle in Subdivision 705-A	Modification in Subdivision 713-L	Tax cost setting amount specified as...
Retained cost base assets are defined in subsection 705-25(5)	Assets of a life insurance company defined as retained cost base assets are:	
	(a) a complying superannuation/FHSA asset or a segregated exempt asset (b) certain assets held for the purpose of discharging liabilities under the net investment component of ordinary life insurance policies, and	The transfer value* just before the joining time**, for the purpose of working out the tax cost setting amounts for reset cost base assets (→ section 705-35), or for all other purposes, the assets' terminating value (→ section 705-30))
	(c) in certain circumstances, the goodwill asset of a life insurance company that has demutualised	The embedded value (under section 121AM of the ITAA 1936) of the life insurance company reduced by the net value of shareholders' assets held by the company.

* The transfer value of an asset is the amount expected to be received from disposal of the asset in an open market after deducting any expected costs in relation to that disposal.

** When a life insurance company joins a consolidated group, the joining time is taken to be a valuation time for the purposes of Division 320. Life insurance companies therefore need to value both complying superannuation/FHSA assets and segregated exempt assets, and their associated liabilities, immediately before they join a group. This ensures the transfer value of the assets is aligned with the value of the relevant liabilities.

Table 2: Modifications to step 2 of the ACA for a life insurance company

Basic principle in Subdivision 705-A	Modification in Subdivision 713-L	Value prescribed as...
In step 2 of the ACA, liabilities are valued in accordance with the joining entity's accounting principles for tax cost setting → subsections 705-70(1) and (3), section 995-1	The following liabilities have a prescribed value:	
	(a) complying superannuation/FHSA liabilities	The amount worked out under section 320-190 at the joining time*
	(b) exempt life insurance policy liabilities	The amount worked out under section 320-245 at the joining time*
	(c) liabilities under net risk components of life insurance policies	The current termination value of that component at the joining time as calculated by an actuary
	(d) liabilities under net investment components of ordinary life insurance policies	The amount worked out for those liabilities under subsection 320-190(2) as if those liabilities were complying superannuation/FHSA liabilities

* When a life insurance company joins a consolidated group, the joining time is taken to be a valuation time for the purposes of Division 320. Life insurance companies therefore need to value both complying superannuation/FHSA assets and segregated exempt assets, and their associated liabilities, immediately before they join a group. This ensures the transfer value of the assets does not exceed the value of the relevant liabilities.

→ Taxation Determination TD 2005/17

Example

Facts

HeadCo, whose income year ends on 30 June, chooses to consolidate with effect from 1 July 2002. Assuming the modified membership rules are satisfied, the consolidated group is structured as shown in figure 1.

Figure 1: Structure of the consolidated group

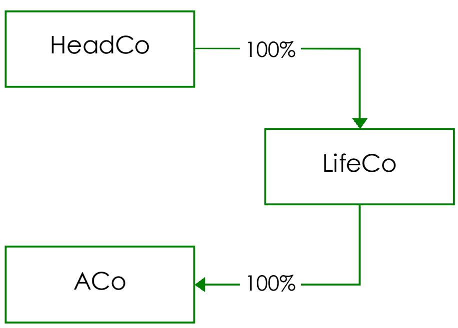


Table 3: LifeCo's financial position at 30 June 2002 ($)

Building	1,000	Capital	1,400
Shares in ACo	300	Retained profits	70
Shares in YCo	200	Liabilities	
Units in Alpha Trust	500	– Loan*	500
Cash	950	– Policy liabilities**	950
		– Income tax	30
	2,950		2,950

* Not an intragroup loan.

** All policy liabilities relate to complying superannuation business and immediate annuity business.

Note: LifeCo uses market value accounting for its investments.

The following assets are segregated for the purposes of Division 320:

- all shares in ACo – complying superannuation/first home saver account (FHSA) assets
- cash includes $150 – complying superannuation/FHSA assets and $100 – segregated exempt assets, and
- all units in Alpha Trust – segregated exempt assets.

Table 4: ACo's financial position at 30 June 2002 ($)

Cash	50	Capital	300
Property	100		
Shares in ZCo	150		
	300		300

Application of cost setting rules

When a consolidated group is formed, no changes are made in relation to the assets of the head company (except that intragroup membership interests and debts are ignored after formation). The cost setting rules establish the tax values of assets owned by the subsidiary companies.

HeadCo must first apply the cost setting rules to LifeCo before it applies them to ACo. → section 705-145

In accordance with section 713-525, LifeCo undertakes a valuation under section 320-175 (for its complying superannuation/FHSA assets) and section 320-230 (for its segregated exempt assets) and carries out any resulting transfers under sections 320-180 and 320-235.

The transfer values of LifeCo's complying superannuation/FHSA assets and segregated exempt assets immediately before joining the consolidated group are set out in table 5. The table also sets out the value of LifeCo's complying superannuation/FHSA liabilities and exempt life insurance liabilities at the joining time.

Table 5: Modified values of segregated assets and liabilities of LifeCo ($)

	Division 320 value
Assets	
Cash (complying superannuation/FHSA asset)	150
Shares in ACo (complying superannuation/FHSA asset)	300
Cash (segregated exempt asset)	100
Units in Alpha Trust (segregated exempt asset)	500
Liabilities	
Complying superannuation/FHSA liabilities	450
Exempt life insurance liabilities	500

As a consequence of these valuations, LifeCo must transfer the excess segregated exempt assets ($100) out of the segregated exempt asset pool within 30 days of the date of valuation → section 320-235.

Assume LifeCo transfers $100 cash from its segregated exempt assets.

Setting tax costs of LifeCo's assets

1. Calculate LifeCo's entry ACA

ACA step 1:	The cost base of membership interests*		$1,400
ACA step 2:	Value of LifeCo's liabilities		
	– loan	$500	
	– income tax	$30	
	– complying superannuation/FHSA liabilities	$450	
	– exempt life insurance liabilities	$500	$1,480
ACA step 3:	Undistributed frankable profits**		$70
LifeCo's entry ACA (assuming no other adjustments are required)			$2,950

* Assume the market value of membership interests equals the cost base of those interests.

** Assume the retained earnings are undistributable frankable profits under section 705-90.

2. Determine ACA to be allocated to LifeCo's reset cost base assets

Total entry ACA for LifeCo			$2,950
Less amounts for retained cost base assets of LifeCo			
	– cash (including complying superannuation/FHSA cash of $150 and $100 cash transferred from segregated exempt assets)	$950	
	– shares in ACo	$300	
	– units in Alpha Trust	$500	$1,750
Remaining ACA			$1,200

Note: For the purpose of working out the tax cost setting amount for reset cost base assets under section 705-35, the transfer values of the shares in ACo and the units in Alpha Trust are used. However, for all other purposes the 'terminating value' under section 705-30 is used → subsection 713-515(2).

3. Allocate remaining ACA to LifeCo's reset cost base assets

Asset	Market value ($)	Apportionment of remainder of entry ACA	Cost setting amount ($)
Building	1,000	1000/1200 x 1200	1000
Shares in YCo	200	200/1200 x 1200	200
Total	**1,200**		**1,200**

Setting tax costs of ACo's assets

1. Calculate ACo's entry ACA

ACA step 1:	The cost base of membership interests*	$300
ACo's entry ACA (assuming no other adjustments are required)		$300

* Generally, the tax cost setting amount calculated for the membership interest in a subsidiary is used as the ACA step 1 amount in order to calculate the tax cost setting amounts for assets of the subsidiary → subsection 705-145(3).

The tax cost setting amount for shares in ACo outlined on p. 4 under '2. Determine ACA to be allocated to LifeCo's reset cost base assets' is $300 only for the purposes of working out the tax cost setting amount for reset cost base purposes → section 705-35.

Shares in ACo are a complying superannuation/FHSA asset of LifeCo. In this situation, the tax cost setting amount is the asset's terminating value → paragraph 713-515(2)(b). Therefore, the step 1 amount of ACo's entry ACA is the terminating value of the complying superannuation/FHSA asset (i.e. the membership interest LifeCo holds in ACo).

In this example, the terminating value is the same as the amount used in determining the ACA to be allocated to LifeCo's reset cost base assets. For all other purposes, the tax cost setting amount is the asset's terminating value.

2. Determine ACA to be allocated to ACo's reset cost base assets

Total entry ACA for ACo	$300
Less amounts for retained cost base assets of ACo	
– cash	$50
Remaining ACA	$250

3. Allocate remaining ACA to ACo's reset cost base assets

Asset	Market value ($)	Apportionment of remainder of entry ACA	Cost setting amount ($)
Property	150	150/250 x 250	150
Shares in ZCo	100	100/250 x 250	100
Total	**250**		**250**

References

Income Tax Assessment Act 1936, section 121AM

Income Tax Assessment Act 1997, sections 705-30, 705-35, 705-70, 705-90 and subsection 705-25(5); as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Income Tax Assessment Act 1997, section 705-145; as amended by *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act* (No. 90 of 2002), Schedule 3

Income Tax Assessment Act 1997, Subdivision 713-L; as amended by:

- *New Business Tax System (Consolidation and Other Measures) Act 2003*, Schedule 6, Part 1
- *First Home Saver Accounts (Consequential Amendment) Act 2008*

Income Tax Assessment Act 1997, sections 705-70 and 995-1; as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 8

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 1

Taxation Determination TD 2005/17 – Income tax: consolidation: life insurance: do sections 705-75 and 705-80 of the *Income Tax Assessment Act 1997* apply to a policy liability that has been valued under section 713-520 for the purposes of working out step 2 of the allocable cost amount for a joining entity that is a life insurance company?

Revision history

Section C9-6-520 first published 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
27.10.03	Table 2 (Modifications to step 2 of the ACA for a life insurance company) amended to include exempt life insurance policy liabilities.	Technical correction
	Table 3 amended to change the composition of assets segregated for the purposes of Division 320.	Technical correction
26.10.05	Reference to new taxation determination.	
6.5.11	Removal of notes on proposed changes to consolidation rules.	
	References to virtual PST assets and virtual PST liabilities replaced.	Enactment of *First Home Saver Accounts (Consequential Amendment) Act 2008*
	Reference to 'accounting standards for tax cost setting' p. 2.	Legislative amendments

Worked example

Value of the net risk component of life insurance policies when a life insurance company joins or leaves a consolidated group

Description

Movements in the value of a life insurance company's net risk component of life insurance policies are reflected in the calculation of the company's taxable income in accordance with Division 320 of the *Income Tax Assessment Act 1997* (ITAA 1997).

To ensure that appropriate amounts are bought to account for the head company's core purposes for the income year in which a life insurance company joins or leaves a consolidated group, and for the entity core purposes in the income year in which the life insurance company leaves, sections 713-511 and 713-565 of the ITAA 1997 apply to determine the value of these liabilities for the purposes of Division 320.

This example demonstrates the values that need to be taken into account.

Commentary

Where the value of a life insurance company's liabilities under the net risk component of life insurance policies is less at the end of an income year than at the end of the previous income year, the difference is included in the company's assessable income. → paragraph 320-15(1)(h), ITAA 1997

Conversely, where the value of those liabilities at the end of an income year is greater than at the end of the previous income year, the difference is allowable as a deduction. → section 320-85, ITAA 1997

Under section 713-505 of the ITAA 1997, the head company of a consolidated group that has a subsidiary member that is a life insurance company at any time during the income year will also be taken to be a life insurance company for that income year for income tax purposes. Consequently, paragraph 320-15(1)(h) and section 320-85 of the ITAA 1997 apply in calculating the head company's taxable income during that income year..

For the income year in which a life insurance company joins a consolidated group, and where the head company does not already carry on life insurance business, the head company's value of the net risk component of life insurance policies at the end of the previous income year is taken to be the joining life insurance company's value of net risk component of life insurance policies at the joining time. → section 713-511

For the income year in which a life insurance company joins a consolidated group and the head company already carries on a life insurance business, the value of the net risk component of life insurance policies at the end of the previous income year includes the joining life insurance company's value of these liabilities at the joining time. → section 713-511

For the income year in which a life insurance company leaves a consolidated group, and the head company does not itself carry on life insurance business, the head company is treated as if the value of its liabilities under the net risk component of life insurance policies include the leaving life insurance company's value of the net risk component of life insurance policies at the leaving time. → subsection 713-565(3)

If the head company continues to carry on life insurance business, the value of the net risk component of life insurance policies at the end of the income year will include the leaving life insurance company's value of the net risk component of life insurance policies at the leaving time. → subsection 713-565(3)

In determining the taxable income of the leaving life insurance company for the income year in which it leaves the consolidated group, the value of the net risk component of life insurance policies at the end of the previous income year will be taken to be the value of the liabilities, for the life insurance company, at the leaving time. → subsection 713-565(4)

Example 1

Facts

AeeCo, the head company of a consolidated group, acquires all the membership interests in ElleCo, a life insurance company, during the 2005-06 income year. AeeCo did not carry on a life insurance business before acquiring ElleCo. The value of ElleCo's net risk component of life insurance policy liabilities at the joining time is $40 million. At the end of 2005-06, AeeCo's value of the net risk component of life insurance policy liabilities is $90 million.

For the purposes of applying section 320-85, under section 713-511 the value of AeeCo's net risk component of life insurance policy liabilities at the end of the 2004-05 income year is taken to be $40 million. Consequently, AeeCo is entitled to a deduction for $50 million under section 320-85.

Example 2

Facts

BeeCo, the head company of a consolidated group, acquires all the membership interests in ElleCo, a life insurance company, during the 2005-06 income year. BeeCo carried on a life insurance business before acquiring ElleCo. The value of ElleCo's net risk component of life insurance policy liabilities at the joining time is $10 million. The value of BeeCo's net risk component of life insurance policy liabilities at the end of the 2004-05 income year was $20 million. At the end of 2005-06, BeeCo's value of the net risk component of life insurance policy liabilities is $5 million.

For the purposes of applying paragraph 320-15(1)(h), under section 713-711 the value of BeeCo's net risk component of life insurance policy liabilities at the end of 2004-05 is taken to be $30 million. Therefore, under paragraph 320-15(1)(h), BeeCo's assessable income will include $25 million.

Example 3

Facts

ElleCo, a life insurance company, leaves the consolidated group headed by CeeCo during the 2005-06 income year. CeeCo does not carry on life insurance business after ElleCo leaves. The value of ElleCo's net risk component of life insurance policy liabilities at the leaving time is $7 million. The value of these liabilities at the end of CeeCo's 2004-05 income year was $10 million. The value of ElleCo's net risk component of life insurance policy liabilities at the end of 2005-06 was $12 million. The income tax consequences are as follows:

For CeeCo: $3 million is included in assessable income in accordance with paragraph 320-15(1)(h). Under subsection 713-565(3) the value of the liabilities at the end of 2005-06 is taken to be $7 million.

For ElleCo: $5 million is allowed as a deduction in accordance with section 320-85. Under subsection 713-565(4) the value of the liabilities at the end of 2004-05 is taken to be $7 million.

References

Income Tax Assessment Act 1997:

- Division 320
- paragraph 320-15(1)(h)
- section 320-85
- section 713-505
- section 713-511
- section 713-565
- subsection 713-565(3)
- subsection 713-565(4)

Explanatory Memorandum to the Tax Laws Amendment (2004 measures No.7) Bill 2004

Revision history

Section C9-6-540 first published 15 November 2006.

Further revisions are described below.

Date	Amendment	Reason
6.5.11	Removal of notes on proposed changes to consolidation rules.	

Worked example

Franking surpluses held by life insurance subsidiaries

Description

Generally, if a joining entity's franking account is in surplus at the joining time, the franking surplus is transferred to the head company's franking account. This is achieved by debiting the joining entity's franking account and crediting the head company's account with an amount equal to the surplus → section 709-60, *Income Tax Assessment Act 1997* (ITAA 1997).

This example shows how the general rule is modified in certain circumstances when a subsidiary entity of a life insurance company (the life insurance subsidiary) joins a consolidated group at the same time as the life insurance company. The modification ensures that the franking surplus is applied to the head company in a way that is consistent with the outcome that would arise if the group did not consolidate.

Commentary

The franking surplus of a life insurance subsidiary that is either directly, or indirectly through one or more interposed entities, wholly or partly owned by a life insurance company is credited to the head company's franking account to the extent that it is attributable to the shareholders of the life insurance company, provided the life insurance subsidiary joins the consolidated group at the same time as the life insurance company. The extent of the attribution is determined by working out the amount of franking credit that would arise in the life insurance company's franking account under item 5 in the table in subsection 219-15(2) of the ITAA 1997 if:

- the life insurance subsidiary made a franked distribution to the life insurance company just before the joining time, and
- the amount of the franking credit on the distribution was equal to the whole amount of the franking surplus.

→ section 713-545, ITAA 1997

Any excess franking surplus, which in essence is attributable to the policyholders of the life insurance company, is dealt with as follows:

- If, immediately before the joining time, all the membership interests in the life insurance subsidiary are either held directly in the segregated exempt assets of the life insurance company or are held directly or indirectly by an interposed entity and the membership interests in that interposed entity are held in the segregated exempt assets of the life insurance company, the head company is entitled to a refundable tax offset equal to the amount of the surplus in the franking account reduced by the amount of the franking credit that is made to the head company's account as a consequence of the deemed franked distribution to the life insurance company. → paragraph 713-545(5)(a)
- If, immediately before the joining time, all the membership interests in the life insurance subsidiary are either held directly in the complying

superannuation/first home saver account (FHSA) assets of the life insurance company or are held directly or indirectly by an interposed entity and the membership interests in that interposed entity are held in the complying superannuation/FHSA assets, the head company is entitled to a refundable tax offset equal to:

$$\text{Excess franking account surplus} \times \frac{\text{Complying superannuation/FHSA class tax rate}}{\text{Ordinary class tax rate}}$$

where the excess franking account surplus is the amount of surplus in the franking account reduced by the amount of franking credit that is made to the head company's account as a consequence of the deemed franked distribution to the life insurance company. → paragraph 713-545(5)(b) and subsection 713-545(6)

- If, immediately before the joining time, all the membership interests in the life insurance subsidiary are assets other than segregated exempt assets or complying superannuation/FHSA assets of the life insurance company, the amount of the tax offset will be nil. → paragraph 713-545(5)(c)

Example 1

Facts AlphaCo, a wholly-owned subsidiary of LifeCo, joins a consolidated group at the same time as LifeCo. All the membership interests in AlphaCo are assets other than segregated exempt assets or complying superannuation/FHSA assets.

At the joining time AlphaCo has a franking surplus of $10,000 in its franking account. If AlphaCo made a distribution to LifeCo that included the whole of the franking surplus, $2,000 would be attributable to the shareholders of LifeCo and $8,000 would be attributable the policyholders of LifeCo.

Consequently, $2,000 will be credited to the head company's franking account and the head company will not be entitled to a refundable tax offset for the remaining $8,000.

Example 2

Facts ElleCo, a wholly-owned subsidiary of LifeCo, joins a consolidated group at the same time as LifeCo. All the membership interests in ElleCo are complying superannuation/FHSA assets of LifeCo.

At the joining time ElleCo has a franking surplus of $7,000 in its franking account. If ElleCo made a distribution to the life insurance company that included the whole of the franking surplus, no amount would be attributable to the shareholders of the life insurance company.

Consequently, no amount will be credited to the head company's franking account. The head company will be entitled to a refundable tax offset of $3,500 (that is $7,000 x 15%/30%).

References

Income Tax Assessment Act 1997:

- section 709-60
- subsection 219-15(2)
- section 713-545
- paragraph 713-545(5)(a)
- paragraph 713-545(5)(b)
- paragraph 713-545(5)(c)
- subsection 713-545(6)

Revision history

Section C9-6-550 first published 15 November 2006.

Further revisions are described below.

Date	Amendment	Reason
6.5.11	Removal of notes on proposed changes to consolidation rules.	
	References to virtual PST assets and complying superannuation class tax rate replaced.	Enactment of *First Home Saver Accounts (Consequential Amendment) Act 2008*

Tax sharing agreements

In a consolidated group, the head company is responsible, on behalf of the group, for the payment of income tax related liabilities (the group liability). If the head company fails to discharge in full its obligation to pay the group's tax liability by the time the tax is due (the head company's due time), subsidiary members (contributing members) that were part of the group for all or part of the liability period become jointly and severally liable for the group liability.

(Note that the group liability does not include PAYG instalments payable by the head company that relate to instalment quarters that ended before the Tax Office gave the head company its initial head company instalment rate.
→ subsection 721-10(3), ITAA 1997)

Contributing members can, however, avoid this liability by entering into a tax sharing agreement (TSA) before the head company's due time. A TSA is an agreement between the head company and one or more contributing members that allows the group liability to be apportioned between group members according to a methodology set out in the agreement. Note that the liability of the head company for the total debt continues whether a TSA exists or not.

These guidelines provide an overview of the provisions relating to TSAs, and should be read in conjunction with 'Collection of Consolidated Group Liabilities' in the *ATO Receivables Policy* → 'References' p. 14. However, a company director should always seek independent professional advice when deciding whether to enter into a TSA and what the form and content of that agreement should be.

Legislative background

Division 721 of the *Income Tax Assessment Act 1997* (ITAA 1997) deals with the liability for payment of tax and some other liabilities when the head company fails to pay on time. It establishes:

- how consolidated groups can apportion the group's tax liabilities through TSAs
- how subsidiary companies can effect a clear exit from a consolidated group through the use of a valid TSA, and
- the circumstances in which TSAs are considered valid for the purposes of Division 721.

Subsection 265-45(2) of the *Taxation Administration Act 1953* (TAA 1953) provides for a right of contribution when persons are jointly liable for a tax-related liability. If a group member pays all or part of a debt for which it is jointly liable, it may be able to seek a contribution towards that amount from other members who are also jointly liable.

Group liability

In accordance with the single entity rule, the head company is responsible for a consolidated group's income tax liabilities.

→ 'Consolidation – key points and pathway', B0-1; 'Glossary', A2

A list of group liabilities is set out in subsection 721-10(2) of the ITAA 1997. When the head company fails to satisfy a group liability by the due time, each contributing member becomes jointly and severally liable, with the head company, for the outstanding amount, unless:

- that member is prohibited by the effect of an Australian law from entering into arrangements that would subject it to joint and several liability, or
- the group liability was covered by a valid TSA that allocates the liability between the members of the group on a reasonable basis.

Valid tax sharing agreements

The members of a consolidated group may avoid the consequences of joint and several liability by entering into a valid TSA with the head company. A TSA is an agreement between the head company and subsidiary members (contributing members). It can be used to allocate a group liability among a number of contributing members, provided that allocation is a 'reasonable allocation'.

Each contributing member covered by a valid TSA is liable for the amount determined under that agreement. A TSA may make a contributing member liable for all, part, or none of a group liability.

Under section 721-25, a group liability will only be covered by a TSA if:

- the agreement between the head company and contributing members exists immediately before the head company's due time
- the agreement determines how the relevant group liability is to be allocated to the contributing members (the contribution amount)
- the allocation of the contribution amounts between the head company and contributing members is a reasonable allocation and accounts for the entire group liability
- the group liability is covered by not more than one TSA, and
- the agreement complies with any requirements set out in the regulations (currently, there are no relevant regulations).

Note that, in respect of income tax liability, the third condition is taken to be satisfied if there is a reasonable allocation of the group liability reduced by the PAYG instalment credits available to the head company under sections 45-30 and 45-865 of Schedule 1 to the *Taxation Administration Act 1953*.

A group liability is not covered by a TSA if:

- it would also be covered by one or more other TSAs (see note below), or
- the agreement was entered into as part of an arrangement, a purpose of which was to prejudice the Tax Office's recovery of some or all of the group liability, or

- the Commissioner serves a notice on the head company in relation to the group liability requesting a copy of the TSA in the approved form and it is not provided within 14 days.

Note that a given TSA may cover any number of group liabilities, and a group may have more than one TSA. However, each group liability must be covered by only one TSA. → subsection 721-25(1B), ITAA 1997; paragraphs 2.183 2.186 of the Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 2) Bill, 2004

Diagram 11.1 (see next page) from the Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002 illustrates the application of TSAs to group liabilities.

Subsection 721-25(3) states that a copy of a TSA must be given to the Commissioner, on request, in the 'approved form'. Because a TSA is an agreement between the head company and other members of the group, a specific TSA form does not exist, but the Commissioner has specified the minimum requirements that a TSA must comply with in order to be produced in the 'approved form'.

The requirements outlined in the *ATO Receivables Policy* chapter headed 'Collection of Consolidated Group Liabilities' stipulate that each TSA must:

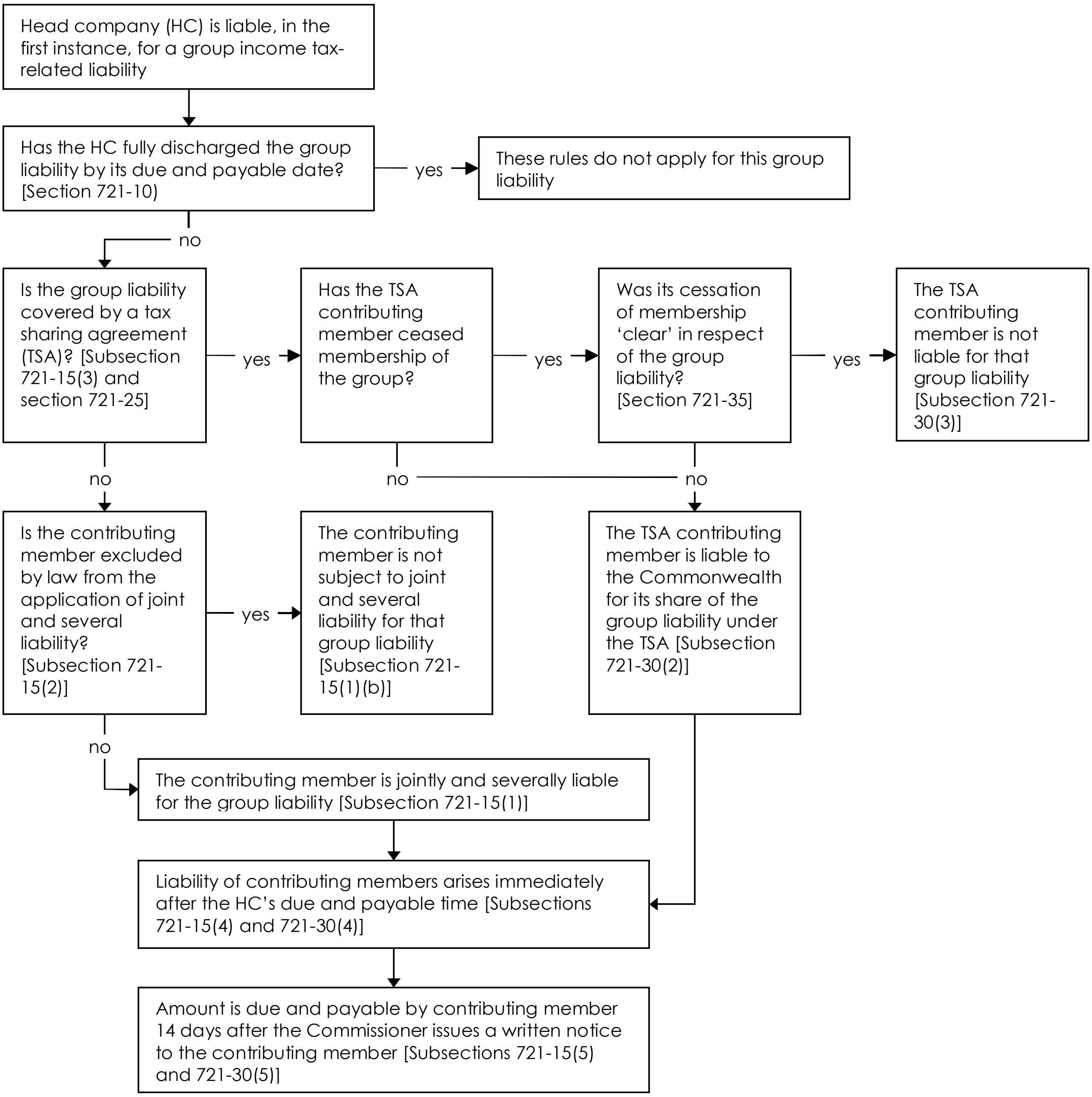
- be in writing
- show the date of execution
- specify the names of the head company and each TSA contributing member
- specify what group liability or liabilities it covers
- specify the method used to allocate the group liability or liabilities, which must provide for a reasonable allocation of the entire group liability or liabilities
- be properly executed by or on behalf of the head company and each contributing member that is a party to the agreement (i.e. the TSA contributing members)
- either:
  - specify the exact contribution amount for each contributing member for the relevant liability, or
  - *if and when required to be produced to the Commissioner*, include a schedule signed by the head company that:
    - specifies the relevant liability or liabilities and period(s) as specified in the Commissioner's notice to produce
    - states the name and ABN or ACN of the head company and each TSA contributing member
    - states the contribution amount of each TSA contributing member in respect of the relevant liability or liabilities

- declares that 'the schedule includes the names of all the TSA contributing members in relation to that liability or liabilities for that/those period(s) and the contribution amount or amounts as calculated under the TSA'.

- *if and when required to be produced to the Commissioner*, include any deeds of assumption in relation to the particular liability or liabilities for the particular period(s).

A new TSA may be necessary if there are changes in the consolidated group's structure (because of the entry or exit of members), or changes to an individual member's operations.

Diagram 11.1



Reasonable allocation

The contribution amounts for each of the contributing members must represent a reasonable allocation of the total group liability.
→ paragraph 721-25(1)(c)

This manual cannot cover all possible methods for achieving a reasonable allocation of a group liability, but examples of reasonable allocations include:

- allocations based on the percentage share of the group accounting profit for the preceding income year
- allocations based on the percentage share of the group accounting profit for the current income year, or
- allocations based on each member's ability to pay the liability.

An example of an unreasonable allocation would be one that allocated the group liability based on the percentage share of the group profit, while excluding members that were major contributors to that profit. The ultimate determination of what is a 'reasonable allocation' will of course rest with the courts.

Formal notice requesting a copy of a TSA

If the Tax Office decides to pursue one or more members for an unpaid group liability, it may issue a notice to the head company under subsection 721-25(3). The head company has 14 days after service of the notice to produce a copy of the relevant TSA in the approved form. If the TSA is not produced, the group liability will be considered never to have been covered by a TSA, and all contributing members will be jointly and severally liable for the group liability. (Note that if a TSA does not exist at the head company's due time, the contributing members' liability arises just after that time, not at the time of any later non-production of the TSA.)

The Commissioner may defer the time for lodgment of a TSA under section 388-55 of the TAA 1953. As a TSA must exist before the head company's due time to be valid, such a deferral would only be granted in exceptional circumstances. → ATO Receivables Policy, 'Deferral of the Due Date for Lodgment and Suspension of Lodgment Action'

Actions prejudicial to recovery

Under subsection 721-25(2), a group liability is not covered by a TSA if the TSA was entered into as part of an arrangement, a purpose of which was to prejudice the recovery of some or all of the group liability by the Tax Office. Actions that might lead to such a determination include:

- disposing of interests in solvent or asset-rich members of a group (while retaining control) to the extent that they are no longer considered to be part of the consolidated group
- allocation of a liability to a member when its likely inability to pay is foreseeable (e.g. because of litigation in progress), or
- uncommercial sale of assets.

Amended liabilities

Generally, a liability resulting from an amendment or revision is considered to be covered by a TSA if the TSA refers to the underlying liability to which the amendment or revision relates. For example, a reference to the group liability for income tax relating to the 2002–03 income year would cover any amendment to that liability, provided the TSA did not specify fixed amounts in relation to the original liability.

Depending on the method used, some groups may wish to consider inserting a clause into their TSAs that provides for any increase in the group liability arising from an amendment or revision to be allocated to the entity or entities responsible for the understatement.

Note

Due and payable date

For income tax assessments for 2003-04 and earlier years, amended assessments become due and payable on the same date as that applying to the original assessment. The debts in both original and amended assessments relate to the same liability, and must therefore be covered by the same TSA. The TSA methodology must remain unchanged, though the Commissioner may require the production of an attachment to the TSA to disclose the new allocations to members arising from the amended or revised liability.

For income tax assessments for 2004-05 and later years, the due date for amended assessments is 21 days from when the taxpayer is notified of the amendment. Although the due date for an amended assessment for these years is later than that of the original assessment, the debts in both original and amended assessments relate to the same liability, and therefore must also be covered by the same TSA. The TSA must be in place – and all its requirements met – before the due time of the original assessment. The TSA methodology must also remain unchanged.

Tax Office review of TSAs

The Tax Office cannot provide a binding view on the validity of a TSA, but it will regularly update guidelines.

If the Tax Office has received a copy of a TSA – whether informally or through a request under subsection 721-25(3) – and has not taken further action, this does not imply that it considers the TSA to be valid or has determined that it provides a reasonable allocation of the relevant group liability.

Clear exit

Under section 721-35, a contributing member can leave a group clear of a specific group liability if:

- it ceases to be a member of the group before the due date of the group liability
- before the leaving time, it pays to the head company an amount equal to the contribution amount or, if that amount cannot be determined at that time, a reasonable estimate of that amount, and
- the member's exit from the group is not part of an arrangement, a purpose of which was to prejudice the recovery of all or part of the group liability by the Tax Office.

As noted before, a group liability is held not to be covered by a TSA where the head company fails to comply with a request to give the Tax Office a copy of the relevant TSA in the approved form within 14 days → 'Valid tax sharing agreements', p. 2. Nevertheless, a contributing member that fulfils the above conditions will achieve a clear exit provided it gives a copy of the TSA to the Tax Office in the approved form within 14 days of the Commissioner giving the contributing member notice of its joint and several liability.

→ subsection 721-15(3A), ITAA 1997

A contributing member cannot have a clear exit if there is a group liability not covered by a valid TSA or if the group liability is due and payable before it ceases to be a member of the group. Note that for income tax assessments for 2003-04 and earlier years, the due date for payment of an amended income tax assessment or revised PAYG instalment is the same as the date the original liability was payable.

Reasonable estimate of contribution amount

When a leaving entity wishes to leave a group clear of a particular group liability, and its contribution amount under the TSA cannot be determined before the leaving time, paragraph 721-35(c) provides that a reasonable estimate of that contribution amount must be made. This reasonable estimate must be based on the TSA. Depending on the particular TSA's methodology, actual income figures or projected cash flows may be used.

Payment of contribution

Documentary evidence that the leaving member has paid the contribution amount, or a reasonable estimate of that amount, to the head company must be retained by the leaving entity in case it is later needed to prove that it left the group clear of a particular group liability. Standard commercial documentation is generally sufficient.

A mere book entry is not sufficient as a form of payment.

Actions prejudicial to recovery

A contributing member will not leave the group clear of a particular group liability if its exit was part of an arrangement, a purpose of which was to prejudice the Tax Office's recovery of some or all of the group liability. This might apply, for example, if the exiting entity is sold for less than its market value.

Amended liabilities

For 2003-04 and earlier years

For income tax assessments for 2003-04 and earlier years, any increase in group liabilities following an amendment or revision is due for payment on the same date as the original liability.

If the entity leaves the group *before* the due time of *both* the original and amended assessments, it can achieve a clear exit if it makes a payment of its (anticipated) post-amendment contribution amount (that is, the contribution amount that takes into account the anticipated amended assessment), or a reasonable estimate of the amount, to the head company, before leaving.

A clear exit may also be obtained if the entity could not have expected that an amended assessment would be issued at a later time and makes a payment of its pre-amendment contribution amount or a reasonable estimate of that amount. In this case, the amount of the increase arising from the amendment would not be due to the leaving entity's activities.

Conversely, a clear exit would not be obtained if the entity could have expected that an amended assessment would be issued at a later time and it does not make a proper contribution to the additional liability.

The leaving entity will usually need to consult with the head company to determine its contribution amount, or a reasonable estimate of the amount. The head company will often be in a better position to anticipate any future amended assessments of the group liability, and therefore to advise of any likely increase in the contribution amount.

Where an amended assessment results from unforeseen or undisclosed activities of another subsidiary of which neither the leaving entity nor the head company were aware (at the leaving time), this may not detract from the 'reasonableness' of the entity's pre-amendment contribution amount and therefore its ability to achieve a clear exit.

If the entity leaves the group at any time *after* the due time of the original assessment of the relevant group liability, the clear exit provisions do not apply to that liability even if the amended assessment has not been issued at the leaving time.

This is because section 721-35 requires the leaving time to be 'before the head company's due time' for that group liability. For income years 2003-04 and earlier, the due date of amended assessments is the same date as the due date of the original assessment. Therefore an entity that leaves after this date cannot achieve a clear exit for that liability.

If the contribution amount for the entity is a fixed sum under the TSA, and does not allow for a variation following the issue of an amended assessment, the allocation may not be considered to be 'reasonable' under paragraph 721-25(1)(c). The group liability in question may therefore not be covered by the TSA.

For 2004-05 and later years

For income tax assessments for 2004-05 and later years the due date for amended assessments is 21 days from when the taxpayer is notified of the amendment.

If the entity leaves the group *before* the due time of *both* the original and amended assessments, its clear exit position is similar to the position of an entity in relation to 2003-04 and earlier income tax assessments.

If the entity leaves the group *after* the due time of the original assessment, but *before* the amended assessment is issued, it may still have the benefit of the clear exit provisions in respect of amended assessments for 2004-05 and later years.

This is because the due time of an amended assessment for these years is prospective, such that the leaving time of an entity in this situation can be said to be 'before the head company's due time'.

A clear exit can be achieved in this case if the entity makes a payment of its (anticipated) post-amendment contribution amount (that is, the contribution amount that takes into account the anticipated amended assessment), or a reasonable estimate of the amount, to the head company, before leaving.

However, it must be remembered that while the due date for an amended assessment for these years is later than that for the original assessment, the debts in both original and amended assessments relate to the same liability. As such they must be covered by the same TSA, and so to achieve a clear exit for the amended assessment the TSA must have been in place before the original assessment's due time. The TSA methodology must also remain unchanged.

Effect of a TSA on amended liabilities

In some cases a TSA can be used to limit a leaving entity's exposure to that part of an increased group liability, relating to a period in which it was a contributing member, that resulted from its own activities.

→ ATO Receivables Policy, Chapter 35 'Collection of Consolidated Group Liabilities'

Issues for contributing members

Contributing members need to consider their statutory and common law responsibilities before becoming a party to a TSA. Issues they need to consider may include:

- **the need for a TSA**:
  - creditors or potential purchasers of the company may wish to examine the terms of the TSA
  - there could be a serious impact on the company's solvency if it does not enter into a TSA (in the event that the Tax Office takes recovery action against it under the joint and several liability provisions)
  - a company can only make a clear exit from a group if it is a party to a TSA
- **time for preparation:** the TSA must be drafted and executed before the head company's liability becomes due and payable
- **regular revision:** TSAs may need to undergo regular revisions as members are purchased by interests outside the consolidated group, or new members are brought into the group – such changes may affect the reasonableness of TSA allocations of group liability, and
- **other matters that may be included in the TSA**: other related issues may be addressed in a TSA provided they do not invalidate its prime purpose – such as, for example, subvention payments or contributions by members to ongoing tax payments.

Frequently asked questions

1. Where can I obtain detailed advice from the ATO on tax sharing agreements?

The Tax Office's advice is contained in Chapter 35 of the *ATO Receivables Policy* and this manual.

However **the Tax Office cannot provide legal advice or a ruling on this topic** and you may need to consult your legal and accounting advisers in preparing a TSA.

2. Can more than one TSA cover the same entire group liability?

No. A head company cannot enter into multiple TSAs with its subsidiaries in relation to one specific group liability. That is, only one TSA can exist for each group liability.

3. Can a TSA cover more than one entire group liability?

Yes. For example, it could cover all PAYG instalment liabilities for a year as well as the annual assessment liability.

4. Can a TSA cover more than one income tax year?

Yes, but the TSA will need to address any subsidiary members leaving the group or new members joining.

5. If a TSA covering two or more liability periods is changed between the due times for those periods, do all versions of the TSA need to be kept?

Yes. The versions that would need to be kept are those in place immediately before the time that *each* liability became due and payable, as they would be the relevant versions for Division 721. Any relevant deeds of assumption (or similar) would also need to be retained.

Draft versions do not need to be retained.

6. Can a head company of a consolidated group have a TSA with only one of its subsidiaries?

Yes, the head company can have a TSA with only one of its subsidiaries provided that:

- the allocation of the group liability to the TSA contributing member is a reasonable one, and
- the TSA covers **the entire group liability.**

7. Are all subsidiary members required to be parties to the TSA?

No. There is no requirement that all subsidiary members must be party to a TSA. The methodology on which the TSA is based may determine who should subscribe to it. For example, if the TSA is based on an accounting profit methodology, it would be prudent for all members to be party to it

→ 'Tax sharing agreement based on percentage of profit methodology, C9-7-510.

Consideration should also be given to due diligence factors such as whether a potential purchaser of a group company would require that the company be covered by a TSA.

8. Are there any guidelines covering what the Tax Office considers to be a 'reasonable allocation'?

Chapter 35 of the *ATO Receivables Policy* provides examples of what the Commissioner would consider to be a reasonably based allocation. The examples are not intended to be prescriptive nor exhaustive. Some example methodologies are also shown under 'Reasonable allocation' in this section → p. 5.

9. Are there any proformas setting out what the Tax Office expects a TSA to contain?

No. There are no proformas available as the Tax Office does not want to constrain consolidated groups in drawing up TSAs.

10. Will the Tax Office provide any guidance on the content of a TSA?

Yes. The minimum requirements for a valid TSA are specified in chapter 35 of the *ATO Receivables Policy*. The requirements are also set out under in this section → 'Valid tax sharing agreements' p. 2.

11. Can a TSA include other material such as arrangements for the ongoing funding of the group's tax liabilities, subvention payments etc.

Yes, provided they do not invalidate the TSA itself. However, as there may be conceptual differences between the TSA methodology and the methodology for ongoing funding arrangements (often called tax funding arrangements), you should consult your advisers about whether separate agreements are preferable.

12. Does a TSA executed after the head company's due time prevent the TSA contributing members becoming jointly and severally liable for the group's debt?

No. The TSA contributing members in such an event would remain jointly and severally liable. → 'Valid tax sharing agreements', p. 2

13. When would the Commissioner issue a notice under subsection 721-25(3) requiring a head company to provide a copy of a TSA?

Generally, the Commissioner would not issue such a notice until after the head company's due time. Even then, such a notice would not automatically be issued – it would depend on the reasons for non-payment. → 'Formal notice requesting a copy of a TSA', p. 5.

14. Chapter 35 of the *ATO Receivables Policy* refers to a schedule being provided to the Commissioner with the TSA showing the liabilities of each member. Does this schedule need to be in place before the head company due time?

No. The schedule is part of the 'approved form' requirements → section 388-50, schedule 1, *Taxation Administration Act 1953*. While the TSA itself needs to be in place before the head company's due time, the schedule only needs to be in place in time for it to be produced to the Commissioner if requested.

However care should be exercised in this regard. It is quite probable that the Commissioner's request for the TSA and schedule will be made after some of the relevant companies have left the group. It may not be convenient to access relevant accounting records of the former subsidiary members in order to complete the schedule. (The question of the group's access to the records of former members should be considered at the time of sale. Access may be needed for the purposes of the TSA and Part IVC objections.)

15. Can a member leave a consolidated group clear of a specific group liability?

Yes, provided that:

- it ceased to be a member of the group on or before the liability's due date, and
- before the leaving time it had paid to the head company an amount equal to either the contribution amount or (if that amount could not be determined) a reasonable estimate of that amount.

For more information see 'Clear exit' → p. 6.

16. If a new member joins the group or a member leaves the group, should a new TSA be drawn up?

In these instances, the group should review its TSAs as the exit or entry of members may affect the reasonableness of existing TSAs.

17. Should the head company send the Tax Office a copy of each new TSA when it is executed?

No. Although the Commissioner may require the head company to produce a copy of the group's TSA at or after the head company's due time, unless the head company defaults on its obligation to pay the group liability subject to the TSA, it is unlikely that it would need to be produced.

It would not be feasible for the Tax Office to review all TSAs as they are compiled. See chapter 35 of the *ATO Receivables Policy* for more detailed information.

18. Can a TSA contributing member provide the Commissioner with a copy of a TSA if it appears that the head company will fail to do so?

The notice to provide the TSA is issued to the head company, whose responsibility it is to provide the TSA. The head company is most likely to have the most current, valid version of the TSA. Should the head company decide not to provide the requested TSA, this is an issue between the head company and the TSA contributing members. See chapter 35 of the *ATO Receivables Policy*.

The exception to this is where a contributing member has achieved a clear exit pursuant to section 721-35, and has provided the Commissioner with a copy of the TSA within 14 days of the Commissioner giving the contributing member a notice of its joint and several liability, following the failure by the head company to provide a copy of the TSA to the Commissioner.

19. Certain entities are excluded by sub-section 721-15(2) from becoming jointly and severally liable. Which entities are these?

Sub-section 721-15(2) of the ITAA 1997 is intended to cover certain entities covered by the prudential requirements of the Australian Prudential Regulatory Authority (APRA). → Taxation Ruling TR 2004/12

References

Income Tax Assessment Act 1997, Division 721; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1, *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 14, and *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (No. 83 of 2004), Schedule 2, Part 10

Explanatory Memorandum to New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraph 11.12, diagram 11.1

Taxation Administration Act 1953, subsection 265-45(2)

The Tax Office has published guidelines for TSAs in the *ATO Receivables Policy,* available on the Legal Database page of its website, **www.ato.gov.au**

Taxation Ruling TR 2004/12 – Income tax: whether the exclusion under subsection 721-15(2) of the *Income Tax Assessment Act 1997* can extend to a participant in a licensed financial market or licensed clearing and settlement facility

Revision history

Section C9-7-110 first published 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
23.4.04	Inclusion of FAQs.	For clarification.
14.7.04	Note on recent changes to consolidation rules.	Legislative amendments.
26.10.05	Extensive changes.	Legislative amendments.
15.11.06	Changes to requirements for TSAs, pp. 3, 6.	Changes to practice statement.
30.6.09	Changes to note on due and payable date, p. 6, and text on amended liabilities under 'Clear exit', p. 7.	To align with changes to *ATO Receivables Policy*.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Tax sharing agreement based on percentage of profit methodology

Description

This example shows what happens, under the tax sharing agreement (TSA) rules, when the head company of a consolidated group receives an assessment, which it pays, and later receives an amended assessment, on which it defaults.

→ 'Tax sharing agreements', C9-7-110

Commentary

Division 721 of the *Income Tax Assessment Act 1997* (ITAA 1997) provides that the primary liability for a consolidated group's tax liability rests with the head company. If, however, the head company fails to discharge this obligation, the subsidiary members of the group could become jointly and severally liable for the group's tax liability.

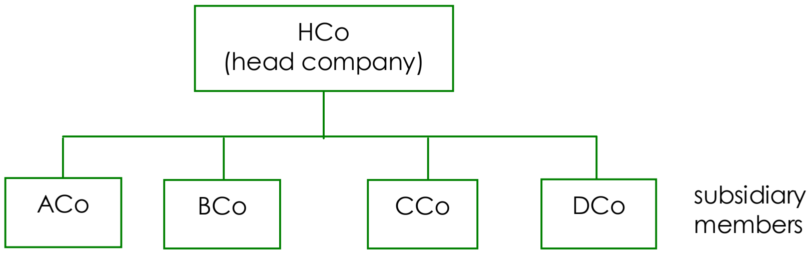
Subsidiary members may decide to limit their individual liability by entering into a tax sharing agreement (TSA) with the other entities in the group. The TSA allows subsidiary members (contributing members) to apportion the group tax liability among themselves, subject to the statutory requirement that any allocation needs to be reasonable. (If the group liability is for income tax for an income year, the group may choose to apportion among its contributing members the amount of the group liability less the PAYG instalment credits to which the head company is entitled for that income year. → subsection 721-25(1A), ITAA 1997.)

Directors and managers of entities considering entering into a TSA need to be aware that other aspects of tax administration, such as the amended assessment provisions, can continue to apply to their obligation under any TSA. Consequently they should seek professional advice on both the application of the law and the content of any agreement.

Example

Facts The example is based on the group structure shown in figure 1.

Figure 1: Group structure



The example focuses on the group's liability for income tax in respect of the year ending 30 June 2006 and, in particular, on the non-payment of part of that group liability relating to an amended assessment. PAYG instalments for the year ending 30 June 2006 are included.

Head company HCo has a standard 30 June year for income tax purposes and has previously chosen to form a consolidated group. Because it received its initial head company instalment rate before 1 July 2005 (i.e. before the start of the 30 June 2006 income year), HCo will be responsible for the group's PAYG instalment liabilities for the year ending 30 June 2006.

The example assumes the PAYG instalments for the 2006 income year are $50 each quarter. (In practice, the amount will be likely to vary because of movements in instalment income and the probable issuance of an updated PAYG instalment rate in the second or third quarter following lodgment of the 30 June 2005 return.)

The group liability for PAYG instalments is allocated under the TSA on the basis of each contributing member's share of group accounting profit for the year ending 30 June 2005 (the preceding year). The example assumes that the group has chosen to allocate among its contributing members its total liability for income tax (rather than that amount reduced by the PAYG instalment credits the head company is entitled to).

The TSA allocates the group liability for income tax in respect of the 2006 income year (→ section 204, *Income Tax Assessment Act 1936*) on the basis of each contributing member's share of group accounting profit for the year ending 30 June 2006 (the current year). The group operates a tax contribution arrangement using the same calculation basis.

HCo returns taxable income for the year ending 30 June 2006 of $1,200 (accounting profit of $1,140 plus tax adjustments) resulting in assessed income tax of $360 (30% of $1200). After credit for PAYG instalments, tax of $160 is payable on 1 December 2006.

The subsidiary members contribute their allocated amounts to HCo, and HCo pays the $160 tax on the due date.

Following an audit of the group, the Tax Office issues an amended assessment in September 2010, which increases the group liability for income tax from $360 to $400. The extra assessable income ($133) relates solely to a transaction undertaken by HCo.

HCo fails to pay the additional $40 and recovery action therefore commences.

The Tax Office issues a notice to HCo requiring a copy of the TSA in the approved form within 14 days → subsection 721-25(3), ITAA 1997. HCo provides the Tax Office with a copy of the TSA as well as a worksheet (indicating the allocation of the group liability in dollars, based on the TSA) within the required period. The worksheet (see table 1) is prepared after receipt of the notice from the Tax Office, as part of providing the TSA in the approved form.

The Tax Office reviews the material provided, considering:

- whether the TSA allocation is reasonable → paragraph 721-25(1)(c)
- whether it complies with the relevant regulations → paragraph 721-25(1)(d), and
- the purpose of the arrangement → subsection 721-25(2),

and concludes that the group liability (income tax assessed for the year ending 30 June 2006) is covered by a TSA under subsection 721-25(1). Because there is a valid TSA, the contributing members are not jointly and severally liable and section 721-30 applies. The Tax Office may proceed with recovery action against contributing members within the limits of the share of group liability allocated to them under the TSA.

For the sake of simplicity, the example ignores the general interest charge (GIC) on the unpaid tax. In practice, however, a TSA should address the allocation of the GIC, including a late GIC for the group liability. TSAs should also provide for the allocation of any penalties resulting from the amendment or revision of a group liability.

Table 1: TSA allocations within HCo's group

	Consolidated group (HCo acting as single entity)	TSA allocations					Notes
		HCo	ACo	BCo	CCo	DCo	
PAYG instalment group liabilities – 2006							
Accounting profit – year ending 30.6.05	$1,000	$50	$400	$150	$300	$100	
% of accounting profit – year ending 30.6.05	100%	5%	40%	15%	30%	10%	
PAYG instalments – year ending 30.6.06	(paid by HCo)						
Quarter 1 – 21.10.05	$50	$2.50	$20	$7.50	$15	$5	TSA allocations of PAYG group liabilities.
Quarter 2 – 21.1.06	$50	$2.50	$20	$7.50	$15	$5	
Quarter 3 – 21.4.06	$50	$2.50	$20	$7.50	$15	$5	
Quarter 4 – 21.7.06	$50	$2.50	$20	$7.50	$15	$5	
(each instalment is a group liability)							
Income tax group liability – 2006							
Accounting profit – year ending 30.6.06	$1,140	$60	$540	$120	$480	($60)	
% of accounting profit* – year ending 30.6.06	100%	5%	45%	10%	40%	0%	
Income tax assessed – year ending 30.6.06 (section 204, ITAA 1936)							
Group liability	$360						
less PAYG instalments raised	($200)						
= tax payable	$160						$160 paid by HCo
TSA allocation of group liability	$360	$18	$162	$36	$144	$0	TSA allocations
Amended income tax assessment issued September 2010 in respect of the year ending 30.6.06 (section 204, ITAA 1936)							
Group liability	$400						
less PAYG instalments raised	($200)						
less tax paid	($160)						
= tax outstanding	$40						$40 not paid – default
TSA allocation of increased group liability	$400	$20	$180	$40	$160	$0	TSA allocations

*The figure on which the percentage is calculated is $1,200, being the total accounting profit of HCo, BCo and CCo, and excluding the $60 loss of DCo.

Calculation

Percentage of profit methodology

The percentage of accounting profit approach is one method that can be used to produce a reasonable allocation of the relevant group liability for the purposes of section 721-25 of the ITAA 1997.

In this example, the preceding year accounting profits are used to allocate PAYG group liabilities, and current year accounting profits are used to allocate the final income tax group liability. Although actual instalment income and taxable income on an entity by entity basis may be different to the result obtained under a percentage of profit allocation, this does not in itself mean the methodology breaches the reasonable allocation requirements in section 721-25.

Under the percentage of profit method, it is not necessary to eliminate intragroup transactions from the accounting profits to ensure the group liability is reasonably allocated (though certain intragroup transactions, such as intragroup dividends, can be eliminated under certain circumstances).

A TSA allocated contribution cannot be a negative amount. Because DCo has an accounting loss of $60, it is allocated a nil amount.

Parties to the TSA

For the TSA to be valid, the allocation of the total group liability among the head company and the subsidiary members that are party to the agreement (the 'TSA contributing members') must be reasonable. There must only be one TSA for each group liability, although one TSA can cover more than one group liability. All members of a consolidated group do not need to be party to a TSA under the current law, provided the TSA represents a reasonable allocation. However, it may be prudent for all subsidiary members to be party to the TSA for due diligence and other commercial reasons.

In this example there are five group liabilities: four PAYG instalments (each instalment is a separate group liability) and the income tax for the 2006 year. These could be dealt with in five separate TSAs or in one or perhaps two (income tax and PAYG) TSAs.

Timing issues

The TSA must be in place before the relevant group liability is due and payable. In this case, therefore, the TSAs for each of the PAYG instalments must be in place before 21 October 2005, 21 January 2006, 21 April 2006 and 21 July 2006 respectively. The TSA for the income tax for the 2006 income year needs to be in place before 1 December 2006.

Note

Due and payable date

For income tax assessments for 2003-04 and earlier years, amended assessments become due and payable on the same date as that applying to the original assessment. The debts in both original and amended assessments relate to the same liability, and must therefore be covered by the same TSA. The TSA methodology must remain unchanged, though the Commissioner may require the production of an attachment to the TSA to disclose the new allocations to members arising from the amended or revised liability.

For income tax assessments for 2004-05 and later years, the due date for amended assessments is 21 days from when the taxpayer is notified of the amendment. Although the due date for an amended assessment for these years is later than that of the original assessment, the debts in both original and amended assessments relate to the same liability, and therefore must also be covered by the same TSA. The TSA must be in place – and all its requirements met – before the due time of the original assessment. The TSA methodology must also remain unchanged.

Worksheets providing specific allocation details may be required if the Tax Office asks for a copy of the TSA, but they are not part of the TSA itself and therefore do not necessarily need to be prepared until that time. Preparation of the worksheets on a more regular basis would, however, help to reduce the amount of work required to be performed within the 14-day notice period.

TSA methodology and contribution arrangements

The TSA only becomes relevant if the head company defaults on a group liability. Contributions between group members to facilitate the funding and payment of group liabilities are contractual matters for the group and are not relevant to the collection of a group liability by the Tax Office.

Although, in this example, the contribution arrangements are on a similar basis to the TSA, this is not a requirement of a valid TSA. The TSA percentage of profit methodology could be considered a reasonable allocation even if the group's contribution arrangements were totally different (if they were based, for example, on stand-alone tax calculations and included, in effect, subvention payments for losses).

It should be noted that the TSA contribution amounts need to be able to be determined at the head company's due time. This does not *require* the TSA to specify a 'particular amount'. Depending on the methodology of the TSA it could show each TSA contributing member's contribution amount as:

- a fixed or variable percentage of the group liability
- an amount based on the 'notional' contributions to taxable income, or
- an amount based on some other formula.

However, if the TSA does not show each TSA contributing member's contribution amount as a specified sum, a schedule will need to be produced with a copy of the TSA, if and when required, showing the contribution amount for each TSA contributing member as determined by applying the method provided in the TSA relating to that group liability.

Group liability

If HCo defaults, the maximum amount of the group liability that the Tax Office can collect from each contributing member is the reasonable allocation amount under a valid TSA. If the amounts allocated under the TSA exceed the outstanding debt, the total amount the Tax Office can collect is limited to the amount of the outstanding debt, but it can choose which member it collects from.

The group liability as defined in section 204 is the total tax assessed *before* credit for PAYG instalments.

The group liability for income tax to be allocated is the tax assessed for one income year. The amount of the group liability may be modified by amended assessments, but the original assessment and any amended assessments are *not* separate group liabilities.

Thus, in this example, there is in effect a part payment ($360) of the tax assessed of $400. The group liability that must be allocated under the TSA is the tax assessed ($400), not the net tax payable ($40). The amount allocated to member subsidiaries is $380 (excluding the $20 allocated to HCo). Because the allocated amount exceeds the outstanding debt, the Tax Office can collect the $40 from ACo, BCo or CCo – or any combination of them. It cannot however collect any amount from DCo, since its allocation is capped at $0.

Note that, even though it was an HCo transaction that gave rise to the amended assessment, the TSA allocation methodology spreads the adjustment across all members of the group. This does not jeopardise the reasonableness of the allocation.

If the TSA allocation methodology in this example was more sophisticated – if it sought to allocate the entire increase in the group liability to those entities whose allocations under the original assessment were understated – the Tax Office would generally respect the intent behind the TSA. Even though the additional $40 is not a separate group liability with its own separate TSA allocation, the Tax Office would only seek payment of the outstanding amount related to the amended assessment from the entities that contributed to the understatement.

As the liability is for the 2006 income year, and the amended assessment is issued in September 2010, a contributing member that leaves the consolidated group after 1 December 2006 (the due and payable date for the original assessment) and before the date of issue of the amended assessment *may* still achieve a clear exit in relation to the amount of the amended assessment, provided all the requirements under section 721-35 are met → 'Clear exit', in C9-7-110. This is because the due and payable date for the amended assessments for the 2005 and later income years is prospective, being 21 days from when the taxpayer is given notification of the amendment. → subsection

204(2), ITAA 1936. A clear exit can be achieved in this case if the entity makes a payment of its (anticipated) post-amendment contribution amount, or a reasonable estimate of the amount, to the head company, before leaving.

→ 'Clear exit' in C9-7-110.

References

Income Tax Assessment Act 1936, section 204

Income Tax Assessment Act 1997, Division 721; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1, *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 14, and *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (No. 83 of 2004), Schedule 2, Part 10

Revision history

Section C9-7-510 first published 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
23.4.04	Revisions to sections on who should be party to a TSA and methodology and contribution arrangements (pp. 4 and 5).	For clarification.
14.7.04	Note on recent changes to consolidation rules.	Legislative amendments.
26.10.05	Extensive changes.	Legislative amendments.
15.11.06	Changes to requirements for TSAs, p, 6.	Change to practice statement.
	Change to text on circumstances for clear exit, p. 8	
30.6.09	Changes to note on due and payable date, p, 6, and text on requirements for a clear exit, p. 8.	To align with changes to *ATO Receivables Policy*.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

C10: **MEC groups**

Multiple entry consolidated (MEC) groups

About this section

Section C10 provides information on the formation, composition, operating processes and cessation of MEC groups. It comprises:

- explanations of MEC groups and how they differ from consolidated groups
- detailed worked examples describing a range of events, rules and processes that may apply during a MEC group's formation, operations and cessation.

Section contents

Notification forms

The notification forms with instructions for their completion can be found at ato.gov.au/consolidation

Multiple entry consolidated (MEC) groups

Eligibility

A foreign-owned group of Australian entities may be able to consolidate despite not having a single Australian head company. The resulting group, known as a multiple entry consolidated (MEC) group, is treated as a consolidated group for income tax purposes – that is, as a single entity. The types of entities eligible to be members of a MEC group are the same as those eligible to be members of a consolidated group. → 'Choosing', B1-1

The MEC group rules enable foreign-owned groups with multiple entry points of investment into Australia to get the benefits of consolidation.

The membership of a MEC group is determined by reference to the ultimate foreign parent company, referred to as the 'top company' → section 719-20, *Income Tax Assessment Act 1997* (ITAA 1997). The Australian-resident companies that constitute the top company's first tier of investment into Australia are referred to as 'tier-1' companies. If a tier-1 company satisfies all the requirements to be a member of a MEC group, it is known as an 'eligible tier-1 company'.

Broadly, the membership of the group consists of the eligible tier-1 companies and all their qualifying wholly-owned subsidiaries.

Generally, an entity cannot be a member of a MEC group unless entities interposed between it and the eligible tier-1 companies of the group are also members. However, where a MEC group is formed during the transitional period, a wholly-owned, Australian-resident subsidiary will be a member, even where there are interposed foreign resident entities, if it satisfies the interposed foreign-resident entity (IFRE) tests. → 'Transitional provisions for foreign-held, Australian-resident subsidiaries to be members of a MEC group', C10-2-120

Requirements to form a MEC group

A MEC group may be formed in one of two ways:

- as a result of two or more eligible tier-1 companies of the top company making a choice to form the group, or
- as a result of a consolidated group converting to a MEC group (a special conversion event) when certain conditions are satisfied. The conditions would be satisfied where, for example, the head company of a consolidated group is an eligible tier-1 company of the top company and that top company acquires another eligible tier-1 company.
  → 'Group conversions', C10-1-210

A MEC group comes into existence only if the eligible tier-1 companies jointly appoint one of themselves to be the provisional head company of the group. However, only an eligible tier-1 company that does not have any of its membership interests owned by another member of the MEC group can be appointed to be the provisional head company of a MEC group. The remaining members of the MEC group are subsidiary members of the group.
→ section 719-25, subsection 719-60(1) and section 719-65, ITAA 1997

Example

Forming a MEC group

TC is the top company and ACo and BCo are its wholly-owned, Australian-resident subsidiary companies. ACo and BCo are eligible tier-1 companies and together they can make the choice to form a MEC group. Either ACo or BCo can be the provisional head company, as neither has any membership interests owned by another member of the MEC group.

Note that unlike the non-MEC group consolidation rules, ACo and BCo are not required to have wholly-owned subsidiaries to form a MEC group. However, there must be at least two eligible tier-1 companies for a MEC group to be formed.

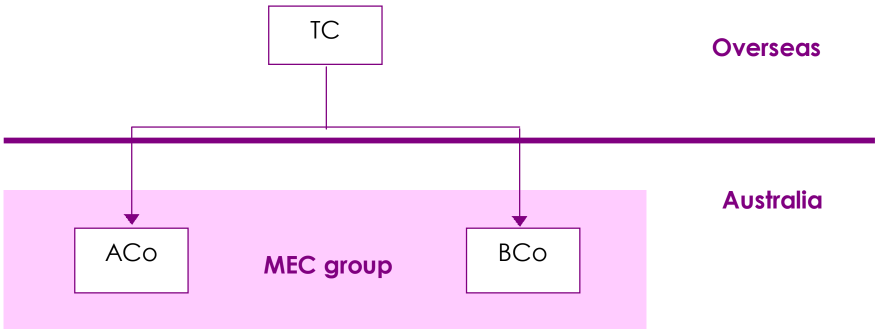


Table 1: Main differences between membership of MEC groups and consolidated groups

	MEC groups	Consolidated groups
Who can join	Australian-resident members of a foreign wholly-owned group can be members of a MEC group.	Australian-resident wholly-owned subsidiaries together with their Australian head company can be members of a consolidated group.
Minimum requirements to form	There must be at least two eligible tier-1 companies to form a MEC group.	There must be a head company and at least one wholly-owned subsidiary (company or trust) to form a consolidated group.
Head company	Only an eligible tier-1 company in which no member of the MEC group holds any interests can be a provisional head company of a MEC group.	The head company must be a company that is not a wholly-owned subsidiary of an entity that can be a member of a consolidatable or consolidated group.
	The provisional head company is nominated jointly by all the eligible tier-1 companies of the group.	The head company declares itself as the head company.
	If a provisional head company becomes ineligible, all the eligible tier-1 companies jointly appoint another qualified eligible tier-1 company as the new provisional head company. The company that is the provisional head company at the end of the income year is taken to be the head company of the MEC group for the whole year.	If the head company becomes ineligible, the consolidated group will cease to exist.

	MEC groups	Consolidated groups
Choice to form	A written choice is made jointly by the eligible tier-1 companies and must include the appointment of the provisional head company.	A written choice is made by the head company.
Notification requirements	Notice of choice in the approved form is given by the head company.	Notice of choice in the approved form is given by the head company.
When a group converts or expands	When the last remaining eligible tier-1 company of a MEC group ceases to be an eligible tier-1 company, the MEC group becomes a consolidated group if that company can qualify as the head company.	If a head company of a consolidated group also qualifies as an eligible tier-1 company and subsequently one or more eligible tier-1 companies join the foreign wholly-owned group, the consolidated group can convert to a MEC group. The head company will become the provisional head company and it must notify the Commissioner of Taxation in the approved form. This conversion is called a 'special conversion event'.
	When a parent company of one MEC group (acquiring MEC group) acquires another MEC group, the two MEC groups can continue to exist separately, or the acquiring MEC group may choose to expand by including the other. If the acquiring MEC group chooses to expand, all the eligible tier-1 companies of the acquired group must join the expanded group.	When a 'special conversion event' happens to a consolidated group, if the new eligible tier-1 companies were members of a MEC group before their acquisition and that MEC group is acquired as a whole, then all the eligible tier-1 companies of that group must join.
Cessation	When the provisional head company of a MEC group ceases to be the provisional head company of the group, the group can continue to exist with a new provisional head company. When none of the remaining eligible tier-1 companies are qualified to be the provisional head company, the MEC group ceases to exist.	When the head company of a consolidated group ceases to be the head company, the consolidated group ceases to exist.

Sources: ITAA 199, Divisions 703 and 719; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapters 3 and 4

Change in provisional head company

Once a MEC group is formed it is possible for the provisional head company of the group to change without affecting the ongoing existence of the group. A change in provisional head company may occur, for example, where the provisional head company ceases to be a wholly-owned subsidiary of the top company – a cessation event. The remaining eligible tier-1 companies in the group may appoint a new provisional head company. The appointment of a new provisional head company must be notified to the Commissioner within 28 days of the cessation event or, if the cessation event happens more than 28 days before a choice to consolidate notice is given to the Commissioner, by the time the choice notification is given. → 'MEC groups – notices to be given to the Commissioner', C10-1-110

Once a replacement has been appointed, some tax attributes of the group such as franking credits and foreign dividend account surpluses are transferred from the former provisional head company to the replacement provisional head company. However, some attributes such as losses are transferred at the end of the income year when head company history is transferred to the new head company.

Joining entities

Broadly, the rules governing the transfer of tax attributes (such as losses and franking credits) when an entity becomes a subsidiary member of a consolidated group apply in the same manner when an entity becomes a subsidiary member of a MEC group.

Cost setting rules

The MEC rules modify the general cost setting rules.

The assets of an eligible tier-1 company enter consolidation with their terminating values because an eligible tier-1 company is treated as if it is a part of the head company of the group. Similarly, the assets of a transitional foreign-held subsidiary (TFHS) enter consolidation with their terminating values because a TFHS is also treated as part of the head company. Assets of other subsidiary members have their tax costs reset in the same way as the assets of subsidiary members of a consolidated group.

Generally, intragroup debts and intragroup membership interests held by an eligible tier-1 company are not recognised for the purposes of Part 3-90 of the ITAA 1997 while it is a member of the group. → 'Cost setting rules for assets of a MEC group – at joining and formation times', C10-2-210; 'Determining asset values', B2-2

Franking credits

The head company of a MEC group is responsible for operating the franking account of the group. However, some membership interests in eligible tier-1 companies and transitional foreign-held subsidiaries are held by entities that are not members of the MEC group. To allow these entities to frank distributions made to their shareholders, any distributions made by a subsidiary member of the group to an entity outside the group will be taken to be made by the head company of the group.

Losses

In recognition of the special characteristics of MEC groups, Subdivision 719-F of the ITAA 1997 modifies the rules about transferring and utilising losses within those groups. It also covers the application of the continuity of ownership test (COT) under section 165-12, which helps to establish whether a loss can be utilised.

Applying the COT to a MEC group

The loss rules cannot be applied to a MEC group in the same way as a consolidated group because, if the COT was applied by reference to the head company of the MEC group, the outcome could change depending on which of the eligible tier-1 companies was chosen to be head company. Applying the COT by reference to all the eligible tier-1 companies collectively is also unworkable, as the COT is designed to trace the ownership of a single loss entity and not a group of loss entities.

In effect, the COT is applied to a MEC group by reference to the group's top company instead of its head company. Ownership changes in the transferor company up to and including the joining time are also recognised in certain circumstances.

In order to apply the COT to a MEC group for the purpose of determining whether a loss can be utilised, a company (the 'test company') identified in relation to the focal company, is assumed to have incurred the loss. It is also assumed that:

- the test company made the loss for a particular income year
- if certain events occur, parts of the ownership structure are considered 'frozen', and
- in certain circumstances, the test company is considered to have failed the COT in relation to the loss (and therefore the focal company is also considered to have failed the COT in relation to the loss).

Satisfaction or failure of the COT by the test company in relation to a loss, is attributed to the head company of the MEC group.

→ 'Identifying the test company to determine continuity of ownership of the focal company in a MEC group (COT transfer of losses)', C10-2-330

→ 'Identifying the test company to determine continuity of ownership of the focal company in a MEC group (SBT satisfied)', C10-2-340

→ 'Determining the start of a test company's loss year to assess the continuity of ownership of the focal company in a MEC group (COT transfer of a loss)', C10-2-350

→ 'Determining the start of a test company's loss year to assess continuity of ownership of the focal company in a MEC group (special conversion event)', C10-2-360

→ 'Freezing the ownership of the test company – COT transfer of a loss to the head company of a MEC group', C10-2-370

→ 'Freezing the ownership structure of a MEC group – when a loss-making company becomes head company of the group', C10-2-380

→ 'Continuity of a potential MEC group when the identity of the top company changes – assumptions about the test company failing the COT', C10-2-390

Calculating available fractions

The available fractions for MEC groups are generally calculated and adjusted in the same way as for consolidated groups, but specific rules apply when a MEC group:

- expands because a new eligible tier-1 company joins, or
- is created from a consolidated group because of the introduction of a company, that was not previously a member of the consolidated group, as an eligible tier-1 company of the same top company (a special conversion event – expansion case).

If a new eligible tier-1 company joins the group in the manner described above, the group's existing available fractions are adjusted. In addition, an available fraction must be calculated for any prior year (group) losses generated before the new eligible tier-1 company joins.

Existing available fractions are adjusted when a new eligible tier-1 company joins the group in the manner described above because the expansion increases the group's income generating capacity. This is because the group has not expended cash or assets in order for the new eligible tier-1 company to join. (The company is a new eligible tier-1 company of the group solely because of its relationship with the top company.) The existing available fractions no longer represent the correct proportion of group income considered to be generated by the entities that transferred the losses.

Also, an available fraction is calculated for the prior year group losses when a new eligible tier-1 company joins a MEC group, or when a MEC group is created from a consolidated group because a company that was not previously a member of the consolidated group becomes an eligible tier-1 company of the same top company. Broadly, this is to ensure that the losses will only be offset against the proportion of the (expanded) group's income considered to have been generated by the entities in the group at the time the losses were made.

→ 'Adjusting available fraction – a new eligible tier-1 company joins a MEC group', C10-2-310; 'Apportioning the use of losses – new eligible tier-1 company joins part-way through income year', C10-2-320

→ 'Group conversions', C10-1-210

Leaving entities

An entity, including the provisional head company (PHC), leaves a MEC group if it no longer satisfies the eligibility tests for being a member of the group. This would occur, for example, where:

- there ceases to be a direct or indirect wholly-owned relationship between the entity and the top company, or
- an ineligible entity is interposed between parts of the existing MEC group.

Calculating cost of membership interests

An entity's departure from a MEC group does not affect the continuation of the group unless the exit results in one of the events that causes the group to cease existing (for example, where a PHC leaves a MEC group and none of the remaining eligible tier-1 companies qualify to be a replacement PHC).

The treatment of the membership interests when an entity leaves a MEC group depends on the type of entity and whether the membership interests are owned by members of the MEC group or owned outside the MEC group. Very broadly, there are separate rules for:

- a company that is the head company:
  - Because the MEC rules require the head company of a MEC group to be wholly owned outside the MEC group, when the head company leaves the group special rules referred to as pooling rules apply to reset the cost of those membership interests. Those reset costs are the amounts used for tax purposes such as calculating the capital gain or loss.
- a company that is an eligible tier-1 company, but not the head company:
  - The treatment of the membership interests at leaving time will depend on whether or not the owner of the membership interests is a member of the MEC group. The new cost of those membership interests owned by members of the MEC group is calculated with reference to Division 711 leaving entity rules modified by Subdivision 719-J → 'An eligible tier-1 company leaving a MEC group', C10-2-430. The cost of those membership interests held outside the MEC group that are pooled interests are reset using the pooling rules in Subdivision 719-K

    → 'Pooling of external membership interests', C10-2-420
- an entity that is a subsidiary member of the MEC group but is not an eligible tier-1 company:
  - The method used to calculate the new cost of membership interests is in the leaving entity rules in Division 711. This includes entities that are members of the MEC group as transitional foreign-held indirect subsidiaries (TFHIS).
  - For transitional foreign-held subsidiaries (TFHS), Division 711 applies as modified by sections 701C-40 and 701C-50 of the *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A 1997).

→ 'Cost setting rules for assets of a MEC group – at joining and formation times', C10-2-210

→ 'Transitional provisions for foreign-held, Australian-resident subsidiaries to be members of a MEC group', C10-2-120

→ 'Determining asset values', B2-2

→ 'The cost setting process on exit', C2-2-210

→ Division 711, ITAA 1997

A head company of a MEC group may not have a relevant equity interest or relevant debt interest in a loss company

Where certain conditions are met, a widely held company does not have a relevant equity interest or relevant debt interest, for the purposes of the inter-entity loss multiplication rules (Subdivision 165-CD of the ITAA 1997), in a loss company.

The head company of a MEC group is ultimately wholly owned by a top company and therefore cannot meet the definition of a widely held company. However, section 719-740 of the ITAA 1997 modifies the operation of the inter-entity loss multiplication rules where the top company of a MEC group is a widely held company. In these circumstances, the head company of the MEC group does not have a relevant equity interest or relevant debt interest in a loss company at a particular time if the widely held top company does not have such an interest in the loss company at that time.

Where the head company does not have a relevant equity interest or relevant debt interest in a loss company at a particular time, the inter-entity loss multiplication rules do not apply. If a subsidiary, other than an eligible tier-1 company, leaves the MEC group and is a loss company at the leaving time, the adjustments set out in sections 715-255 and 715-270 of the ITAA 1997 would not need to be made to the tax cost setting amount of the membership interests in the leaving entity just before the leaving time.

Note

Section 715-265 of the ITAA 1997 modifies the operation of the inter-entity loss multiplication rules so that they also apply to a head company of a consolidated group where, at a particular time:

- the head company of a consolidated group is an eligible tier-1 company of a top company, and
- the top company is a widely held company.

The head company of the consolidated group does not have a relevant equity interest or relevant debt interest in a loss company at a particular time if the top company does not have such an interest in the loss company at that time.

→ 'Effect of Subdivision 165-CD for MEC groups', C2-6-150; 'Application of the loss reduction method to consolidated and MEC groups', C2-6-160; 'Subdivision 165-CD widely held company concession for an eligible tier-1 company that is head company of a consolidated or MEC group', C2-6-155

Membership interests in eligible tier-1 companies

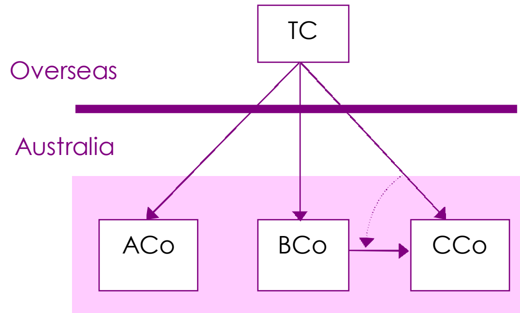
Because assets may be transferred between members of the MEC group without tax consequences, the costs of pooled membership interests are reset each time either one or both events that trigger the pooling rules happen to a pooled interest (pooled interests are only held in eligible tier-1 companies). Recalculation of the cost of pooled interests is triggered when either or both of the following events happen:

- an eligible tier-1 company leaves the MEC group
- a CGT event happens to the pooled interests in an eligible tier-1 company of the group.

→ 'Events that trigger pooling in a MEC group', C10-2-410; 'Pooling of external membership interests', C10-2-420

Example

A CGT event happens to some of the pooled interests in an eligible tier-1 member of the MEC group but it does not leave the group



TC sells some of its interests in CCo to BCo

MEC group ceases to exist

A MEC group will cease to exist when:

- there is no longer a provisional head company for the MEC group
- there is no longer at least one eligible tier-1 company in the group
- the top company changes and the eligible tier-1 companies in the MEC group are no longer the same, or
- the top company changes and all the eligible tier-1 companies of the MEC group (the first MEC group) become members of another MEC group; after the change the first MEC group ceases to exist.

Transitional rules

Transitional rules apply to groups consolidating during the transitional period (1 July 2002 to 30 June 2004). → section 701-1, IT(TP)A 1997

The transitional rules are applicable to MEC groups with some modifications.

Entry case

The head company of a transitional MEC group can choose that the assets of certain subsidiary members of the group can enter consolidation with their existing 'costs' for tax purposes.

For groups consolidating during the transitional period, the cost setting rules enable the head company to choose terminating values for the assets of certain subsidiaries on consolidation. → 'Treatment of assets', C2-1

For transitional MEC groups, this concession is available to those subsidiaries that are not eligible tier-1 companies or transitional foreign-held subsidiaries.

Even though eligible tier-1 companies other than the provisional head company (PHC) are known as subsidiary members once a MEC group is formed, they are treated for cost setting purposes as part of the head company. The cost of their assets is not reset, so that, like the PHC, terminating values must always be used, whether during the transitional period or later.

Exit case

When an eligible tier-1 company leaves a transitional MEC group, the head company of the group can choose to use formation time market values of certain pre-CGT assets.

When an entity leaves a transitional consolidated group, the head company may choose to use formation time market values instead of terminating values for certain pre-CGT assets. → 'Treatment of assets', C2-1

This concession does not apply to those assets held by the head company of the transitional group for which there was a Subdivision 126-B rollover after 11.45 a.m. by legal time in the Australian Capital Territory on 21 September 1999. The asset of the subsidiary that is leaving the group must still have a pre-CGT status just before leaving.

This concession has been extended to apply to pre-CGT assets that satisfy the same conditions as those for consolidated groups but were held by other eligible tier-1 companies of a transitional MEC group at the time it was formed.

→ Division 701, IT(TP)A 1997
→ Subdivision 126-B, ITAA 1997
→ Explanatory Memorandum to New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, paragraphs 1.112 to 1.114
→ Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill (No 2) 2002, paragraph 3.134

Pre-formation rollover after 16 May 2002 and transitional groups

The rollover of an asset under Subdivision 126-B or section 40-340 is disregarded for tax cost setting purposes on consolidation, with certain exceptions, if:

- the rollover takes place after 16 May 2002,
- the group consolidates after the rollover and before 1 July 2004, and
- the rollover changes the tax values of the assets of the group.

→ sections 701-35 and 719-163, IT(TP)A 1997

This rule is designed to prevent groups from using rollover relief to maximise their choices for cost setting of their assets on consolidation.
→ 'Cost setting rules for assets of a MEC group', C10-2-210

Exception where there is a demerger

There is also an exception if:

- the act, transaction or event that gave rise to the CGT event for which there was a rollover under Subdivision 126-B or section 40-340 happened before a demerger and in connection with the demerger:
  - either the originating company or the recipient company ceased to be a member of the 'demerger group' (as defined in section 125-65 of the ITAA 1997) because of the demerger, and

– the recipient company and the originating company do not both join the same consolidation transitional group.

→ subsection 701-35(2A), IT(TP)A 1997

References

Income Tax Assessment Act 1997, Divisions 711 and 719; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 4

Income Tax Assessment Act 1997, Subdivisions 719-J and 719-K; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 8

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, paragraphs 3.50 – 3.71

Income Tax Assessment Act 1997, sections 719-740 and 715-265; as inserted by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 16

Income Tax Assessment Act 1997, Subdivision 715-H and subsections 165-115X, 165-115Y, 715-230, 715-255, 715-270 and 715-450; as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 16

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5, paragraphs 5.325 – 5.348 and 5.65 - 5.100

Supplementary Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 2.26 – 2.32

Income Tax Assessment Act 1997, Subdivision 719-BA; as inserted by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 2

Income Tax (Transitional Provisions) Act 1997, Division 701 and section 701-35; as amended by *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002*, (No. 90 of 2002), Schedule 7

Income Tax (Transitional Provisions) Act 1997, sections 701-35 and 719-163; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 17

Tax Laws Amendment (2006 Measures No. 4) Act 2006 (No. 168 of 2006), Schedule 2

Explanatory Memorandum to New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, paragraphs 1.104 to 1.107

Explanatory Memorandum to Tax Laws Amendment (2006 Measures No. 4) Bill 2006

Income Tax Assessment Act 1997, Subdivision 126-B

New Business Tax System (Consolidation and Other Measures) Act 2003 (No. 16 of 2003), Subdivision 719-H, Schedule 5, Subdivision 719-F, Schedule 13

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapters 9, 5, 4, 3

Revision history

Section C10-1 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on recent changes to consolidation rules (since deleted).	Legislative amendments.
26.10.05	Changes to the cost setting rules on the entry and exit of a transitional foreign-held subsidiary (TFHS), pp. 4, 6. Minor editorial changes.	Legislative amendments.
6.5.11	Significant revisions to reflect changes to the cost setting rules when groups convert, pre-formation rollovers, loss multiplication rules and the choice provisions.	Legislative amendments.

MEC groups – notices to be given to the Commissioner

Key point

The Commissioner must be notified in the approved form where a choice in writing is made in relation to a multiple entry consolidated (MEC) group or where there are changes in the membership of the MEC group.

Choices in writing to be notified

The Commissioner must be notified in the approved form if a choice in writing is made:

- to form a MEC group and appoint the provisional head company (PHC)
- to create a MEC group from a consolidated group (a special conversion event)
- for a new eligible tier-1 company to become a member of a MEC group
- to appoint a new PHC and continue the MEC group because the previous PHC ceases to be the PHC (the cessation event).

The notification forms for these choices are listed in table 1.

Note

Making a choice in writing is separate to the requirement that a notice be given to the Commissioner. Completion of a notification of formation of a MEC group does not fulfil the requirement to make a choice in writing. The choice to form a MEC group will not be effective unless a valid choice in writing is made within the prescribed time. → 'Choice in writing', C7-1-110

Changes to be notified

The Commissioner must also be notified in the approved form of any of the following changes to a MEC group:

- an entity (other than an eligible tier-1 company) becomes a member of the MEC group
- an entity ceases to be a member of the MEC group
- the PHC ceases to be the PHC.

These changes are known as notifiable events. The notification forms for these events are listed in table 2.

Where the relevant information about an entity joining or leaving a group has been provided when notifying of a choice to form a group, additional notification of the entry or exit is not necessary.

Table 1: Notices for a choice in writing

Choice to be notified and form (→ forms available at **www.ato.gov.au/consolidation**)	**Notification deadline**	**Who must give notice**
1. A choice in writing is made to form a MEC group and to appoint the PHC under section 719-50 and subsection 719-60(1) Notify using *Notification of formation of a multiple entry consolidated (MEC) group* (NAT 7024) Notice required by section 719-76	The notice must be lodged no later than: • if the head company is required to lodge an income tax return for the income year in which the choice is made – the day on which the company lodges the income tax return for that income year, or • if a return is not required for that income year, the date it would have otherwise been due	Head company
2. A choice in writing is made that a MEC group is created from a consolidated group under section 719-40 (a special conversion event) Notify using *Notification of conversion to a multiple entry consolidated (MEC) group* (NAT 7026) Notice required by section 719-78	As above (item 1 of this table)	The eligible tier-1 company that was the head company of the consolidated group just before the conversion
3. A choice in writing is made that a new eligible tier-1 company and its eligible subsidiaries join a MEC group under subsection 719-5(4) Notify using *Notification of a new eligible tier-1 company of a multiple entry consolidated (MEC) group* (NAT 73442) Notice required by section 719-77	As above (item 1 of this table)	Head company
4. A choice in writing is made to appoint a new PHC, and continue the MEC group under subsection 719-60(3) after the former PHC ceases to be the PHC Notify using *Notification of continuation of a multiple entry consolidated (MEC) group with a new provisional head company* (NAT 7052) Notice required by section 719-79	Within 28 days of the former PHC ceasing to be the PHC. If the former PHC ceased to be the PHC more than 28 days before the group lodged the notification of formation of a MEC group, this notice must be lodged no later than the formation notification	The new PHC

Table 2: Notices for notifiable events

Notifiable event and form (→ forms available at **www.ato.gov.au/consolidation**)	**Notification deadline**	**Who must give notice**
1. An entity becomes a member of a MEC group (other than as an eligible tier-1 company) Notify using *Notification of members joining and/or leaving a multiple entry consolidated (MEC) group* (NAT 7025) Notice required by section 719-80	Within 28 days of the event However, if the event occurs: • before the notification of formation of the MEC group is lodged, the information for the event is required to be included in the *Notification of formation of a multiple entry consolidated (MEC) group* (see item 1, table 1) • before the notification of the conversion to a MEC group is lodged, the information for the event is required to be included in the *Notification of conversion to a multiple entry consolidated (MEC) group* (see item 2, Table 1)	The PHC
2. An entity ceases to be a member of a MEC group Notify using *Notification of members joining and/or leaving a multiple entry consolidated (MEC) group* (NAT 7025) Notice required by section 719-80	As above (item 1 of this table)	PHC
3. The PHC ceases to be the PHC of a MEC group Notify using *Notification of provisional head company no longer eligible* (NAT 7053) Notice required by section 719-80	Within 28 days of the PHC ceasing to be the PHC of the group If the PHC ceases to be the PHC: • before the notification of formation of a MEC group is lodged, or • in the case of a special conversion to a MEC group, before the notification of the formation of a consolidated group is lodged, this notice must be lodged no later than the day on which the income tax return is lodged for the income year in which the notifiable event occurs, or if a return is not required for that income year, the day it would have otherwise been due	The company or the public officer of the company just before it ceased to exist

References

Income Tax Assessment Act 1997, sections 719-5, 719-40, 719-50, 719-60, 719-75 and 719-80; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *Tax Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5

Income Tax Assessment Act 1997, sections 719-76, 719-77, 719-78 and 719-79; as inserted by *Tax Amendment (2010 Measures No. 1) Act 2010 (*No. 56 of 2010), Schedule 5

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.382 to 5.423

Revision history

Section C10-1-110 first published 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
26.10.05	Change to who must notify and which form to use when a new eligible tier-1 company joins a MEC group. Other minor editorial changes.	To correct an error.
6.5.11	Extensively revised (including the title) to reflect changes to the choice and notification provisions.	Legislative amendments.

Group conversions

A group conversion happens when:

- a consolidated group is created from a MEC group, or
- a MEC group is created from a consolidated group (a special conversion event).

New rules introduced in the *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010) enable a group conversion to happen with minimal tax consequences for ongoing members. The new rules are contained in Subdivision 719-BA of the *Income Tax Assessment Act 1997* (ITAA 1997).

The new rules apply to group conversions that happen on or after 27 October 2006. However, the head company of the MEC group or consolidated group can choose for the new rules to apply from 1 July 2002. The choice must be made in writing, on or before 30 June 2011 or within a further time allowed by the Commissioner. → *Taxation Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010) Item 17, Schedule 5

The time at which a consolidated group is created from a MEC group (→ section 703-55) or a MEC group is created from a consolidated group (→ section 719-40) is known as the conversion time. The group that existed before the conversion time is referred to as the old group and the group that exists after the conversion time is referred to as the new group.

Entities that were members of the old group just before the conversion time and that remain members of the new group at the conversion time are referred to as ongoing members.

→ 'Choice on formation, special conversion events and acquisition of new eligible tier-1 companies', C10-2-110; 'A consolidated group is created from a MEC group', C10-2-140

Key changes

When a group conversion happens, the old group ceases to exist and the new group comes into existence. Under the old rules covering group conversions, the ongoing members ceased to be members of the old group (i.e. they left the old group) and joined the new group, resulting in significant tax consequences and compliance costs. Under the new rules, ongoing members continue to leave the old group and join the new group but certain tax provisions that would normally apply when an entity leaves or joins a consolidated group or MEC group do not apply in relation to the ongoing members when a group conversion happens.

To minimise the tax consequences for the ongoing members, the new rules provide that:

- the head company of the new group retains the history of the old group → section 719-125 of the ITAA 1997

- the tax cost setting rules that normally apply when an entity leaves or joins a consolidated group or MEC group do not apply in relation to ongoing members. → subsection 719-120(2), section 719-130, ITAA 1997

New group's head company retains history of old group's head company

When a group conversion happens, the head company of the new group retains the history of the head company of the old group. This means that everything that happened in relation to the head company of the old group before the conversion time is taken to have happened to the head company of the new group. However, history in relation to assets, liabilities and businesses that ceased to be that of the head company of the old group (as a result of an entity leaving the old group) under the exit history rules is not inherited by the head company of the new group → section 719-125, ITAA 1997.

In most cases, the company that was the head company of the old group will be the head company of the new group. But, where a MEC group is created from a consolidated group and there is change in the provisional head company, after the conversion time, in the same income year as the conversion time, the new group will have a different head company. In either case, the head company of the new group retains the history of the head company of the old group. → subsection 719-125(1)

The history that is retained by the new group's head company includes everything that was taken to have happened immediately before the conversion time to the old group's head company because of:

- the single entity rule → subsection 701-1(1), ITAA 1997
- the entry history rule → section 701-5, ITAA 1997
- the effects of a choice by a consolidated group to continue as a consolidated group after an interposed company becomes the new head company → section 703-75, ITAA 1997
- the effects of a change in the head company of a MEC group → section 719-90, ITAA 1997, and
- any previous applications of Division 719 of the ITAA 1997.

For example, where a consolidated group is created from a MEC group, and there has been one or more changes to the head company of the MEC group before the conversion time, and history was transferred to each successive head company of the MEC group under section 719-90, the new group's head company inherits all the previous history of the MEC group and is treated as if it has always been the head company of the group.

Retaining the history of the old group's head company enables the tax liability or tax loss to be worked out

The retention of the history enables the new head company to fulfil its core purpose of working out its income tax liability or tax loss for the income year in which the conversion time happens and the subsequent income years.

→ subsection 701-1(2), paragraph 719-125(3)(a), ITAA 1997

Similarly, it enables a subsidiary member of the old group to work out its income tax liability or tax loss for any non-membership periods. → subsection 701-1(3), paragraph 719-125(3)(b), ITAA 1997

Further, it enables the head company or provisional head company of the new group to determine the franking account balance of the new group at or after the conversion time.

→ Subdivision 709-A, section 719-430, paragraph 719-125(3)(c), ITAA 1997; 'Franking accounts in consolidated groups', C5-2-110

Provisions that *do not* apply to ongoing members

Joining time provisions that do not apply to ongoing members

Certain joining time provisions that ordinarily apply when an entity joins a consolidated group or MEC group, other than the single entity rule (→ subsection 701-1(1)), do not apply to an ongoing member – in particular:

- CGT events L1, L2, L3, L4 and L8, which may apply when an entity joins a consolidated group or MEC group → Subdivision 104-L, ITAA 1997
- the modification to the operation of the same business test that ordinarily applies when an entity becomes a subsidiary member of a consolidated group or MEC group → section 165-212E, ITAA 1997
- the consolidation provisions in Part 3-90 that ordinarily apply when an entity joins a consolidated group or MEC group (other than the single entity rule and Subdivision 719-BA), and
- the transitional consolidation provisions in Part 3-90 of the *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A 1997) that ordinarily apply when an entity joins a consolidated group or MEC group.

→ subsections 719-130(1), (2) and (5), ITAA 1997

As a consequence of joining time provisions not applying:

- The tax cost setting rules in Division 705 do not apply in relation to the assets of an ongoing member when it joins the new group and, therefore, the tax costs of these assets are not reset.
- The loss transfer rules in Subdivision 707-A do not apply to an ongoing member when it becomes a member of the new group and, as a result, losses transferred from an ongoing member to the head company of the old group are taken to be transferred to the head company of the new group.

As these concessions apply only to ongoing members, they are not available for an entity that joins the new group at the conversion time. For example, where a MEC group is created from a consolidated group, the joining time provisions listed above will continue to apply in relation to those entities whose joining resulted in the MEC group being created.

Leaving time provisions that do not apply to ongoing members

Certain leaving time provisions that ordinarily apply when an entity leaves a consolidated group or MEC group do not apply to an ongoing member – in particular:

- Division 711, which ordinarily applies when an entity leaves a consolidated group or MEC group → Division 711, ITAA 1997
- CGT event L5, which applies because Division 711 applies → Subdivision 104-L, ITAA 1997
- the consolidation provisions in Part 3-90 that ordinarily apply when an entity leaves a consolidated group or MEC group (other than Subdivision 719-BA), and
- the transitional consolidation provisions in Part 3-90 of the IT(TP)A 1997 that ordinarily apply when an entity leaves a consolidated group or MEC group.

→ subsections 719-120(2) and 719-130(3) to (5), ITAA 1997

As a consequence of the leaving time provisions not applying, the tax cost setting rules in Division 711 do not apply in relation to an ongoing member of the old group and therefore the tax cost of its membership interests are not worked out.

As these concessions apply only to ongoing members, they are not available for an entity that leaves the old group at the conversion time. For example, a transitional foreign-held subsidiary in the old group will not be able to qualify as a member of the new group and therefore the leaving time cost setting rules will continue to apply.

Note

Where a MEC group is created from a consolidated group as a result of a subsidiary member of the consolidated group becoming an eligible tier-1 company of the top company at the conversion time (commonly referred to as a 'transfer-up'), Division 711 applies. → 'MEC group created from a consolidated group – special conversion event due to transfer-up (Division 711 and CGT event L5)', p. 7 of this section

'MEC group ceases to exist' provisions that do not apply

Where a consolidated group is created from a MEC group, the following provisions that would normally apply when the MEC group ceases to exist at the conversion time do not apply:

- section 719-280, which deems that the head company of the MEC group fails the continuity of ownership test in relation to unused losses because a MEC group ceases to exist[249]
- section 719-465, which deems the head company of the MEC group to fail the continuity of ownership test in relation to bad debts because a MEC group ceases to exist
- sections 719-705 and 719-725, which deem a changeover time and an alteration time under the loss integrity rules for the head company of the group at the time a MEC group ceases to exist, and
- any other provision in Part 3-90, to the extent that the application of the provision is necessary for the application of sections 719-280, 719-465, 719-705 and 719-725. This would include, for example, other provisions in Subdivisions 719-F, 719-I and 719-T. → section 719-40, ITAA 1997

Provisions that continue to apply to ongoing members

Consolidated group created from a MEC group – pooling rules

When a consolidated group is created from a MEC group, the pooling rules in Subdivision 719-K, together with any other provisions to the extent they are necessary for the application of the pooling rules, continue to apply to an ongoing member. → section 719-135, ITAA 1997; 'Pooling of external membership interests', C10-2-420

Broadly, the pooling rules ensure that the cost base or reduced cost base of the membership interests in the head company of the consolidated group created from the MEC group, that were previously pooled interests in the head company of the MEC group, is set at the cost setting amount determined under Subdivision 719-K.

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[249] As section 719-280 does not apply where a consolidated group was created from the MEC group and this conversion took place:

- on or after 27 October 2006, or
- before 27 October 2006 and a choice is made within the prescribed time for Subdivision 719-BA to apply from 1 July 2002,

the provisions in Subdivision 719-F that modify the continuity of ownership test for MEC groups will not apply to the consolidated group after the conversion time. → section 719-140, item 17 of *Tax Laws Amendment (2010 Measures No. 1) Act 2010;* paragraphs 5.92, 5.105 and 5.106, Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010.

MEC group created from a consolidated group – special conversion event due to expansion

Available fractions

A MEC group is created from a consolidated group (that is itself a potential MEC group) due to an expansion when one or more companies that are not ongoing members become eligible tier-1 companies of a top company, and the top company already wholly owns, directly or indirectly, the head company of a consolidated group, and the head company makes a written choice that a MEC group is to form and informs the Commissioner of that choice in the approved form and within the prescribed time. → sections 719-40 and 719-78, ITAA 1997

Where a MEC group is created from a consolidated group because of an expansion, the provisions that apply to deem prior group losses to be transferred losses, and the provisions that apply to adjust or cap the available fractions for previously transferred loss bundles, and the prior group loss bundles, continue to apply at the conversion time. → sections 719-300 and 719-325, ITAA 1997

That is, for the purposes of section 719-300, the prior group loss of the old group will be taken to be transferred to the head company of the new group, and an available fraction calculated. → section 719-305, ITAA 1997

Similarly, the available fractions of the loss bundles in the old group will be adjusted when they become loss bundles in the new group. → section 719-310, ITAA 1997

Also, for the purposes of section 719-325, which deals with the choice to cancel losses in a bundle, the ongoing head company can choose to cancel all the losses in its bundle of prior group losses. It can also choose to cancel the losses in any previously transferred bundle of losses that is deemed to be transferred at the conversion time to the MEC group head company.

→ 'Adjusting available fraction - a new eligible tier-1 company joins a MEC group', C10-2-310

Loss integrity rules

Provisions that apply to set the reference time for the head company of the MEC group for the purposes of the loss integrity rules in Subdivisions 165-CC and 165-CD will continue to apply. → sections 719-700 and 719-720, ITAA 1997

→ 'Effect of Subdivision 165-CD for MEC groups', C2-6-150; 'Effect of Subdivision 165-CC for MEC groups', C2-6-140

MEC group created from a consolidated group – special conversion event due to transfer-up (Division 711 and CGT event L5)

Another way in which a MEC group is created from a consolidated group is when the head company of a consolidated group, which itself is a potential MEC group, transfers all the membership interests in a subsidiary member (the transferred-up entity) to the top company (a 'transfer-up'), the transferred-up entity qualifies as an eligible tier-1 company of the top company and the head company makes a written choice that a MEC group forms and notifies the Commissioner, in the approved form and within the prescribed time, of that choice.

In a group conversion involving a transfer-up, even though the new eligible tier-1 company is an ongoing member, the tax cost setting rules in Division 711 apply to set the tax cost of the membership interests in that member.

The tax cost of the membership interests in the transferred-up entity just before the conversion time is worked out, under Division 711, to determine whether the head company has made a capital gain or loss on the transfer. As a result of Division 711 applying, CGT event L5 may also apply.

→ subsection 719-130(4), ITAA 1997

Where the transferred-up entity has membership interests in any lower tier subsidiary members, the tax cost setting rules in Division 711 apply to determine the tax cost of the transferred-up entity's membership interests in the lower-tier subsidiary members (i.e. using the 'bottom-up' approach). It is necessary to determine the tax cost of the lower tier subsidiary members' membership interests in order to work out the tax cost of the membership interests in the transferred-up entity. However, in applying Division 711 to the lower tier subsidiary members' membership interests, CGT event L5 will not happen in relation to the lower tier subsidiary members.

→ subsection 719-130(1), ITAA 1997

Example

In figure 1, HCo is the head company of a foreign-owned consolidated group. The ultimate foreign parent, TCo, qualifies as a top company.

HCo also satisfies the requirements to be an eligible tier-1 company. SubCo 1 and SubCo 2 are subsidiary members of the consolidated group.

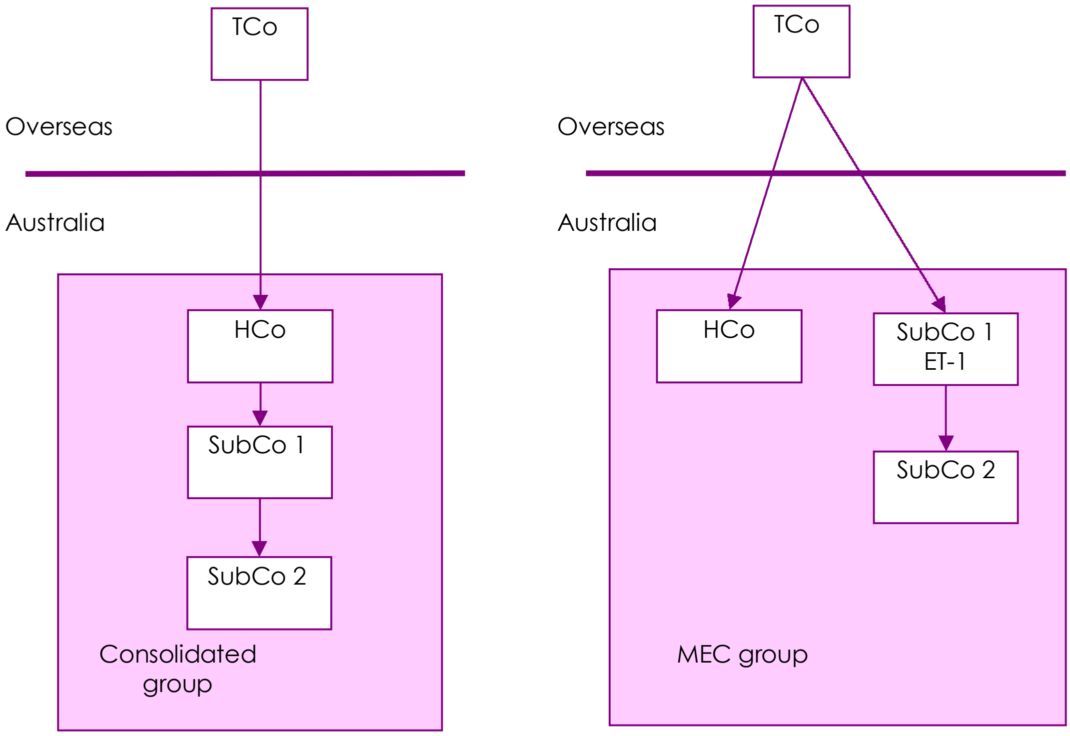
As part of a group restructure, HCo transfers all its membership interests in SubCo 1 to TCo.

SubCo 1 qualifies as an eligible tier-1 company of TCo, and HCo makes a written choice that a MEC group is to form with SubCo 1 as the new eligible tier-1 company and informs the Commissioner of that choice in the approved form and within the prescribed time.

Just before the conversion time, the tax cost of the membership interests in SubCo 2 is worked out under Division 711. However, CGT event L5 will not happen in relation to SubCo 2.

The tax cost of the membership interests in SubCo 2 is used in applying Division 711 to determine the tax cost of the membership interests in SubCo 1. This will determine whether HCo has made a capital gain or capital loss on the transfer. HCo may also make a capital gain under CGT event L5 in relation to the membership interests in SubCo 1.

Figure 1: Transfer-up



References

Income Tax Assessment Act 1997, Divisions 705 and 711, Subdivisions 104-L, 165-CC, 165-CD, 707-A, 719-F, 719-H, 719-I, 719-K and 719-T, sections 701-5, 703-55, 703-75, 719-40 and 719-90, and subsection 701-1(1).

Income Tax Assessment Act 1997, Subdivision 719-BA and Section 719-78; as inserted by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 2

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.65 - 5.10

Revision history

Section C10-1-210 first published 6 May 2011.

Worked example

Choice on formation, special conversion events and acquisition of new eligible tier-1 companies

Description

This example shows what happens when:

- a top company with existing consolidated, multiple entry consolidated (MEC) groups and unconsolidated eligible tier-1 companies acquires a new eligible tier-1 company
- two or more companies become eligible tier-1 companies of the top company of both a consolidated and a MEC group
- the top company of a MEC group acquires another consolidated MEC group
- there is a special conversion event – the top company of a MEC group which is also the top company of a consolidated group, acquires a consolidated or MEC group, and
- only some of the eligible tier-1 companies of a MEC group with a different top company join a consolidated or a MEC group.

Commentary

A MEC group can be formed in one of two ways:

1. when two or more eligible tier-1 companies of a top company make the choice to form a MEC group, or
2. when a MEC group is created from a consolidated group. This is known as a special conversion event.

→ 'Group conversions', C10-1-210

Once a decision is made by two or more eligible tier-1 companies to consolidate, the options for any remaining eligible tier-1 companies are to:

- form another MEC group
- form one or more consolidated groups, or
- remain outside consolidation.

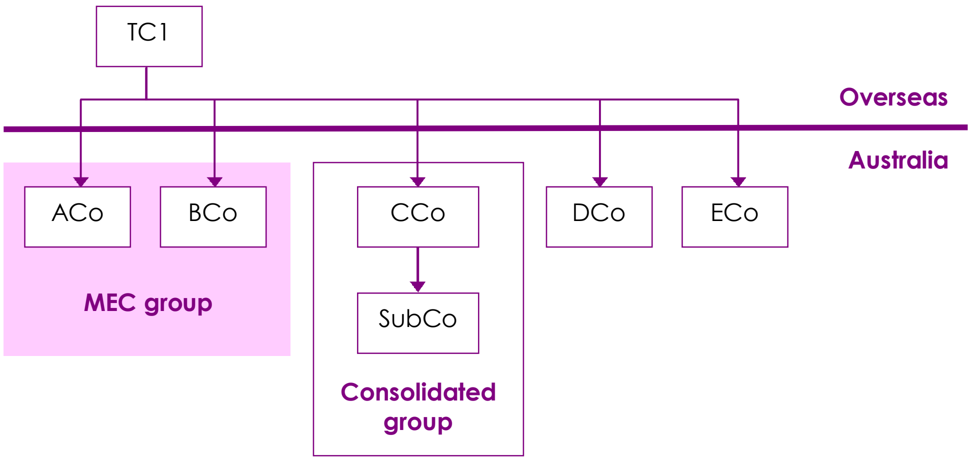
There are additional rules that apply to any new eligible tier-1 companies.

Examples

Assume that TC1 is the top company and ACo, BCo, CCo, DCo and ECo are eligible tier-1 companies, that is, they satisfy the residency and ownership requirements to consolidate.

Formation of a MEC group

Figure 1: Consolidation options of eligible tier-1 companies



Initially, all the eligible tier-1 companies have several ways to choose to consolidate:

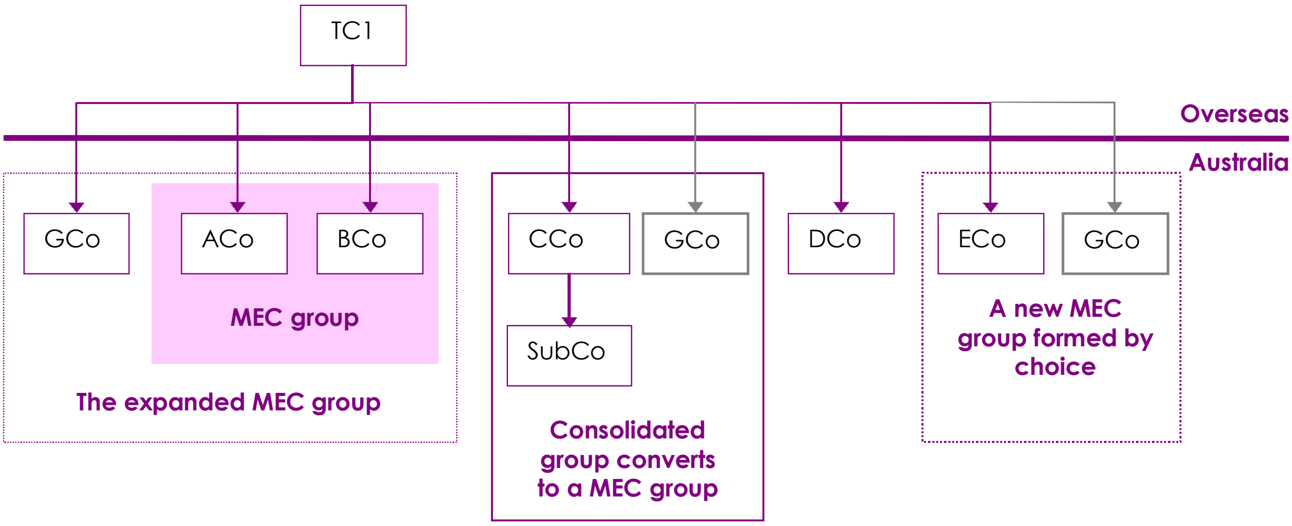
- Any two or more eligible tier-1 companies can choose to form a MEC group. Example: ACo and BCo.
- Each eligible tier-1 company together with a wholly-owned subsidiary can form a consolidated group with itself as the head company. Example: CCo and SubCo.
- Any eligible tier-1 company can choose not to consolidate. Example: DCo or ECo.

Once two or more eligible tier-1 companies form a MEC group or an eligible tier-1 company and its subsidiary or subsidiaries form a consolidated group, the remaining eligible tier-1 companies of the group cannot choose to join either of those particular groups. For example: DCo and ECo cannot choose to join either the MEC group or the consolidated group. While any eligible tier-1 companies remain outside consolidation, they are also prevented from becoming members of the MEC group as eligible tier-1 companies when it expands (example C). Nor can they become members of the MEC group as eligible tier-1 companies when a MEC group is created from the consolidated group (example D).

After the formation of a MEC group

(A) A top company with existing consolidated groups, MEC groups and unconsolidated eligible tier-1 companies acquires a new eligible tier-1 company

Figure 2: GCo becomes an eligible tier-1 company after group formation



Assume GCo becomes an eligible tier-1 company of the top company. This could occur through an acquisition of GCo by TC1.

When another company becomes a new eligible tier-1 company of the top company, some of the possibilities are:

- The provisional head company of the MEC group consisting of ACo and BCo can choose to make GCo a new eligible tier-1 company of that MEC group – that is, the MEC group expands.
- The head company of the consolidated group can choose to have the new eligible tier-1 company join as a member, thereby creating a MEC group from the consolidated group – that is, a special conversion event.
- Either at the joining time of GCo or later, any two or all of DCo, ECo and GCo can choose to form a separate MEC group.
- Either at the joining time of GCo or later, any one of DCo, ECo or GCo can choose to form a consolidated group – provided they have at least one qualifying subsidiary.
- The new eligible tier-1 company, GCo, can remain outside consolidation, similar to DCo and ECo in figure 1.

(B) When two or more companies become eligible tier-1 companies of the top company of both a consolidated group and a MEC group

When two or more companies become eligible tier-1 companies of the top company, some of the possibilities are:

- The provisional head company of the MEC group (see figure 1) can choose to expand to include any one or more of the new eligible tier-1 companies.
- The head company CCo, by including any one or more of the new eligible tier-1 companies, can create a MEC group from the consolidated group – a special conversion event.
- Some of the new eligible tier-1 companies can be in the expanded MEC group and the others in the MEC group formed by special conversion.
- Either at joining or later, any two or more of DCo, ECo and the acquired eligible tier-1 companies can choose to form a separate MEC group.
- Either at joining time or later, any one of DCo, ECo or the acquired eligible tier-1 companies can choose to form a consolidated group – provided they have at least one qualifying subsidiary.
- All of the new eligible tier-1 companies can remain outside consolidation.

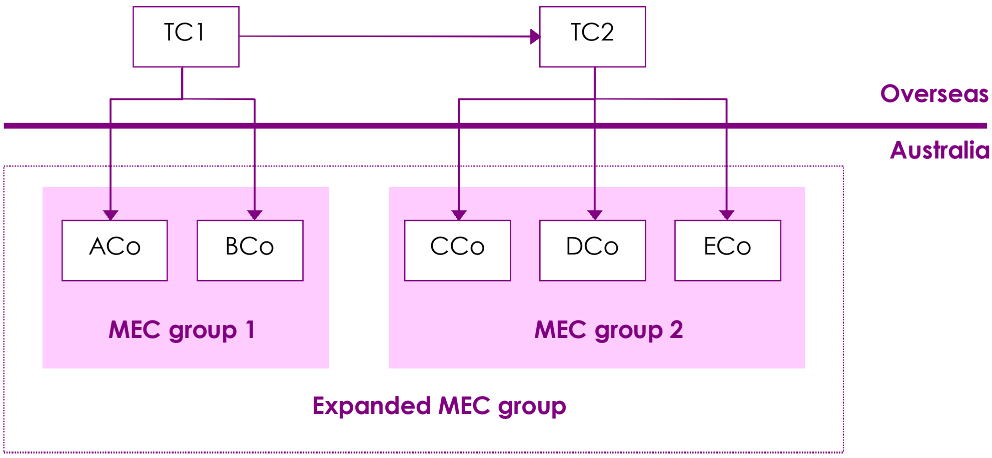
Note that if the new eligible tier-1 companies are members of a MEC group, and the MEC group is acquired as a whole, the provisional head company of the acquiring MEC group or the head company of the acquiring consolidated group must include all the eligible tier-1 companies of the acquired group in the expanded MEC group or the MEC group created from the consolidated group (a special conversion event).

When a special conversion event happens, the head company of the consolidated group becomes the provisional head company of the new MEC group.

(C) When the top company of a MEC group acquires another consolidated or MEC group

Assume that initially MEC group 1 and MEC group 2 are separately formed groups and subsequently TC1 acquires TC2.

Figure 3: Top company acquires other top company



When TC1 acquires TC2, the choices are either:

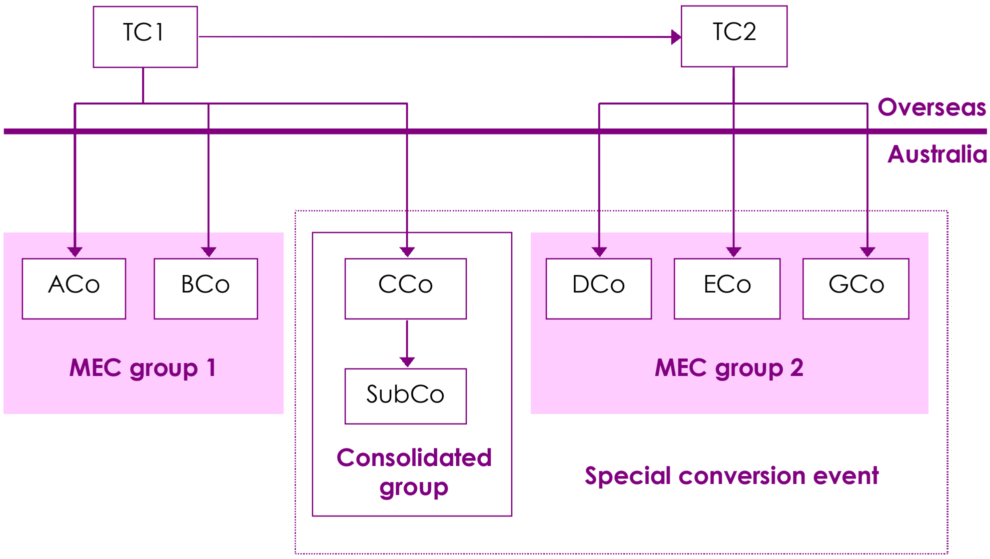
- MEC group 1 and MEC group 2 can remain independently consolidated with respect to each other, or
- the provisional head company of MEC group 1, ACo, can choose to expand to include the eligible tier-1 companies in MEC group 2 to become members of MEC group 1. All the eligible tier-1 companies in MEC group 2 must be included. The expanded MEC group will consist of ACo, BCo, CCo, DCo and ECo.

MEC group 2 ceases to exist from the time its members become members of MEC group 1. The provisional head company of MEC group 1, ACo, will be the provisional head company of the expanded MEC group.

(D) Special conversion event – when a MEC group's top company that is also the top company of a consolidated group acquires a consolidated or MEC group

Assume MEC group 1 and MEC group 2 are separately formed groups and TC1 acquires TC2. CCo is the head company of a consolidated group and an eligible tier-1 company of TC1 (figure 4).

Figure 4: Special conversion event



When TC1 acquires TC2, the choices are:

- MEC group 1 and MEC group 2 can merge as explained in example (C).
- MEC group 1 and MEC group 2 can remain as two separate MEC groups.
- CCo, as the head company of the consolidated group, can choose to make all of the eligible tier-1 companies of MEC group 2 its members and create a MEC group. This is known as a special conversion event. CCo will become the provisional head company of the new MEC group. Again, CCo must include all the eligible tier-1 companies of MEC group 2 as members.

(E) When only some of the eligible tier-1 companies of a MEC group with a different top company join a consolidated or a MEC group

In example D above, if instead of acquiring membership interests in TC2, TC1 were to acquire all the membership interests in DCo and ECo but not in GCo, it will be treated like the acquisition of two eligible tier-1 companies by TC1 (see example B). This is because DCo and ECo cease to be members of MEC group 2 as soon as they cease to be wholly-owned subsidiaries of TC2.

Note: GCo should nominate itself as the new provisional head company of MEC group 2.

Some of the options available to the group owned by TC1 on the acquisition of DCo and ECo are:

- The provisional head company of MEC group 1 can choose to expand its group by including DCo or ECo or both in its group.
- A MEC group can be created from the consolidated group by CCo, the head company of the consolidated group, including DCo or ECo or both in its group.
- In a combination of these first two options, one of DCo or ECo could join MEC group 1 as a new eligible tier-1 company, and the other could join CCo's consolidated group, creating a MEC group.
- DCo and ECo can form a new MEC group by making a choice to do so.
- DCo and ECo can remain outside consolidation (since neither of them has a wholly-owned subsidiary, they are unable to form their own consolidated group with themselves as the head company).

References

Income Tax Assessment Act 1997, sections 719-5, 719-40 and 719-50; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 4

Income Tax Assessment Act 1997; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 8

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, Chapter 8, paragraphs 8.19 to 8.23

Income Tax Assessment Act 1997, Subdivision 719-BA; as inserted by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 2

Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5, paragraphs 5.65 – 5.100 and 5.105 – 5.108

Revision history

Section C10-2-110 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
26.10.05	Extensive changes throughout.	For clarification.
6.5.11	Revisions to reflect changes to the cost setting rules when groups convert.	Legislative amendments.

Worked example

Original and new eligible tier-1 companies of a MEC group

Description

This example explains the differences between 'original' and 'new' eligible tier-1 companies and how those differences apply when a MEC group expands or a MEC group is created from a consolidated group. A MEC group may expand when it (or its top company) acquires another MEC group, a consolidated group or new eligible tier-1 companies. Note that only the provisional head company of the acquiring group can make the choice to expand. The acquired group cannot choose to expand.

Commentary

Broadly, original eligible tier-1 companies of a MEC group are those eligible tier-1 companies that:

- were party to the choice to form the MEC group and have continued to be eligible tier-1 companies of the top company since that formation, or
- joined at the time when a MEC group was created from a consolidated group under the special conversion event rules and have continued to be eligible tier-1 companies of the top company since that creation.

In the second situation, the head company of the consolidated group would be an original eligible tier-1 company of the MEC group created from the consolidated group.

→ 'Group conversions', C10-1-210

Note

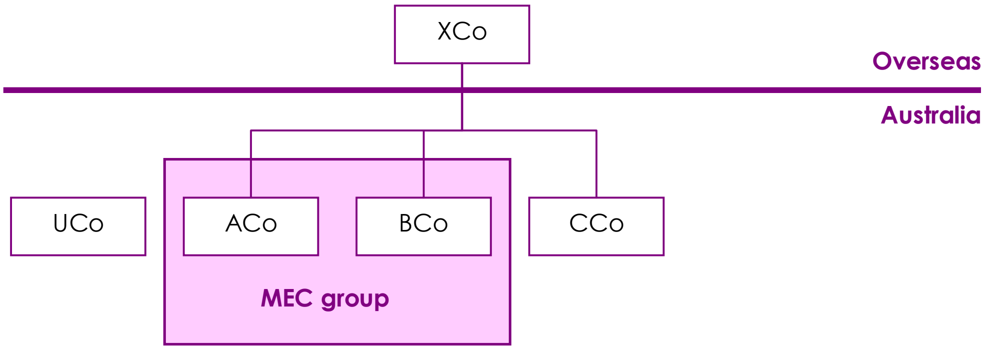
Making a choice in writing and notifying the Commissioner

The choice to expand a MEC group or create a MEC group from a consolidated group must be made in writing and notified to the Commissioner in the prescribed time. → 'Choice in writing', C7-1-110; 'MEC groups – notices to be given to the Commissioner, C10-1-110

Example 1 Original eligible tier-1 companies when a MEC group forms by choice

In figure 1, ACo, BCo, and CCo are eligible tier-1 companies of the top company XCo. UCo is an unrelated Australian-resident company. ACo and BCo have chosen to form a MEC group, but CCo has not chosen to be part of the MEC group.

Figure 1: MEC group formed by choice

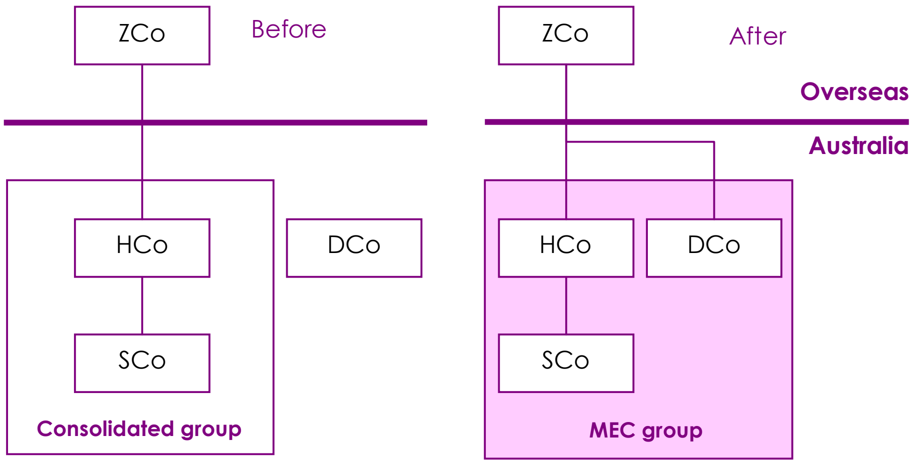


ACo and BCo are original eligible tier-1 members of the MEC group. CCo cannot later join this MEC group as a new eligible tier-1 member because it did not become an eligible tier-1 company of the top company after the group formed. Nor can CCo join the MEC group if the group expands as a consequence of new eligible tier-1 companies becoming members of the group.

Example 2 Original eligible tier-1 members after a special conversion event

In figure 2, HCo is the head company of a consolidated group formed with its wholly-owned subsidiary, SCo. HCo is the wholly-owned Australian-resident subsidiary of the foreign parent, ZCo.

Figure 2: MEC group from a consolidated group (special conversion event)



HCo is also an eligible tier-1 company of a potential MEC group with ZCo as its top company.

DCo is an unrelated Australian-resident company.

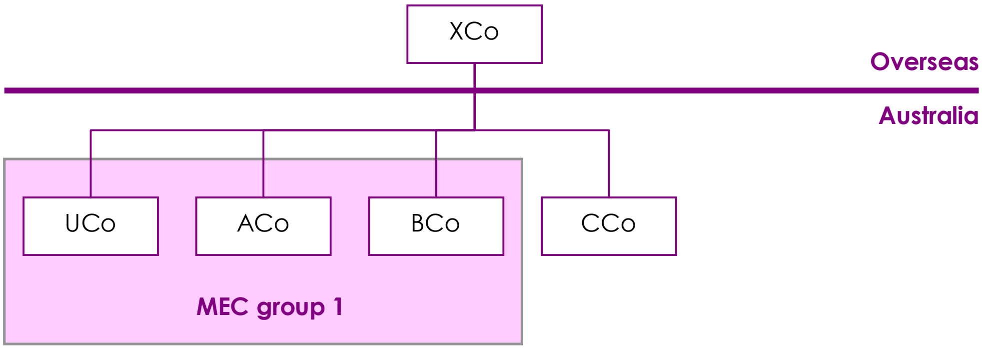
If ZCo acquires all the membership interests in DCo, the latter would also become an eligible tier-1 company of ZCo. HCo, as the head company of the consolidated group, can make a choice in writing that DCo is to become a member of the group, and as a result a MEC group is created at that time (the conversion time). This is known as a special conversion event. At the conversion time, HCo's consolidated group ceases to exist and HCo's MEC group comes into existence. Both HCo and DCo will be original eligible tier-1 members of the MEC group.

→ 'Choice in writing', C7-1-110; 'Group conversions', C10-1-210

Example 3 New eligible tier-1 members of a MEC group

Broadly, new eligible tier-1 members of a MEC group are companies that become eligible tier-1 companies of the top company, and members of the MEC group, after the group has formed. Figure 3 shows how this might apply to the companies described in example 1.

Figure 3: New eligible tier-1 companies of a MEC group



XCo acquires all the membership interests in UCo, and UCo becomes an eligible tier-1 company of XCo. ACo, the provisional head company, makes a choice in writing that UCo is to become a member of the MEC group. UCo will be a new eligible tier-1 member of the MEC group.

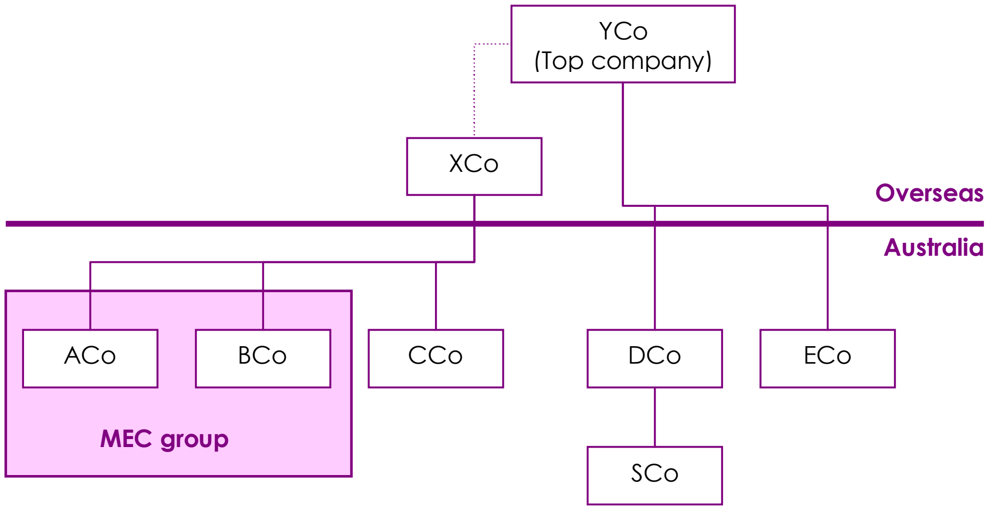
→ 'Choice in writing', C7-1-110

CCo can never become a new eligible tier-1 member of the MEC group formed by ACo and BCo, because it did not become an eligible tier-1 company of the top company after the MEC group formed.

Example 4 When a new top company has no consolidated or MEC groups

When the top company of a MEC group is taken over by a new top company whose Australian subsidiaries have not formed either consolidated groups or MEC groups, a number of outcomes are possible.

Figure 4: The new top company has no MEC or consolidated groups



The following information is known about the companies in figure 4:

- ACo, BCo and CCo are all eligible tier-1 companies of top company XCo.
- ACo and BCo have chosen to form a MEC group, while CCo has not chosen to be part of the MEC group.
- DCo and ECo are eligible tier-1 companies of top company YCo.
- SCo is a wholly-owned subsidiary of DCo.
- DCo and ECo have not formed a MEC group.
- DCo and SCo have not formed a consolidated group.

After the MEC group is formed, YCo takes over XCo and becomes the new top company of the MEC group formed by ACo and BCo. This MEC group continues with ACo and BCo as original eligible tier-1 members. DCo, ECo and SCo are not members of a MEC group or a consolidated group at the time of YCo taking over XCo so there cannot be an expansion of a MEC group.

CCo cannot join ACo and BCo's MEC group as an eligible tier-1 member, because CCo did not become an eligible tier-1 company of the top company, YCo, after the MEC group formed. DCo and ECo cannot join as eligible tier-1 members either because they are not new eligible tier-1 companies with respect to YCo, the top company for the MEC group.

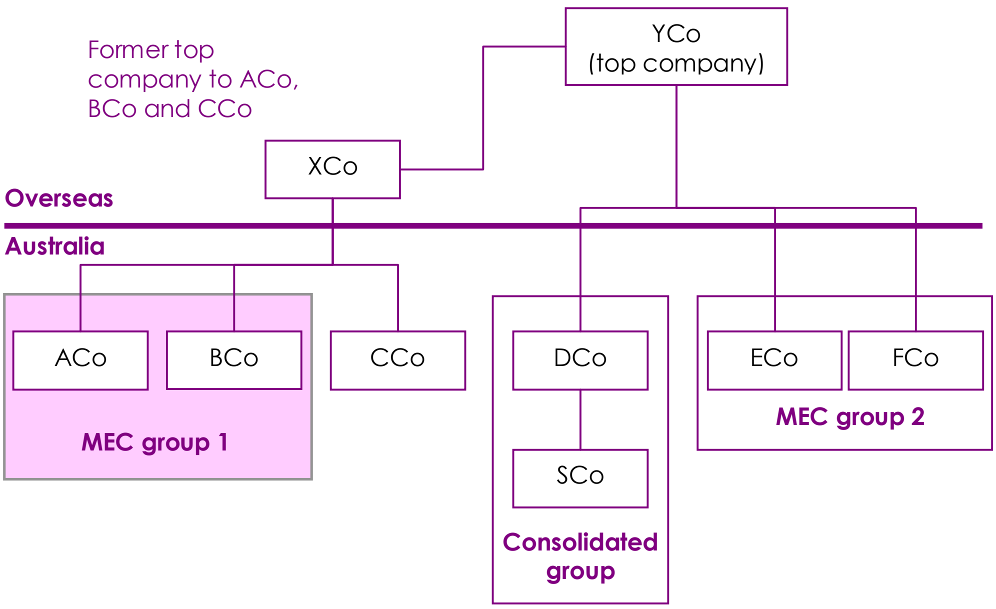
Possible outcomes include:

- DCo and ECo can form a MEC group (they will be original eligible tier-1 members of that potential MEC group)
- DCo and SCo can form a consolidated group
- CCo can join with DCo and ECo if they form a MEC group, or
- either DCo or ECo can join with CCo to form a MEC group.

Example 5 When the new top company has MEC groups or consolidated groups

When the top company of a MEC group is taken over by another company that already has MEC groups or consolidated groups in Australia, a number of outcomes are possible.

Figure 5: The new top company has MEC or consolidated groups



The following information is known about the companies in figure 5:

- ACo, BCo and CCo are eligible tier-1 companies of top company XCo.
- ACo and BCo have chosen to form MEC group 1, with ACo as provisional head company. CCo did not choose to consolidate.
- DCo, ECo and FCo are eligible tier-1 companies of top company YCo.
- SCo is a wholly-owned subsidiary of DCo.
- DCo (as head company) has formed a consolidated group with SCo.
- ECo and FCo have formed MEC group 2, with ECo as provisional head company.

After the groups have formed, YCo takes over XCo and becomes the top company of MEC group 1 formed by ACo and BCo.

Possible outcomes include:

- MEC group 1, MEC group 2, Consolidated group and CCo remain as they were before the restructure.
- DCo could make a choice for:
  - ACo and BCo only
  - CCo only, or
  - ACo, BCo and CCo

  to become members of DCo's group. If DCo makes any of these choices, a MEC group will be created from DCo's consolidated group. Depending on which choice DCo makes, DCo and the other eligible tier-1 companies who join the group will be original eligible tier-1 members of the MEC group created from the consolidated group.
- MEC group 2 could expand if its provisional head company, ECo, chooses to include:
  - ACo and BCo only
  - CCo only, or
  - ACo, BCo and CCo

  as members of MEC group 2. ECo together with FCo will be original eligible tier-1 members. And, depending on which choice ECo makes, the other eligible tier-1 companies who join the group will be new eligible tier-1 members of the expanded MEC group.

Only provisional head companies or head companies of an acquiring group can choose to expand their groups. In this case, ACo and ECo are the provisional head companies of MEC group 1 and MEC group 2 respectively, and DCo is the head company of the consolidated group. Because YCo acquires XCo, the head company and provisional head company of the 'acquiring' groups, DCo and ECo respectively, are able to expand their respective groups by including ACo, BCo and CCo from the 'acquired' group.

Note that, because ACo and BCo are members of a MEC group, both must be included in the MEC group created from the consolidated group or the expanded MEC group.

References

Income Tax Assessment Act 1997, Division 719 as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Income Tax Assessment Act 1997, Division 719 as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 8

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 4

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, Chapter 8, paragraphs 19 to 23

Income Tax Assessment Act 1997, Subdivision 719-BA as inserted by *Tax Laws Amendment (2010 Measures No. 1) Act 2010 (* No. 56 of 2010) Schedule 5, Part 2

Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5, paragraphs 5.65 to 5.100 and 5.105 to 5.108

Revision history

Section C10-2-115 first published 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
26.10.05	Editorial changes.	For clarification.
6.5.11	Significant revisions to reflect changes to the choice provisions and group conversions.	Legislative amendments.

Worked example

Transitional provisions for foreign-held, Australian-resident subsidiaries to be members of a MEC group

Description

The examples in this section show how a wholly-owned, Australian-resident subsidiary can be a member of a MEC group even when a foreign-resident entity is interposed between it and other members of the MEC group, provided the MEC group is formed during the transitional period, 1 July 2002 to 30 June 2004.

This section also shows how the application of the cost setting rules for such a member depends on whether membership interests in the entity are held directly or indirectly by the foreign-resident entity.

Commentary

A wholly-owned, Australian-resident subsidiary of one or more eligible tier-1 companies of a MEC group can generally be a member of that MEC group only if any entities interposed between it and the eligible tier-1 companies:

- are also members of the MEC group, or
- hold membership interests only as nominees for other members of the MEC group.

However, where a MEC group is formed during the transitional period, a wholly-owned, Australian-resident subsidiary will be a member (where there are interposed foreign resident entities) if it satisfies the interposed foreign-resident entity (IFRE) tests.

For a company to be a subsidiary member of a MEC group under the IFRE tests, the group must form before 1 July 2004 and, at the formation time:

- the company (the test company) must be a wholly-owned, Australian-resident subsidiary of one or more eligible tier-1 companies of the group
- there must be at least one non-resident company or non-resident trust interposed between the test company and the eligible tier-1 companies
- any other entity interposed between the test company and the eligible tier-1 companies must be either:
  - a non-resident company or non-resident trust (or a partnership in which each partner is a non-resident company or non-resident trust), or
  - a member of the MEC group (or an entity holding membership interests as a nominee for one or more other members of the MEC group), and
- the company must qualify to be a member of the MEC group if it were assumed that each of the interposed non-resident entities were a member.

There are restrictions on trusts and partnerships being members of a MEC group under the IFRE tests. A resident trust or resident partnership (and its subsidiaries, if any) cannot be a member of a MEC group where it immediately follows the interposed foreign resident – that is, where any membership interests are directly held by the interposed foreign resident. Trusts and partnerships can be members under the IFRE tests only if some or all membership interests in them are owned by entities that are already subsidiary members of the MEC group under the IFRE tests and any remaining interests are held by other members of the group.

→ For more information on eligibility see page 3.

Note

'All in' principle applies

Where an entity qualifies to be a subsidiary member of a MEC group under the IFRE tests, the 'all in' principle in consolidation requires that it must be a member of the group, subject to the operation of Division 701D of the *Income Tax (Transitional Provisions) Act 1997*. → 'Transitional foreign loss makers', C3-4-550

Classification of foreign-held subsidiaries

Members of a MEC group that qualify under the IFRE tests are classified into two categories:

- If any membership interests in the member are held directly by an interposed non-resident entity, the member is a 'transitional foreign-held subsidiary' (TFHS).
- If no membership interest is held directly by an interposed non-resident entity, that is all of the membership interests are held by other members of the group, the member is a 'transitional foreign-held *indirect* subsidiary' (TFHIS).

→ For more information on the categories of foreign-held subsidiary and cost setting implications see page 6.

Transitional period

Only MEC groups that form by 30 June 2004 can have members under the IFRE tests. This means a potential MEC group that has not formed a MEC group by 30 June 2004 does not include foreign-held subsidiaries.

After formation, an entity can be a TFHS of a MEC group only if it was a subsidiary member under the IFRE tests at the formation time. This prevents a company becoming a TFHS of an existing MEC group if the company was not at least partly foreign-held at the formation time.

→ For more information on eligibility at and after the formation time see page 4.

Examples

Basic eligibility

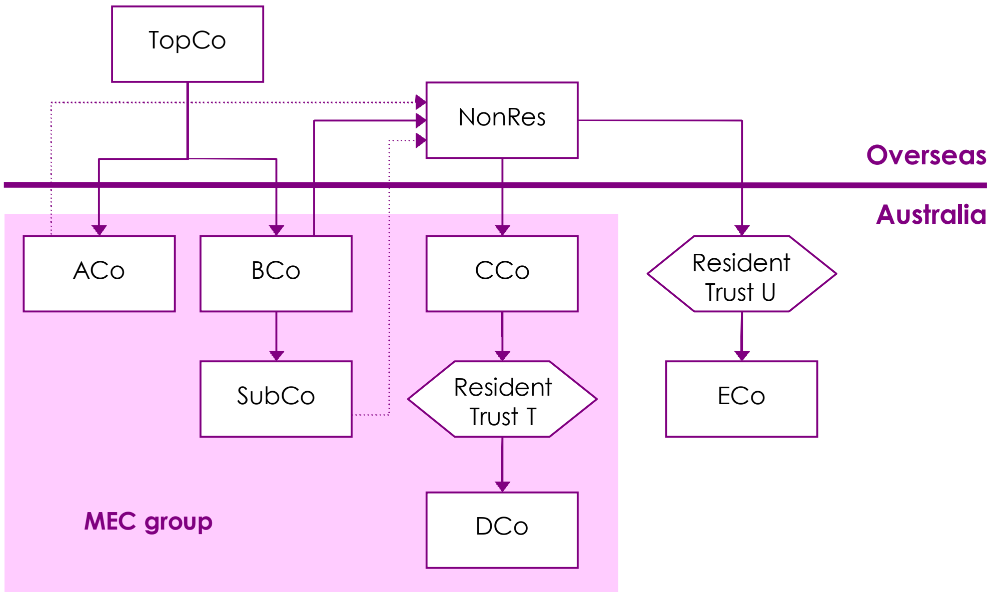
In figure 1, the foreign resident entity NonRes is interposed between an eligible tier-1 company (BCo) and some of its wholly-owned Australian resident subsidiaries: the companies CCo, DCo and ECo, and the trusts Resident Trust T and Resident Trust U.

Under the IFRE tests:

- CCo is a member of the MEC group.
- Resident Trust T and its subsidiary company DCo are members of the MEC group because Resident Trust T is a wholly-owned subsidiary of CCo, which is a member of the MEC group under the IFRE tests.
- Resident Trust U is not a member of the MEC group because a resident trust or partnership cannot be a member if it immediately follows an interposed foreign resident. ECo, which is a subsidiary of Resident Trust U, also cannot be a member.

The interposed foreign resident can be a wholly-owned subsidiary of one or more eligible tier-1 companies of the MEC group and/or other subsidiary members of the group. In this example, the eligibility of the foreign-held subsidiaries would be the same if NonRes were wholly owned by BCo, SubCo or ACo, or any combination of these.

Figure 1: Membership of foreign-held subsidiaries



Eligibility – time of formation and post-formation changes

After formation, a company can cease to be a TFHS of a MEC group if its circumstances change. It cannot, however, *become* a TFHS after formation unless it qualified as a TFHS under the IFRE tests at the time the MEC group was formed (which must have been before 1 July 2004).

Figure 2 shows the TopCo group of entities at the time that its Australian-resident companies form a MEC group, which is before 1 July 2004. ACo and BCo are two eligible tier-1 companies of the MEC group.

DCo is a TFHS of the MEC group at the formation time.

After formation, NonRes acquires all of the membership interests in CCo and XCo, and the remaining membership interests in DCo (figure 3).

Figure 2: Group at formation time (before 1 July 2004)

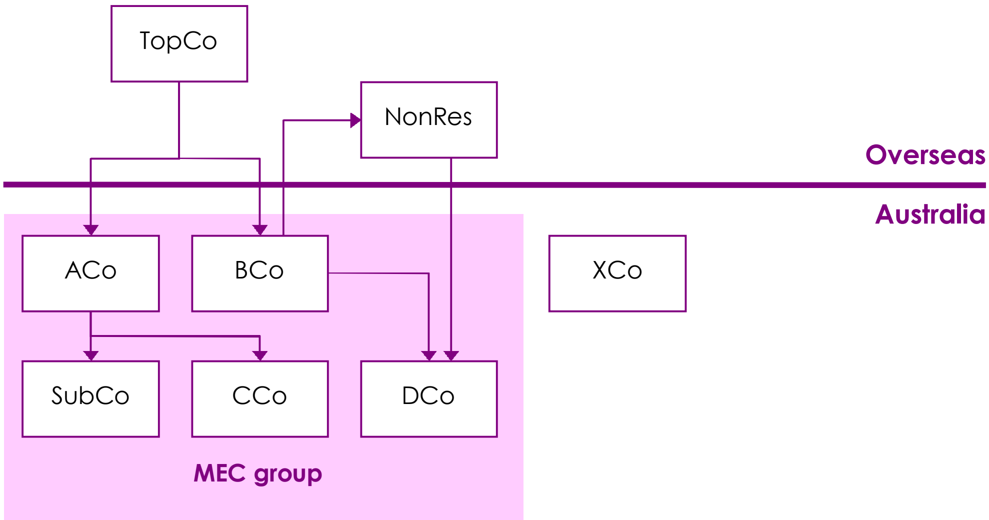
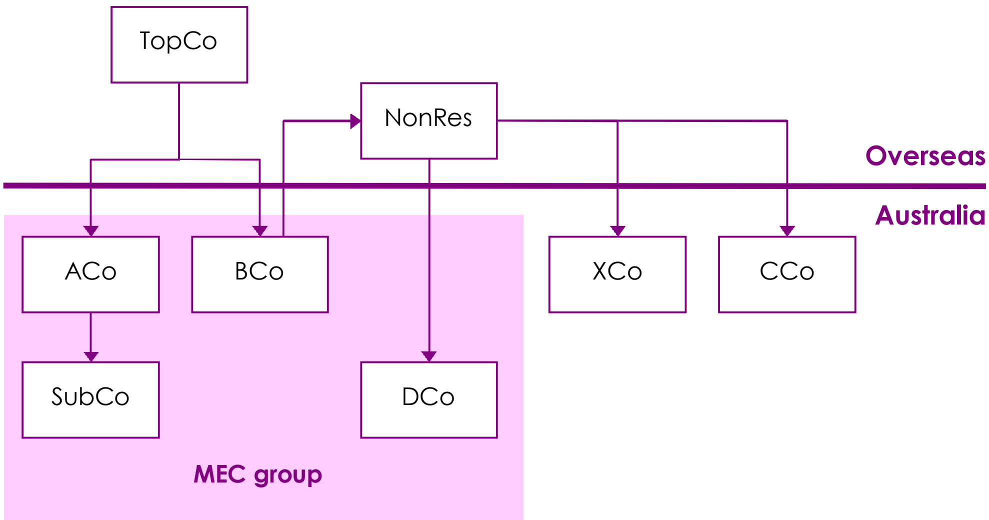


Figure 3: Group after post-formation changes in membership interests



Although XCo becomes a wholly-owned Australian resident subsidiary of TopCo it cannot become a member of the MEC group because at the time of formation it was not a TFHS of the MEC group.

CCo cannot continue to be a member of the MEC group when NonRes acquires all the membership interests in CCo from ACo because the interposed foreign resident (NonRes) did not have any membership interests in CCo at the time the MEC group was formed (CCo was not a TFHS at the time the MEC group was formed).

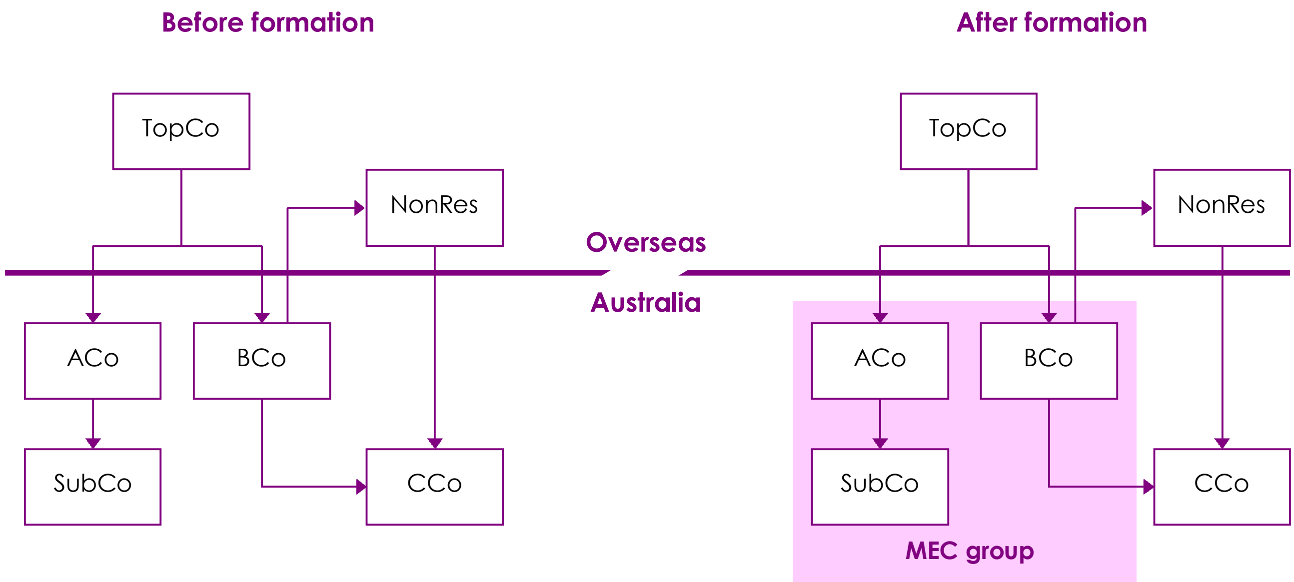
DCo will continue to be a TFHS of the MEC group when NonRes acquires the remaining membership interests in DCo from BCo because at the formation time some of its membership interests are held by NonRes (DCo was a TFHS at the time the MEC group formed).

Formation after 1 July 2004

For an entity to be considered for membership of a MEC group under the IFRE tests, the group must form before 1 July 2004.

ACo, BCo, CCo, SubCo, TopCo and NonRes are members of a wholly-owned group. If the resident entities of the group consolidate after 1 July 2004, CCo cannot be a member of the resulting MEC group.

Figure 4: Group formation after 1 July 2004



Cost setting implications

Subsidiaries that qualify as members of a MEC group under the IFRE tests are classified as either a:

- transitional foreign-held subsidiary (TFHS), in which one or more membership interests are directly held by a foreign resident (in figure 5, ACo, BCo and CCo), or a
- transitional foreign-held *indirect* subsidiary (TFHIS), in which no membership interests are directly held by a foreign resident – that is, the membership interests are held entirely by members of the MEC group (in figure 5, the AB partnership, Trust T and DCo).

The cost setting rules apply differently to each category.

An eligible member in which some membership interests are held directly by a foreign resident and the remaining interests are held by a TFHS (such as BCo in figure 5) is itself a TFHS.

A MEC group or a consolidated group can have a TFHIS only if it has a TFHS.

Figure 5: TFHS and TFHIS members

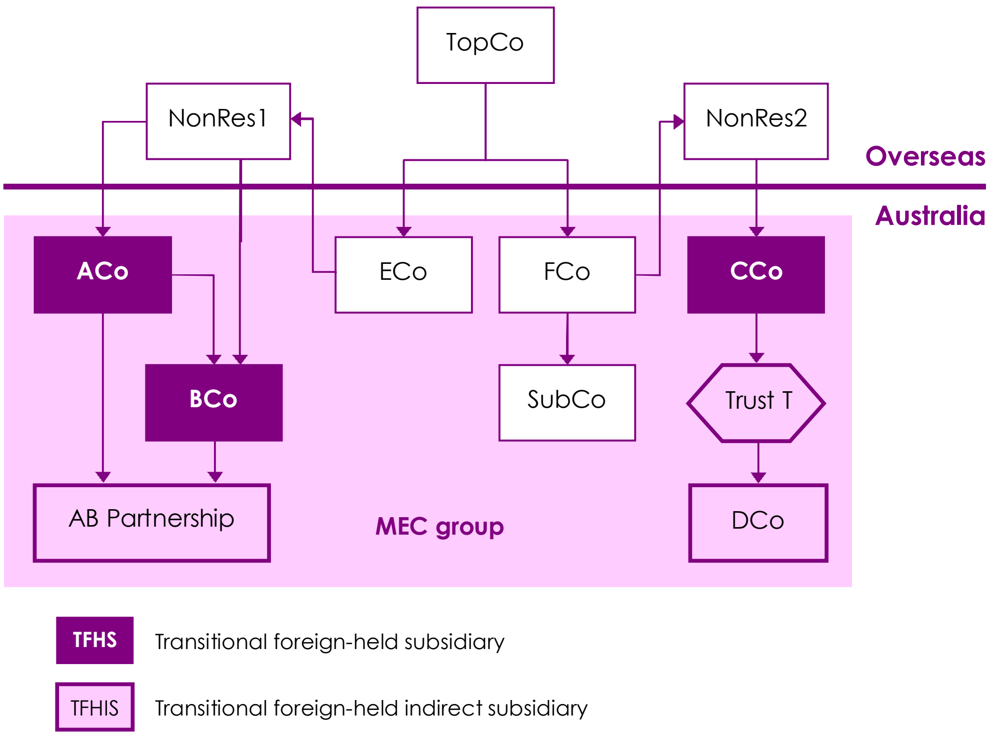


Table 1: Cost setting rules for TFHS and TFHIS members

	Transitional foreign-held subsidiary (TFHS)	Transitional foreign-held indirect subsidiary (TFHIS)
At formation time	A TFHS is treated as if it were a part of the head company of the MEC group. The effect of this modification is that the tax costs of the assets of a TFHS are not set – they retain their terminating values.	The formation cost setting rules for a TFHIS of a MEC group apply in a similar way as they apply to a subsidiary member of a consolidated group. The head company can choose to either retain the terminating values of the assets of the TFHIS or set new tax costs if it is a transitional entity of the transitional group. → For more information see 'Treatment of transitional entity and TFHIS'.
Trading stock	As the tax costs of the assets of a TFHS are not set, it is not necessary to set a tax neutral amount for the trading stock of a TFHS. → section 701C-35, *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A 1997)	If the tax cost set for trading stock of a TFHIS would otherwise be more than its market value or terminating value, it is restricted to the greater of the two amounts. → section 705-40, *Income Tax Assessment Act 1997* (ITAA 1997) If the TFHIS is also a 'continuing majority owned entity', the trading stock is treated as a retained cost base asset and the value of the trading stock is worked out under Division 70 of the ITAA 1997.
At leaving time	When a TFHS leaves a MEC group, modified leaving time cost setting rules apply. Membership interests in the TFHS held by non-residents are treated as if the head company of the group holds them. → sections 701C-40 and 701C-50, (IT(TP)A 1997)	Leaving time cost setting rules apply without any modification when a TFHIS leaves a MEC group.

Treatment of 'transitional entity' and TFHIS

A 'transitional entity' is an entity that becomes a member of a consolidated or MEC group during the transitional period and satisfies certain additional ownership requirements prior to becoming a member. A consolidated or MEC group that has a transitional entity is a 'transitional group'. The head company of a transitional group may choose that the assets of a transitional entity retain their existing tax values at the joining time instead of being reset.

→ 'Treatment of assets', C2-1

The head company of a TFHS does not have this choice. The assets of a TFHS retain their tax costs at the joining time.

Where a TFHIS also qualifies as a transitional entity, the head company of the group may choose between setting the costs of the assets and retaining their costs at the joining time.

Cost setting on exit

When a TFHS leaves a MEC group, Division 711 of ITAA 1997, as modified by Subdivision 701C-C of IT(TP) Act 1997, applies to set the cost of membership interests in the TFHS held by a non-resident entity. Membership interests in the TFHS held by an interposed non-resident entity are treated as if the head company of the group held the interests.

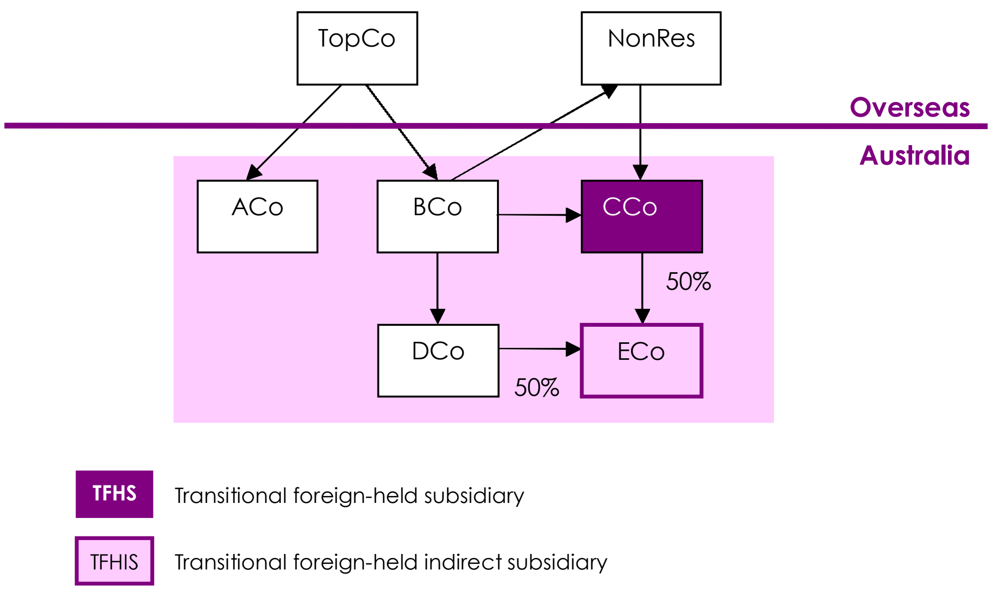
As membership interests in a TFHIS can only be held by members of the MEC group, Division 711 of ITAA 1997 applies to set the cost of membership interests in these entities when they leave a MEC group, in the same way it applies to any other subsidiary member leaving the group.

Example – cost setting

Facts

Figure 6 shows the TopCo group of entities at the time its Australian resident companies form a MEC group, which is before 1 July 2004. ACo and BCo are eligible tier-1 companies. CCo is a TFHS at the formation time because some of its membership interests are held by NonRes, a wholly-owned non-resident subsidiary of BCo. ECo is a TFHIS because 50% of its membership interests are owned by CCo, a TFHS, but none of its membership interests are directly owned by NonRes.

Figure 6: Group structure at formation time



The financial positions of CCo and ECo at the formation time are shown in tables 2 and 3.

Table 2: CCo – financial position at formation time ($)

Cash	100	Equity	410
Land (MV $200, CB $100)	100		
Motor vehicle (MV $10, AV $10)	10		
Membership interests in ECo MV $250, CB $200)	200		
	410		410

MV: market value. CB: market value. AV: adjustable value

Table 3: ECo – financial position at formation time ($)

Cash	200	Equity	400
Land (MV $200, CB $100)	100		
Equipment (MV $100, AV $100)	100		
	400		400

Assume the tax cost setting amount (TCSA) for the membership interests DCo holds in ECo as calculated under Division 705 of the ITAA 1997 is $150.

For more information about calculating the TCSAs for assets that a subsidiary brings into a consolidated group see 'The cost setting process on entry', C2-2-110.

Calculating the TCSAs for CCo's assets

CCo is a TFHS. It is treated as part of the head company for cost setting purposes and the tax costs of its assets will not be reset at the formation time. The group's tax costs for CCo's assets are:

Cash	$100
Land	$100
Motor vehicle	$10
Membership interests in ECo	$200

Calculating the TCSAs for ECo's assets

ECo is a TFHIS. The tax costs of the assets it brings to the group at formation are set under Division 705 of the ITAA 1997 (unless ECo meets the requirements to be a transitional entity of a transitional group in which case the head company may choose to retain existing tax values for Eco's assets).

Calculating the ACA

Step 1. Cost of membership interests

As the market value of CCo's membership interests in ECo ($250) is greater than the cost base ($200), the step 1 amount is the cost base → section 705-65, ITAA 1997. The step 1 amount for the membership interests DCo holds in ECo is the TCSA calculated for those interests ($150) → section 705-145, ITAA 1997.

The total step 1 amount is therefore $350.

Steps 2 to 7

There are no steps 2 to 7 amounts.

The ACA available to be allocated to ECo's assets is therefore $350.

Allocating the ACA

ECo's cash is a retained cost base asset with a tax cost setting amount equal to the amount of Australian currency concerned ($200) → section 705-25, ITAA 1997. The remainder of the ACA ($150) is then apportioned among ECo's remaining assets, other than excluded assets, in proportion to their market values, as shown in table 4 → section 705-35, ITAA 1997.

Table 4: Apportionment of ACA to ECo's reset cost base assets ($)

Asset	Terminating value (TV)	Market value (MV)	ACA apportioned	Assets held on revenue account – excess over greater of TV or MV	TCSA
Land	100	200	100		100
Equipment	100	100	50	0	50
Total		300	150	0	150

The TCSA of a depreciating asset cannot exceed the greater of the asset's market value and the joining entity's terminating value for the asset → section 705-40, ITAA 1997.

The terminating value for the Equipment, a depreciating asset, is equal to its adjustable value just before the joining time ($100) → section 705-40, ITAA 1997. As the TCSA of the equipment ($50) does not exceed the greater of the MV ($100) and the TV ($100), there is no adjustment to the TCSA.

Frankable distributions by a TFHS

Any frankable distributions made by a TFHS to a foreign resident are treated as distributions made by the head company of the MEC group.

→ subsection 719-435(2), ITAA 1997

References

Income Tax Assessment Act 1997, sections 703-45 and 719-10

Income Tax (Transitional Provisions) Act 1997:

- Division 701A
- Division 701D
- Subdivisions 701-A and 701C-B
- section 719-15

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 4

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002:

- chapter 4
- paragraphs 9.51 to 9.54

Explanatory Memorandum to the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, paragraphs 1.77 to 1.88

Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 6) 2003, paragraphs 3.122 to 3.129

Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 7) 2003, Chapter 4

Revision history

Section C10-2-120 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
27.10.03	Complete revision of section to include more information on: • eligibility under the IFRE tests • the transitional period – restrictions on when a MEC group must form to have members under the IFRE tests, and restrictions on post-formation membership changes • the cost setting implications for different types of members under the IFRE tests.	Provide more information about the operation of the measure generally. Include rules set out in *Taxation Laws Amendment Act (No. 6) 2003* (No. 67 of 2003).
26.10.05	Extensive changes throughout.	For clarification.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Provisional head company

Description

This example explains:

- how a company qualifies to be a provisional head company (PHC) of a multiple entry consolidated (MEC) group
- how a PHC is appointed
- a PHC's income tax obligations, and
- how a PHC may be replaced, and what happens when it is replaced.

Commentary

Only an eligible tier-1 company can be a PHC of a MEC group. To qualify as the PHC, the eligible tier-1 company must have all its membership interests owned by entities outside the MEC group.

All the eligible tier-1 companies that make a choice in writing to form the MEC group must jointly appoint one of themselves to be the PHC of the group. The choice to consolidate and the appointment of the PHC must be notified to the Commissioner. → subsections 719-50(1), 719-60(1), section 719-76, *Income Tax Assessment Act 1997* (ITAA 1997); 'Choice in writing', C7-1-110; 'MEC groups – notices to be given to the Commissioner', C10-1-110

When a MEC group is created from a consolidated group as a result of a special conversion event, the eligible tier-1 companies of the MEC group are taken to have appointed the head company of the former consolidated group as the PHC of the MEC group. → section 719-40, subsection 719-60(2), section 719-78, ITAA 1997; 'Choice on formation, special conversion events and acquisition of new eligible tier-1 companies', C10-2-110; 'Group conversions', C10-1-210)

The provisional head company remains the PHC until a cessation event, which happens if the PHC ceases to exist or ceases to satisfy the qualifying conditions for being a PHC. The Commissioner must be notified if a cessation event happens. → 'MEC groups – notices to be given to the Commissioner', C10-1-110

Income tax obligation of a PHC

The PHC of the group at the end of the income year is taken to be the head company of the MEC group for the whole income year. The head company fulfils the end-of-year income tax obligations of the group, including lodging one income tax return for the group and reconciling PAYG instalments.

During the year, the PHC is also responsible for maintaining the franking account.

A frankable dividend paid by an eligible tier-1 company or a transitional foreign-held subsidiary of the MEC group to an entity that is not a member of the MEC group is taken to have been paid by the PHC for the purposes of applying the franking rules.

The head company is an Australian corporate tax entity for the purposes of applying the conduit foreign income provisions in Subdivision 802-A of the ITAA 1997. Amounts of conduit foreign income received by subsidiary members of the MEC group are treated as being received by the head company. → 'Treatment of conduit foreign income', C6-2-410; section 715-875, ITAA 1997

Replacing a PHC

Once a MEC group is formed, circumstances may change whereby the group no longer has a PHC, such as where a PHC becomes ineligible because it ceases to be a wholly-owned subsidiary of the top company. Such a change will not necessarily affect the ongoing existence of the group. All the eligible tier-1 companies of the group can make a choice in writing to appoint a replacement PHC → 'Choice in writing', C7-1-110.

A replacement PHC can be appointed provided that:

- it has all its membership interests owned by entities outside the MEC group, and
- it has been a member of the MEC group at all times during the period beginning at either:
  - the start of the income year – if the group was in existence at the beginning of the income year in which the cessation event happened, or
  - the time the group came into existence – if the group came into existence during the income year in which the cessation event happened,

  and ending when the cessation event happened.

→ subparagraph 719-65(3)(d)(i), ITAA 1997; paragraphs 5.101 to 5.104 of Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No. 1) Bill 2010

The appointment of a new PHC must be notified to the Commissioner.
→ 'MEC groups – notices to be given to the Commissioner', C10-1-110

A replacement PHC must take on the same accounting period as that adopted by the former PHC.

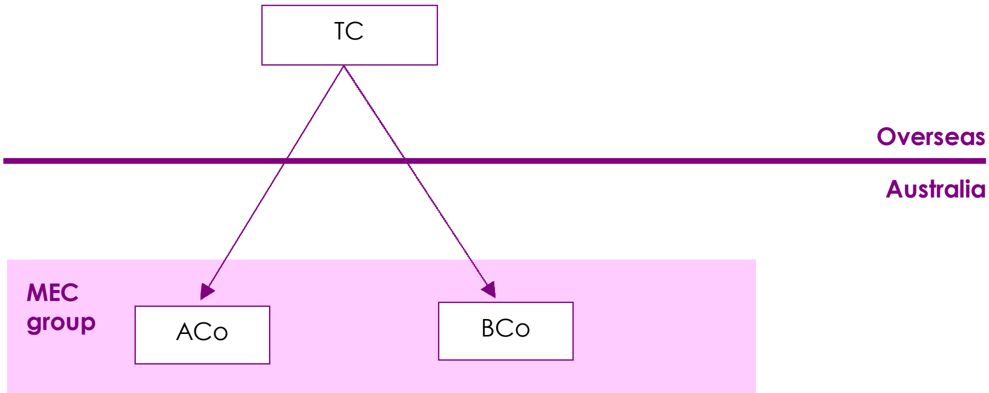
Certain tax attributes (for example, losses and foreign tax credits) of the old head company will be inherited by the new head company under the 'transfer of history' rule. → sections 719-85 and 719-90, ITAA 1997; paragraphs 3.117 to 3.129 of Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002

When a new PHC is appointed and the Commissioner is notified within the specified period, the franking account balance (including franking deficit) of the old PHC just before the cessation event happened, is transferred to the new PHC. → section 719-430, ITAA 1997

Example 1 Appointment of a provisional head company

TC is the top company. Either ACo or BCo can be the provisional head company as neither has any membership interests owned by another member of the MEC group. In this example, ACo and BCo are both eligible tier-1 companies who make a choice in writing to form a MEC group, jointly appoint ACo to be the PHC and notify the Commissioner within the prescribed time → 'Choice in writing', C7-1-110.

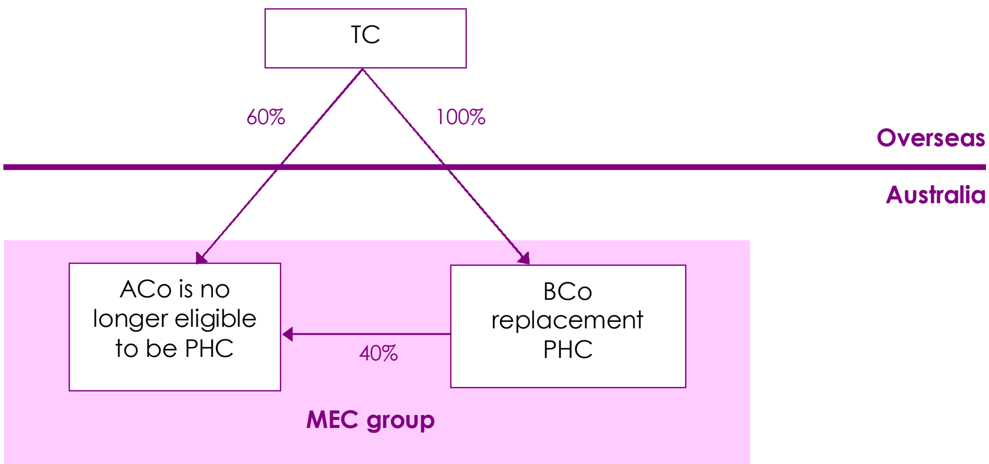
Figure 1: MEC group



Example 2 Replacement of a provisional head company

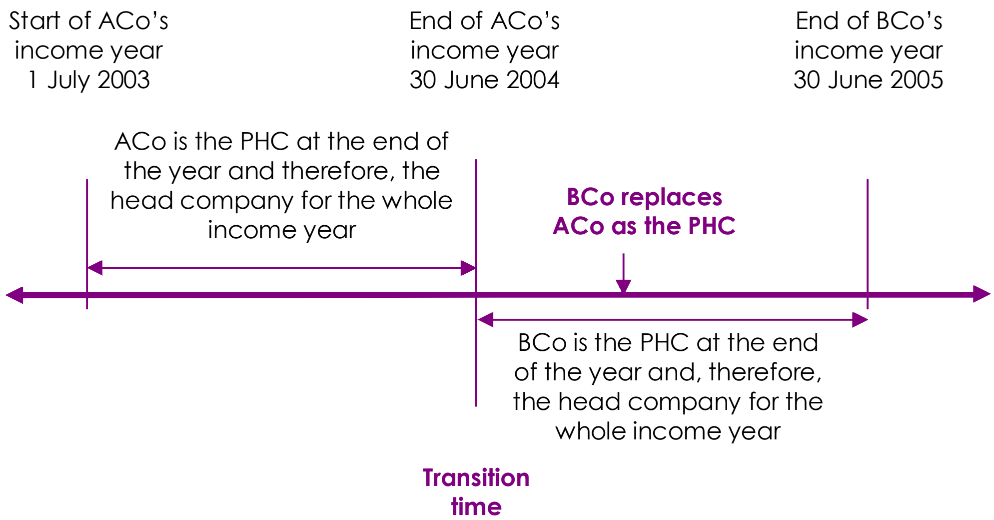
Taking the circumstances of Example 1 further: if BCo acquires 40% of ACo from TC, ACo will fail to satisfy the conditions for being a PHC and must notify the Commissioner of this within 28 days → section 719-80, ITAA 1997. ACo and BCo can make a choice in writing to appoint BCo as the new PHC, and must notify the Commissioner of this within 28 days → section 719-79, ITAA 1997; 'Choice in writing', C7-1-110; 'MEC groups – notices to be given to the Commissioner', C10-1-110.

Figure 2: Replacement of provisional head company



If BCo remains as the PHC at the end of the income year, it will be the head company of the MEC group for the entire income year → section 719-75, ITTA 1997. The time at which BCo replaces ACo as the head company is the start of the income year in which BCo became the PHC, and this is the transition time. Everything that happened to ACo before the transition time is taken to have happened to BCo → sections 719-85 and 719-90, ITAA 1997. This is referred to as the transfer of history rule and it allows BCo to inherit everything that ACo inherited under the entry history rule and the single entity rule → sections 701-5 and 701-1 respectively, ITAA 1997. The purpose of the transfer of history rule is to enable the new head company to calculate its income tax liability, or tax loss, for the income year in which the PHC is replaced, and any later income years.

Figure 3: Timeline of events



References

Income Tax Assessment Act 1936, Part III, Division 18

Income Tax Assessment Act 1997, sections 701-1, 701-5, 719-60, 719-65, 719 –80; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 4, paragraphs 4.87–105

Income Tax Assessment Act 1997, sections 719-85 and 719-90; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 8

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, paragraphs 3.117 to 3.129

Income Tax Assessment Act 1997, sections 719-430 and 719-435; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedules 5, 9 and 24

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2), Chapters 8 and 9

Explanatory Memorandum to Tax Laws Amendment ((Loss Recoupment Rules and Other Measures) Bill 2005, paragraphs 5.101 to 5.105

Income Tax Assessment Act 1997, Subdivision 715-U; as inserted by *(Loss Recoupment Rules and Other Measures) Act 2005* (No 147 of 2005), Schedule 2

Explanatory Memorandum to Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Bill 2005 paragraphs 5.101 – 5.123

Income Tax Assessment Act 1997, subparagraph 719-65(3)(d)(i); as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 2

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.101 – 5.110

Income Tax Assessment Act 1997, sections 719-76 and 719-78; as inserted by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 18

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.382 – 5.396 and 5.418 to 5.427

Revision history

Section C10-2-130 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on changes to consolidation rules, p. 2.	Legislative amendments.
26.10.05	Changes throughout reflecting changes in the treatment of foreign dividend accounts.	Legislative amendment.
26.6.07	New text and figure in Example 2.	To clarify meaning of 'transition time'.
	Extensive changes to Commentary in relation to conduit foreign income.	Legislative amendment.
6.5.11	Significant revisions to reflect changes to the choice and notification provisions and for group conversions.	Legislative amendments.

Worked example

A consolidated group is created from a MEC group

Description

This example explains the conditions under which a consolidated group is created from a multiple entry consolidated (MEC) group.

Commentary

A consolidated group is created from a MEC group where the MEC group has a single eligible tier-1 company (which is the provisional head company) and that company fails to satisfy the conditions for continuing as an eligible tier-1 company but satisfies the conditions to be a head company of a consolidated group. → 'Choosing', B1-1

The company becomes the head company of the consolidated group, and the subsidiary members of the MEC group (if any) become subsidiary members of the consolidated group.

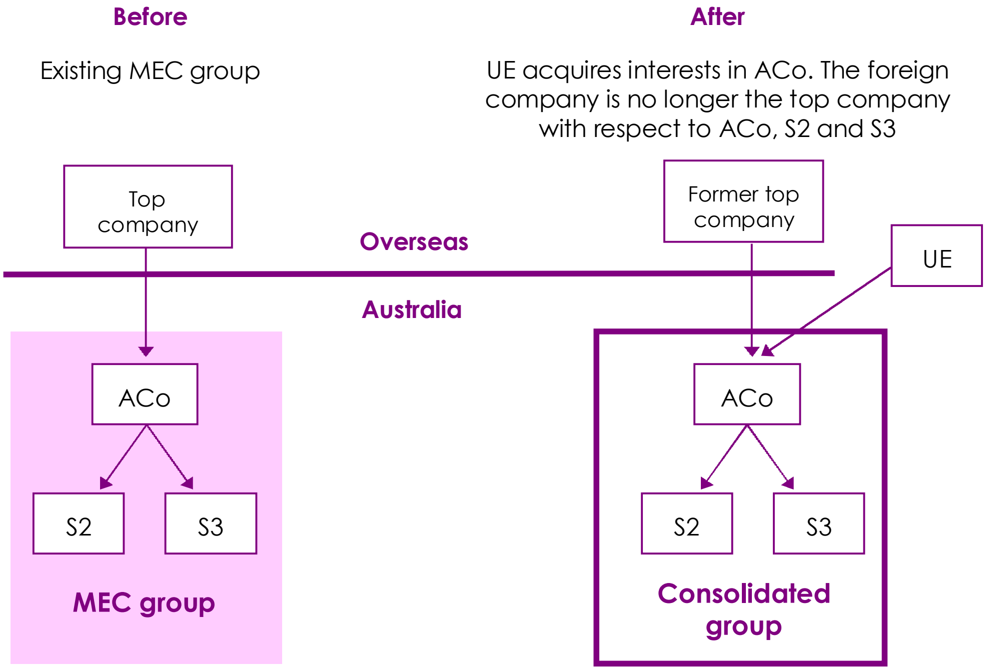
→ 'Group conversions', C10-1-210

Example

Figure 1 shows a MEC group where the provisional head company, ACo, no longer qualifies as an eligible tier-1 company due to some of its membership interests being acquired by UE, an unrelated entity. Because there are no other eligible tier-1 companies, the MEC group ceases to exist.

However, as ACo is eligible to be its head company, the group will become a consolidated group, with all the subsidiary members of the MEC group (S2 and S3) becoming subsidiary members of the consolidated group.

Figure 1: Conversion of MEC group to consolidated group



References

Income Tax Assessment Act 1997, sections 703-55; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 3.13 and 3.14

Income Tax Assessment Act 1997, Subdivision 719-BA; as inserted by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 2

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.65 – 5.100 and 5.105 – 5.108

Revision history

Section C10-2-140 first published (excluding drafts) 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
26.10.05	Minor changes.	For clarification.
6.5.11	Revisions to reflect changes to the cost setting rules when groups convert.	Legislative amendments.

Worked example

Cost setting rules for assets of a MEC group – at joining and formation times

Description

This example explains how:

- broadly, the cost setting rules apply to multiple entry consolidated (MEC) groups in the same way as they do for the head company and subsidiary members of a consolidated group → 'Treatment of assets', C2-1, and
- modifications and additions to those rules take into account the special characteristics of a MEC group.

Commentary

Overview

The legislation for the cost setting rules is structured to cover the basic case of an entity joining a consolidated group, with modifications and some additional rules for the following situations:

- the formation of a consolidated group
- where a consolidated group joins an existing consolidated group, and
- where entities that are linked by membership interests join an existing consolidated group.

The rules are further modified as necessary to ensure they apply appropriately to MEC groups. → Subdivision 719-C, *Income Tax Assessment Act 1997* (ITAA 1997); section 719-2, ITAA 1997; section 719-2, *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A 1997); Subdivision 719-C, IT(TP)A 1997

Determining asset tax costs at joining and formation time

For the formation of a MEC group, the cost setting rules are applied by considering:

1. the rules associated with the formation of a consolidated group – that is, the joining entity rules modified for the formation case → 'Treatment of assets', C2-1
2. any further modifications that apply to MEC groups.

The assets of the head company of a MEC group retain their existing tax values at the formation time – as with the assets of a head company of a consolidated group. → 'Determining asset values', B2-2

The cost setting rules are modified for the eligible tier-1 companies of a MEC group because those companies are treated for cost setting purposes as if they were part of the head company of a consolidated group. As a result, the assets of eligible tier-1 companies do not have their tax costs reset and they retain their existing tax values. → 'Cost setting rules' in 'Multiple entry consolidated (MEC) groups', C10-1; section 719-160, ITAA 1997

The same rule applies even where there are some membership interests held in an eligible tier-1 company by members of the MEC group. (Note, however, that two sets of rules apply when such an eligible tier-1 company leaves the group → 'An eligible tier-1 company leaving a MEC group', C10-2-430.)

Likewise, the assets of a transitional foreign-held subsidiary member of a MEC group do not have their tax costs reset because such a subsidiary is also treated as part of the head company (as in the case with a normal consolidated group). → 'Transitional provisions for foreign-held, Australian-resident subsidiaries to be members of a MEC group', C10-2-120; Subdivision 701C-C, subsection 719-161(2), IT(TP)A 1997; section 719-160, ITAA 1997

There is no modification to the cost setting rules for those subsidiary members (other than eligible tier-1 companies) that have *all* of their membership interests directly owned by the other members of the MEC group. At the forming or joining time, the tax cost of each asset of a subsidiary member includes a component for the liabilities of the subsidiary with adjustments for certain undistributed profits, losses and certain deductions to which the head company becomes entitled.

Transitional option

Where a MEC group is formed during the transitional period (1 July 2002 to 30 June 2004), the head company may choose to retain the existing tax values of a non-eligible tier-1 company subsidiary member's assets instead of setting new tax costs if the subsidiary member qualifies as a transitional entity. This option is available on a subsidiary by subsidiary basis on the group's formation. → 'Overview of cost setting process on formation and entry (including transitional rules)', C2-1-010

To qualify as a transitional entity in a MEC group, the subsidiary member can be a wholly-owned subsidiary of one or more eligible tier-1 companies.

A transitional entity for which the head company has chosen not to reset the cost of its assets is a chosen transitional entity.

The head company must make the choice by the later of 31 December 2005 and the day on which it lodges its income tax return for the income year in which the choice is made (or the last day on which it would be required to lodge if it was required to lodge). The head company is able to revoke this choice until 31 December 2005, providing that it obtains the agreement of each entity that left the group before the revocation time taking with it one or more assets that were previously those of the head company under the single entity rule. → Transitional rules: sections 701-1, 701-5 and 701-15, IT(TP)A 1997

Summary Table 1 summarises the asset cost setting rules for members of a MEC group.

Table 1: Asset cost setting treatment for MEC group

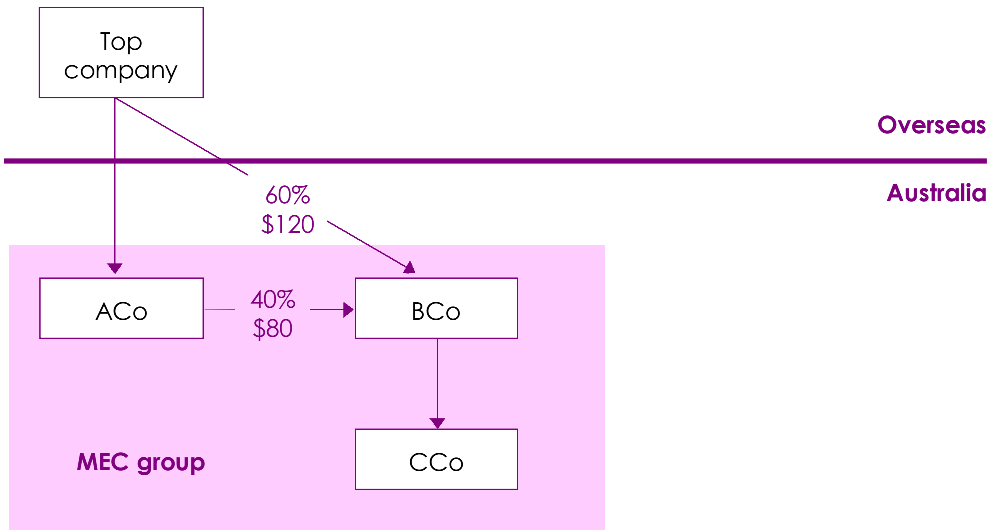
Type of entity	Asset treatment for cost setting purposes	Legislation
Head company – an eligible tier-1 company that has all its membership interests owned outside the MEC group and that has been jointly appointed by the other eligible tier-1 companies of the MEC group.	Existing tax values of assets are used – that is, assets are treated like the assets of a head company of a consolidated group.	Division 701
Subsidiary members that are eligible tier-1 companies including any that have some of their membership interests held by MEC group members.	Eligible tier-1 companies are treated as part of the head company; assets retain their existing tax values rather than having their costs reset.	Division 701 Division 705 Subdivision 719-C
Subsidiary members in which all membership interests are directly owned by other members of the MEC group (i.e. subsidiary members other than a transitional foreign-held subsidiary – TFHS).	The cost setting rules are used to reset asset costs – that is, assets are treated like the assets of a subsidiary member of a consolidated group.	Division 705 Subdivision 719-C
Transitional foreign-held subsidiary (TFHS) members.	The TFHS is treated as if it were a part of the head company of the group; assets retain their existing tax values rather than having their costs reset.	Subdivision 701C-C IT(TP)A 1997 Division 701
Transitional foreign-held indirect subsidiary members (TFHIS)	The cost setting rules are used to reset asset costs – that is, assets are treated like the assets of a subsidiary member of a consolidated group.	Subdivision 701C-C IT(TP)A 1997 Division 705B

Example

Formation case – where some of the membership interests in an eligible tier-1 company are held by members of the MEC group

Following an initial acquisition of 60% of the membership interests in BCo by the top company for $120, ACo pays $80 to acquire the remaining 40% of BCo. ACo, BCo and CCo then consolidate as a MEC group, as shown in figure 1. BCo has no liabilities and only one asset (being all the membership interests in CCo), which has an existing tax value of $200.

Figure 1: Formation case



ACo's assets will not be reset because it is the head company of a MEC group and the existing tax values of the assets are used.

BCo's assets will not have their costs reset as BCo is an eligible tier-1 company and will be taken to be a part of ACo, the head company of the MEC group. BCo's only assets are all the membership interests in CCo, which have an existing tax value of $200.

CCo is a subsidiary member of the MEC group but it is not an eligible tier-1 company. The cost of CCo's assets will be reset, unless the group qualifies under the transitional rules and the head company elects to use existing tax values for CCo's assets. If CCo's assets are reset, the allocable cost amount will include $200 as the cost of membership interests in CCo together with its liabilities and other adjustments.

Pre-formation rollover after 16 May 2002 and transitional groups

If there has been a rollover of an asset under Subdivision 126-B or under item 4 of the table in subsection 40-340(1), and:

- the rollover was after 16 May 2002
- the group consolidates after the rollover but before 1 July 2004, and
- the tax values of the group's assets change because of the rollover,

then the rollover is disregarded for tax cost setting purposes on consolidation with certain exceptions. → sections 701-35 and 719-163, IT(TP)A 1997

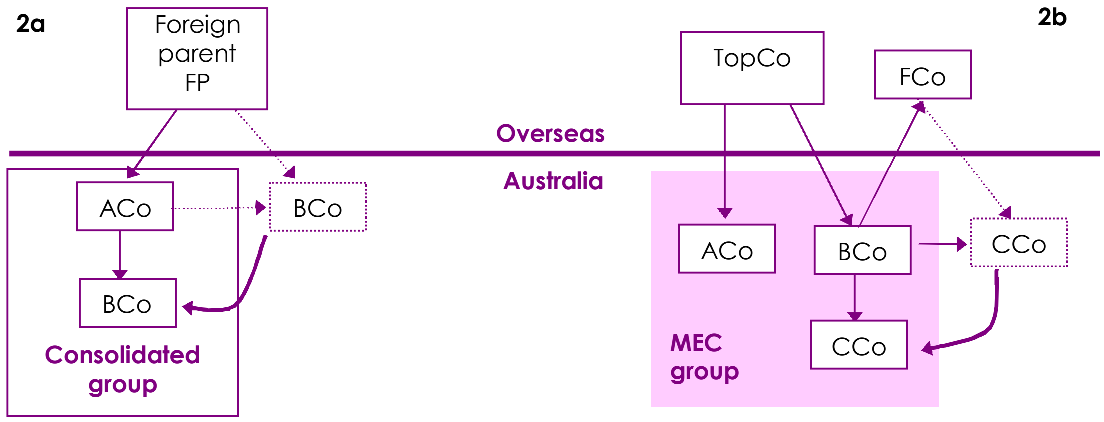
The rule is to prevent groups from using rollover relief to maximise their choices for the cost setting of their assets on consolidation.

Exception to pre-formation rollover after 16 May 2002 for foreign-owned groups

To enable a foreign-owned group that restructures to reset the cost of its assets on consolidation, an exception exists when the following conditions are satisfied:

- the rollover asset is a membership interest in an entity
- the membership interest is rolled over from a foreign-resident company to an Australian-resident company
- the entity whose membership interests were rolled over becomes a subsidiary member of a consolidated or MEC group at the time of formation
- the group is a transitional group, and
- the entity is not an eligible tier-1 company of a MEC group or an entity in which a foreign-resident company or a non-resident trust holds membership interests.

Figure 2: Rollover of membership interest in a company (Subdivision 126-B)



In figure 2a, the foreign parent rolls over its membership interests in BCo to ACo after 16 May 2002. After the roll-over and before 1 July 2004, ACo and BCo form a consolidated group. In this case, the rollover of the membership interests is not disregarded when the cost of the assets of the group is reset. ACo's cost base of the membership interests in BCo will be FP's cost base in BCo at the time of the roll-over plus ACo's cost base in BCo.

In figure 2b, FCo, a foreign subsidiary of BCo, rolls over its membership interests in CCo to BCo after 16 May 2002. After the roll-over and before 1 July 2004, ACo, BCo and CCo form a MEC group. CCo does not become an eligible tier-1 company of the MEC group. In this case, the rollover of the membership interests is not disregarded when the cost of the assets in CCo is reset. BCo's cost base for the membership interests in CCo will be FCo's cost base of the membership interests in CCo at the time of the roll-over plus BCo's cost base in CCo.

Exception where there is a demerger

There is also an exception if the rollover happens before a demerger and is in connection with the demerger, and:

- either the originating company or the recipient company ceases to be a member of the 'demerger group' (as defined in section 125-65 of the ITAA 1997) because of the demerger, and
- the recipient company and the originating company do not both join the same transitional group.

References

Income Tax Assessment Act 1997, Division 705; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 5

Income Tax Assessment Act 1997, Subdivision 719-C; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 8 and *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedules 11 and 12

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, Chapter 3

Income Tax (Transitional Provisions) Act 1997, sections 701-35 and 719-163; as amended by:

- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 7
- *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 17
- *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (No. 83 of 2004), Schedule 2
- *Tax Laws Amendment (2006 Measures No. 4) Act 2006* (No. 168 of 2006), Schedule 2

Income Tax (Transitional Provisions) Act 1997, section 701-5; as amended by *Tax Laws Amendment (2005 Measures No. 5) Act 2005* (162 of 2005), Schedule 3, Part 2

Explanatory Memorandum to New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, paragraphs 1.104 to 1.107

Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, paragraphs 5.75 to 5.88

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 2) Bill 2004, paragraphs 2.107 to 2.117

Revision history

Section C10-2-210 first published 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
26.10.05	Changes to 'Commentary' explain how wholly-owned subsidiaries of one or more eligible tier-1 companies of a MEC group can qualify as transitional entities.	Legislative amendments.
12.9.06	Extension of time for head companies to make or revoke a choice to retain existing tax costs for assets or reset tax costs, p. 2.	Legislative amendment.
6.5.11	Reference to exception to section 701-35 of the IT(TP)Act 1997 applying where the rollover is because of a demerger, p. 6.	Legislative amendment.

Worked example

Tax cost setting of assets – expansion of a MEC group to include new eligible tier-1 companies

Description

This example explains how the tax cost setting rules apply when a MEC group expands to include new eligible tier-1 companies (ET-1s).

→ Subdivision 719-C; Division 701; Subdivisions 705-A, 705-C and 705-D

Commentary

The tax cost setting rules are modified for MEC groups so that when a company joins an existing MEC group as an eligible tier-1 company it does not have the cost of its assets reset.

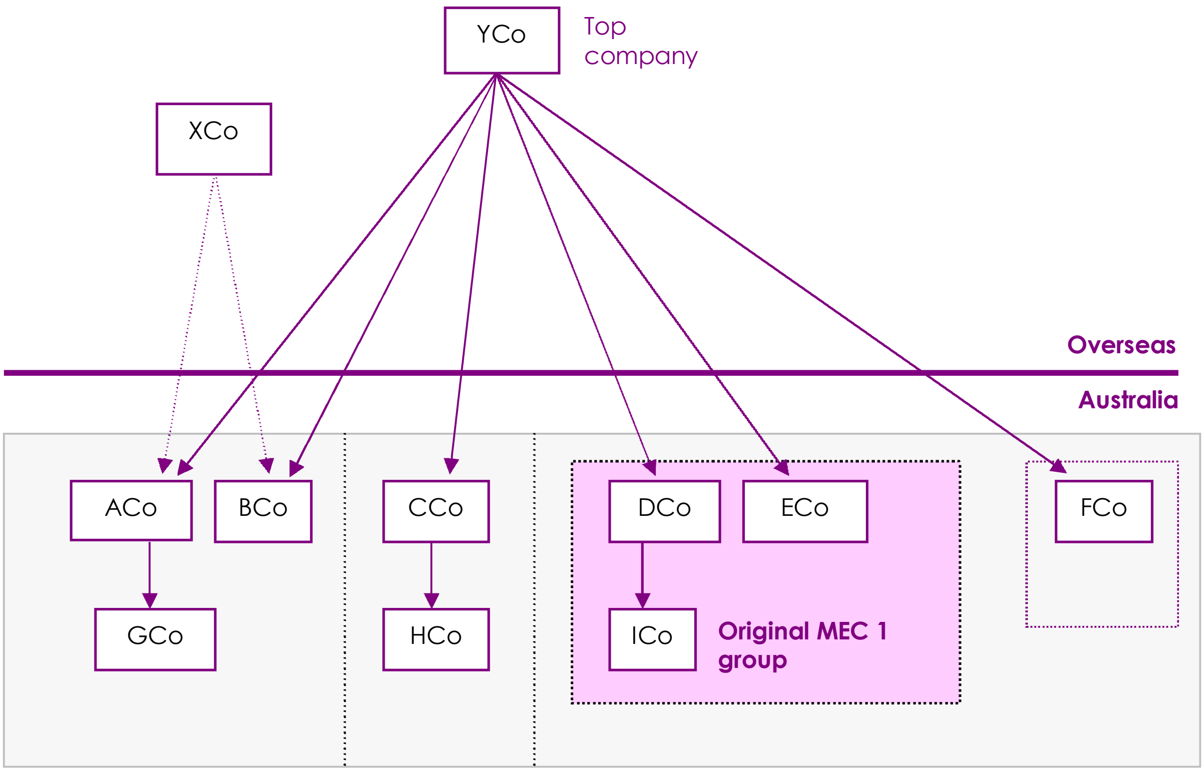
Nor are the tax costs of the assets of any new eligible tier-1 company reset where the head company of an existing consolidated group joins the expanding MEC group, or where some or all of the eligible tier-1 companies of an existing MEC group join the expanding MEC group, at the eligible tier-1 company level.

In some cases where a MEC group expands at the eligible tier-1 company level to include a consolidated group, or another MEC group, the tax costs are not reset for the assets of any of the entities that join the expanding MEC group. This applies where the MEC group expands at the eligible tier-1 company level and the head company of the consolidated group, or all of the eligible tier-1 companies of the MEC group, are acquired at the same time, by either the top company of the expanding MEC group, or one or more wholly-owned subsidiaries of the top company of the expanding MEC group, or a combination of those entities.

Example

Facts All Australian-resident entities in figure 1 are companies that meet the eligibility requirements for consolidation.

Figure 1: MEC group expands



Initially, YCo (a foreign resident) has three wholly-owned Australian subsidiaries: DCo, ECo and ICo. DCo and ECo choose to form a MEC group (MEC 1) consisting of the three companies, with DCo as the provisional head company (PHC). DCo becomes the head company at the end of the income year.

This example shows how the cost setting rules apply if YCo acquires:

- FCo (by acquiring all the membership interests in that company)
- CCo and HCo (by acquiring all the membership interests in CCo), or
- ACo, BCo and GCo (by acquiring all the membership interests in ACo and BCo).

In each case, assume the decision is made to expand MEC 1. Note that only the provisional head company of the acquiring MEC group can choose to expand. → 'Original and new eligible tier-1 companies of a MEC group', C10-2-115

Possible outcomes

Acquisition of a single company at ET-1 level

When YCo acquires all the membership interests in FCo, FCo becomes an eligible tier-1 company. Although a non-head-company eligible tier-1 company is a subsidiary member of a MEC group (section 719-25), for the purposes of tax cost setting, such an eligible tier-1 company is treated as part of the head company. Therefore, when FCo becomes a member of the MEC 1 group, the tax costs of its assets are not reset (i.e. the assets retain their existing tax values). → Subdivision 705-A as modified by Subdivision 719-C

Acquisition of linked companies (i.e. CCo and HCo are not consolidated)

When YCo acquires all the membership interests in CCo, CCo joins the MEC 1 group as an eligible tier-1 company, and HCo joins as a subsidiary member of the group. As with the acquisition of FCo, the assets of CCo retain their existing tax values. However, the cost setting rules apply to the assets of HCo. → Subdivisions 705-D as modified by Subdivision 719-C

Acquisition of a consolidated group

If CCo and HCo had formed a consolidated group before their acquisition by YCo, the tax costs of all the assets of the acquired group are not reset (i.e. the assets retain their existing tax values). This is because CCo is treated as the only entity joining the MEC 1 group, with HCo treated as being a part of CCo. Also, CCo is an eligible tier-1 company so it is treated as if it is part of DCo.
→ Subdivision 705-C as modified by Subdivision 719-C

Acquisition of a number of companies at ET-1 level (i.e. ACo, BCo and GCo are not consolidated)

When YCo acquires all the membership interests in ACo and BCo, they join the MEC 1 group as eligible tier-1 companies. Again, the assets of these companies retain their existing tax values. The assets belonging to GCo have their tax cost reset when it becomes a member of the MEC 1 group.
→ Subdivisions 705-A and 705-D as modified by Subdivision 719-C

Acquisition of a MEC group by acquiring all the eligible tier-1 companies at the same time

If ACo, BCo and GCo were members of a MEC group (MEC 2 with XCo as its top company, and ACo as the PHC) before the acquisition by YCo of ACo and BCo, all the assets of ACo, BCo and GCo would retain their existing tax values. This is because ACo is treated as the only entity joining the MEC 1 group, with BCo and GCo treated as parts of ACo. Also, ACo is an eligible tier-1 company so it is treated as if it is part of DCo. → Subdivision 705-C as modified by Subdivision 719-C

Table 1 summarises how the tax cost setting rules apply in each case:

Table 1: Application of tax cost setting rules

	Acquired entities and how acquired	Consolidation status before acquisition by YCo	Eligible tier-1 companies	Other member companies	Are tax costs of the entity's assets reset?	Relevant Subdivision
1	FCo	Single company	FCo		No	705-A*
2	CCo and HCo – by acquiring CCo	Not consolidated	CCo		No	705-D*
				HCo	Yes	
3	CCo and HCo – by acquiring CCo	Consolidated group	CCo		No	705-C*
				HCo	No	
4	ACo, BCo and GCo – by acquiring ACo and BCo	Not consolidated	ACo		No	705-D*
			BCo		No	705-A*
				GCo	Yes	
5	ACo, BCo and GCo – by acquiring ACo and BCo	MEC group	ACo		No	705-C*
			BCo		No	
				GCo	No	

* as modified by Subdivision 719-C

The outcomes in rows 1, 2 and 4 of table 1 will also apply if:

- YCo, or wholly-owned subsidiaries of YCo that are foreign-resident entities or entities that are ineligible to be members of the MEC 1 group (for example, a prescribed dual resident), individually or jointly acquire the new ET-1s, or entities that wholly-own the new ET-1s, or
- any of the acquiring entities in the previous point makes the acquisition(s) jointly with any member(s) of the MEC 1 group.

The outcomes in rows 3 and 5 of table 1 will also apply if:

- YCo, or wholly-owned subsidiaries of YCo that are foreign-resident entities or entities that are ineligible to be members of the MEC 1 group (for example, a prescribed dual resident), individually or jointly, directly acquire the membership interests in the new ET-1s, or
- any of the acquiring entities in the previous point makes the acquisition(s) jointly with any member(s) of the MEC 1 group.

Acquisition at other than ET-1 level

When an entity is acquired at a level other than the eligible tier-1 company level, the costs of its assets are reset under the relevant subdivision of Division 705 as modified by Subdivision 719-C.

References

Income Tax Assessment Act 1997, Division 705; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 5

Income Tax Assessment Act 1997, Division 705; as amended by *New Business Tax System (Consolidation, Value Shifting, Demerger and Other Measures) Act 2002* (No. 95 of 2002), Schedule 1

Explanatory Memorandum to the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, Chapter 1

Income Tax Assessment Act 1997, Division 705 and Subdivision 719-C; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedules 4 and 8

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, Chapters 1 and 3

Income Tax Assessment Act 1997, Subdivision 719-C; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003 (No. 16 of 2003)*, Schedules 11 and 12

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 2

Revision history

Section C10-2-215 first published 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
26.10.05	Extensive changes throughout.	For clarification.
12.9.06	References deleted to acquisition of a MEC group as a whole due to Y Co acquiring X Co, pp. 1, 2, 3, 4.	To correct error.
	Changes to table 1 and following outcomes, p. 4.	For clarification.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Adjusting available fraction – a new eligible tier-1 company joins a MEC group

Description

This example shows how, where a new eligible tier-1 company joins an existing multiple entry consolidated (MEC) group, the MEC group:

- establishes an available fraction for any prior year group losses, and
- adjusts all existing available fractions to take into account the entry of the new company.

Note

For more information about:

- MEC groups → C10-1
- loss bundles and calculating the available fraction → 'Treatment of losses', C3-1; 'Consolidation loss provisions', C3-2-110 (worked example)
- working out modified market value → 'Modified market value of a single joining entity', C3-4-110 (worked example)
- market values → 'Market valuation guidelines', C4-1

Commentary

Generally, available fractions for MEC groups are calculated and adjusted in the same way as they are for ordinary consolidated groups. However, a group's existing available fractions are adjusted if the group expands because a new eligible tier-1 company (→ section 719-15) joins the group. Also, any prior year losses generated by the group (group losses) prior to the eligible tier-1 company joining are treated as transferred losses from the joining time of the new eligible tier-1 company.

Adjusting existing available fractions

The inclusion of a new eligible tier-1 company in a MEC group increases the group's income generating capacity, which reduces the proportion of the group's income that the original loss entities can be regarded as generating. The increase in the group's income generating capacity occurs because the group has not exchanged cash or assets (or increased liabilities) to bring the eligible tier-1 company into the group. As the foreign parent (the 'top company') finances the acquisition, capital has effectively been injected into the group. Hence, all existing available fractions must be adjusted.

The available fraction for each bundle of previously transferred losses is adjusted by multiplying it by the following factor ('market value factor'):

$$\frac{\text{market value of the existing group just before the eligible tier-1 company joins}}{\text{market value of the expanded group just after the eligible tier-1 company joins}}$$

Calculating an available fraction for prior year group losses

Any group losses held by a MEC group at the time an eligible tier-1 company joins are treated as though they are transferred losses of the expanded group[250]. This ensures they form a loss bundle for which an available fraction is calculated. Subdivision 707-C then applies in determining how much of the losses can be used for an income year (in the same way that Subdivision applies to other transferred losses). This broadly ensures that the group losses can only be utilised against the portion of the group's income and gains generated by the entities that contributed to the making of the loss.

The available fraction for prior year group losses is calculated under subsection 707-320(1) as follows:

$$\frac{\text{modified market value of the real loss-maker}}{\text{transferee's adjusted market value}}$$

The real loss-maker (the head company of the original group that made the loss) works out its modified market value as if each subsidiary member of the original group at the time the eligible tier-1 company joins were a part of the head company. → subsection 719-305(3)

The transferee's adjusted market value includes all of the group members, including those that join as a result of the eligible tier-1 company joining the group[251].

Capping the available fractions

The original group may have both group losses and previously transferred losses when the new eligible tier-1 company joins. In these situations, available fractions are capped so that their total does not exceed what would otherwise be the available fraction for the group loss bundle. The available fraction for each bundle is adjusted by multiplying it by the following factor ('capping adjustment factor'):

$$\frac{\text{available fraction for the group loss bundle}}{\text{sum of the available fractions for the group loss bundle and the (adjusted) available fractions for the existing transferred loss bundles}}$$

This adjustment ensures available fractions bear the correct proportion to each other[252].

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[250] These group losses are not actually tested and transferred, just treated *as if* they had passed the transfer tests and were transferred under Subdivision 707-A of the ITAA 1997.

[251] As a result of the single entity rule in section 701-1 of the ITAA 1997.

[252] This adjustment mirrors adjustment item 2 in the table in subsection 707-320(2) of the ITAA 1997. That item caps the available fractions for bundles transferred from the head company of a group that is acquired by another group.

Example

Facts

ET-1 Group consolidates on 1 July 2003. A loss made by subsidiary member CCo is transferred to the head company, ET-1, at the time the group consolidates. An available fraction of 0.875 is established for bundle CCo at the initial transfer time.

MEC1 Group consists of a provisional head company – PHC – and two other companies, ACo and BCo. A loss made by BCo is transferred to PHC when BCo joins the group. An available fraction of 0.385 is established for bundle BCo at the initial transfer time. MEC1 Group also incurs a group loss for the 2004 income year.

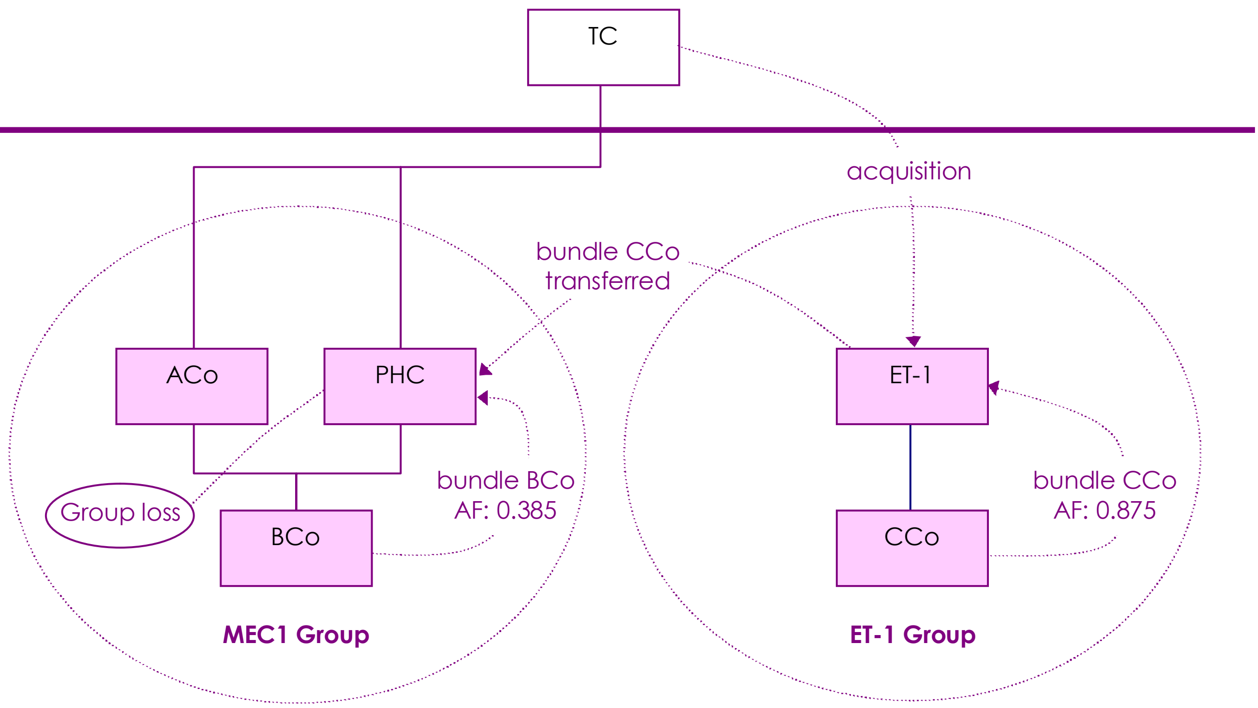
The top company – TC – of MEC1 Group acquires ET-1 Group on 1 July 2004. A choice is made to expand MEC1 Group to include ET-1 and CCo.

→ subsection 719-5(4); 'Choice on formation, special conversion events and acquisition of new eligible tier-1 companies', C10-2-110

When ET-1 Group joins MEC1 Group, the loss in bundle CCo is transferred to PHC.

This sequence of events is shown in figure 1. MEC1 Group must establish an available fraction for the prior year group loss and adjust all available fractions in recognition of the entry of ET-1 Group.

Figure 1: TC acquires ET-1 Group



Market values are ascertained as at the time of ET-1 Group joining (1 July 2004) as follows:

- market value of ET-1 Group = $300
- market value of MEC1 Group (excluding the market value of ET-1 Group) = $900
- market value of MEC1 Group (including the market value of ET-1 Group) = $1,200
- modified market value of PHC (as the real loss-maker) = $810
- adjusted market value of PHC (as the transferee) = $1,080

Calculation

Step 1 – Establish the available fraction for the group loss bundle (bundle GL):

$$\frac{810}{1,080} = 0.750$$

Step 2 – Adjust the available fraction for bundle BCo by multiplying it by the market value factor:

$$0.385 \quad x \quad \frac{900}{1,200} = 0.289$$

The sum of available fractions for bundles GL and BCo is 1.039 (0.750 + 0.289). This figure will be the denominator of the capping adjustment factor.

Step 3 – Cap the available fractions for bundles GL and BCo by multiplying each by the capping adjustment factor[253]:

$$\text{GL :} \quad 0.750 \quad x \quad \frac{0.750}{1.039} = 0.541$$

$$\text{BCo :} \quad 0.289 \quad x \quad \frac{0.750}{1.039} = 0.209$$

The sum of the available fractions for bundles held by PHC is 0.750 (0.541 + 0.209). This corresponds with the available fraction initially calculated for bundle GL.

[253] The group may avoid the application of step 3 by choosing to cancel the loss in bundle GL. Broadly, the effect of cancellation is that the cancelled loss could be used up until ET-1 joins but cannot be used thereafter. The choice to cancel a loss is contained in section 719-325. The choice to cancel a loss may be revoked where the revocation takes place before 1 January 2006.

Step 4 – Adjust the available fraction for bundle CCo under item 1 in the table in subsection 707-320(2):

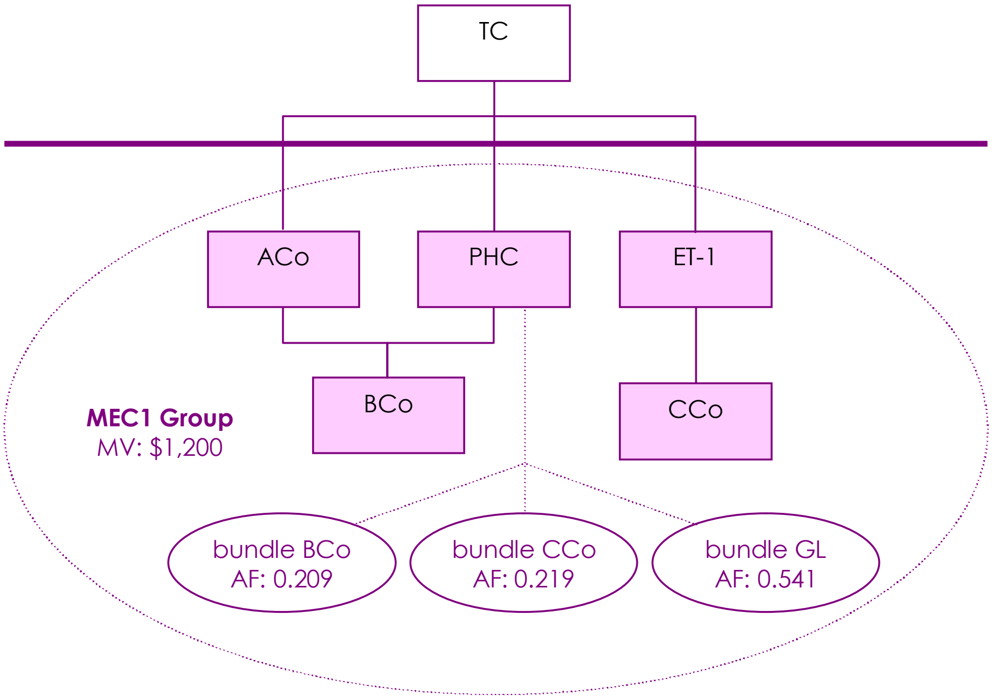
$$0.875 \quad \times \quad \frac{300}{1{,}200} \quad = \quad 0.219$$

There is no need to further adjust the available fraction for bundles GL and BCo as a result of bundle CCo being transferred. Item 3 in the table in subsection 707-320(2)[254] does not apply when a new eligible tier-1 company joins a group, regardless of whether the new eligible tier-1 company or any of its subsidiaries are loss entities. → subsection 719-310(3)

The utilisation of the losses in all bundles for the 2005 income year is subject to limits determined by reference to the available fraction method.

The expanded MEC1 Group structure just after ET-1 Group joins is shown in figure 2.

Figure 2: The expanded MEC1 Group



[254] Applies to adjust the available fractions of existing loss bundles when another loss bundle is transferred to the group at a later time.

References

Income Tax Assessment Act 1997 – as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1:

- subsection 707-320(1)
- subsection 707-320(2)

Income Tax Assessment Act 1997, Subdivision 719-F; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 8

Income Tax (Transitional Provisions) Act 1997, Subdivision 719-F; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 10

Income Tax (Transitional Provisions) Act 1997, Subdivision 707-C; as amended by *Tax Laws Amendment (2005 Measures No. 5) Act 2005* (162 of 2005), Schedule 3, Part 2

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 8

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, Chapter 3

Revision history

Section C10-2-310 first published 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
26.10.05	Government announces extension of time for head companies to make or revoke certain elections, p. 4.	Proposed legislative amendment.
12.9.06	Extension of time to revoke election to cancel a loss, footnote 4.	Legislative amendment.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Apportioning the use of losses – new eligible tier-1 company joins part-way through income year

Description

This example shows how a group apportions use of its unutilised prior year losses if a new eligible tier-1 company joins the group part-way through the group's income year.

Note

For more information about:

- loss bundles and calculating the available fraction → 'Treatment of losses', C3-1; 'Consolidation loss provisions', C3-2-110 (worked example)
- adjustments to available fractions → 'Adjusting available fraction – eligible tier-1 company joins MEC group', C10-2-310 (worked example)
- apportioning the use of transferred losses → C3-4-610 (worked example)

Commentary

The apportionment rule in section 707-335 applies when the numerical value of an available fraction for a bundle of losses changes during an income year. The apportionment rule ensures an adjusted available fraction only applies from the date it is reset.

Existing available fractions are reset when a new eligible tier-1 company (→ section 719-15) joins a group. Also, any prior year losses generated by the group (group losses) before the eligible tier-1 company joins are treated as transferred losses from the joining time. Apportionment applies (assuming losses can be utilised) if the new eligible tier-1 company joins part-way through the group's income year.

In the income year the eligible tier-1 company joins, apportionment applies to both transferred losses and group losses. The use of group losses for the pre-joining period is unrestricted. This is achieved by treating the group losses as being in a bundle with an available fraction of 1 for the pre-joining period. The use of group losses for the post-joining period is subject to the available fraction established for their bundle.

The available fraction of 1 that is assigned to the group loss bundle is *not* reset if an adjustment would be required in relation to an event occurring during the pre-joining period. This is consistent with the losses maintaining their group loss status for the pre-joining period.

The amount of a group loss that can be used with reference to the pre-joining period is taken *not* to have been a loss transferred under Subdivision 707-A. The status of the group loss remains and hence the amount attributable to the pre-joining period must be deducted from the group's income and gains before applying the available fraction when determining the limits on utilisation of other transferred losses. Once a new eligible tier-1 company joins the group, the status of the group loss changes to a transferred loss. Hence the amount attributable to the post-joining period is *not* deducted from the group's income or gains when determining the limits on utilisation of other transferred losses under the available fraction method.

Example

Facts

MEC1 Group consists of a provisional head company, PHC, an eligible tier-1 company, BCo, and another company, ACo. A loss made by ACo is transferred to PHC when ACo joins the group. An available fraction of 0.223 is established for bundle ACo at the initial transfer time. MEC1 Group also incurs a group loss in the 2003 income year.

On 1 October 2003 the group's market value is increased as a result of a non-arm's length (NAL) transaction involving MEC1 Group and its top company, TC. The market value of the group just before the event is $1,000. The non-arm's length transaction has the effect of increasing the group's market value by $150.

On 1 January 2004, TC acquires an eligible tier-1 company, ET-1 and a choice is made for ET-1 to join MEC1 Group. → subsection 719-5(4)

This sequence of events is shown in figures 1 and 2.

Figure 1: TC acquires ET-1

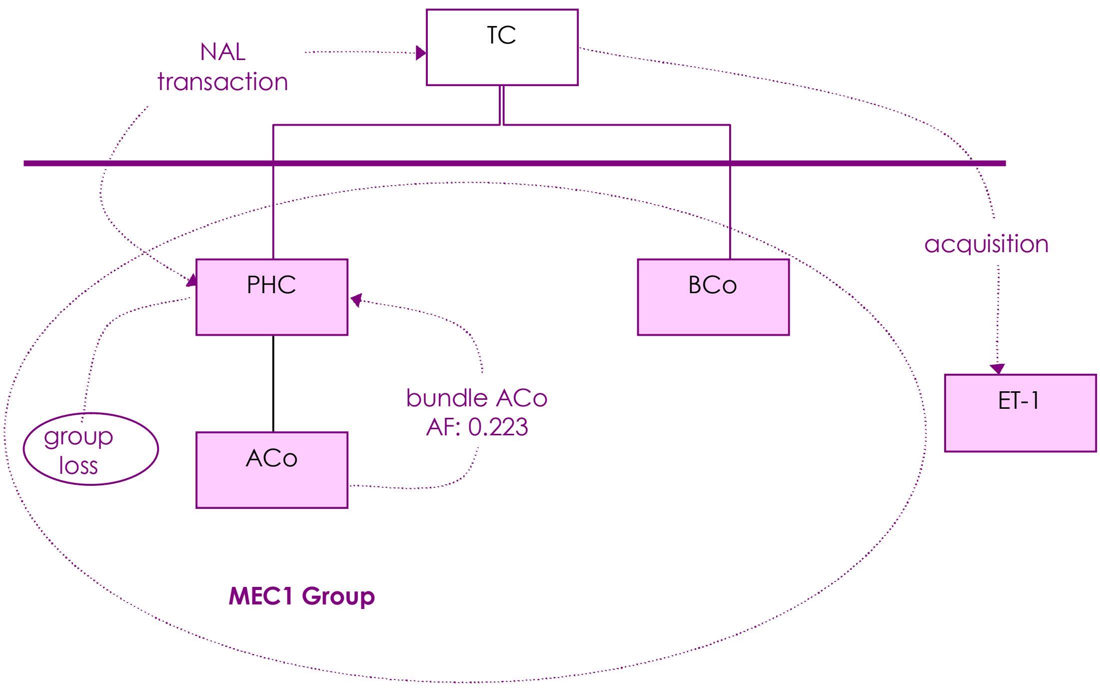
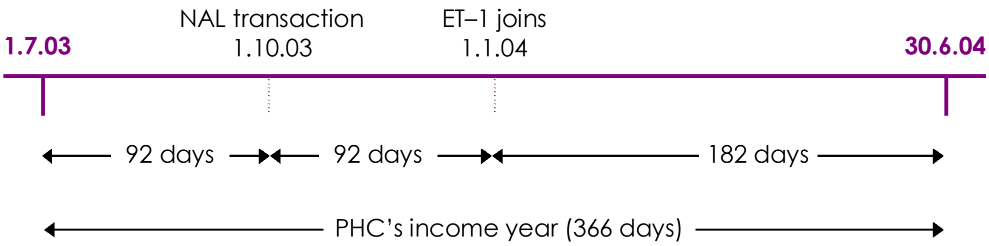


Figure 2: The 2004 income year



As a result of the non-arm's length transaction, MEC1 Group must adjust the available fraction for bundle ACo under item 4 in the table in subsection 707-320(2). MEC1 Group must also establish an available fraction for the prior year group loss and adjust the available fraction for bundle ACo in recognition of the entry of ET-1.

Market values were ascertained as at the time of ET-1 joining (1 January 2004) as follows:

- market value of MEC1 Group (excluding market value of ET-1) = $1,150
- market value of MEC1 Group (including market value of ET-1) = $1,600
- modified market value[255] of PHC (as the real loss-maker) = $820
- adjusted market value[256] of PHC (as the transferee) = $1,420

Losses available for utilisation in the 2004 income year are shown in table 1.

Table 1: Losses available in 2004 income year

Loss bundle	Unused transferred losses
Group loss	$480 tax loss (not film)
Bundle ACo	$120 tax loss (not film)

PHC satisfies the recoupment tests for utilisation of both the group loss and the transferred loss in the 2004 income year.

[255] Section 707-325. Modified market value is the market value reduced by the value of the NAL transaction ($150) and assuming the group had no losses. The value of losses in this example is assumed to be the quantum of the losses multiplied by the prevailing corporate tax rate ($600 x 0.30 = $180).

[256] Subsection 707-320(1). Adjusted market value is the value of the expanded group ignoring any losses it has and assuming that its franking account balance is nil.

PHC generates $975 of assessable income. Its deductions in relation to that income are $178.

Calculation – available fractions

Step 1 – *Apply adjustment item 4 to the available fraction for bundle ACo (as at 1 October 2003) by multiplying each by the item 4 factor:*

$$0.223 \quad \times \quad \frac{1{,}000}{1{,}000 + 150} \quad = \quad 0.194$$

Step 2 – *Establish an available fraction (as at 1 January 2004) for the group loss (bundle GL):*

$$\frac{820}{1{,}420} \quad = \quad 0.577$$

Step 3 – *Adjust the available fraction for bundle ACo (as at 1 January 2004) by multiplying it by the market value factor*[257]*:*

$$0.194 \quad \times \quad \frac{1{,}150}{1{,}600} \quad = \quad 0.139$$

The sum of available fractions for bundles GL and ACo is 0.716 (0.577 + 0.139). This figure will be the denominator of the capping adjustment factor.

Step 4 – *Cap the available fractions for bundles GL and ACo by multiplying each by the capping adjustment factor*[258]*:*

$$\text{GL}: \quad 0.577 \quad \times \quad \frac{0.577}{0.716} \quad = \quad 0.465$$

$$\text{ACo}: \quad 0.139 \quad \times \quad \frac{0.577}{0.716} \quad = \quad 0.112$$

The sum of available fractions for bundles GL and ACo is 0.577 (0.465 + 0.112). This corresponds with the available fraction initially calculated for bundle GL.

The utilisation of losses for the 2004 income year is subject to limits determined by reference to the available fraction method.

[257] Market value of the original group divided by market value of the expanded group.

[258] The group may avoid the application of step 3 by choosing to cancel the loss in bundle GL. Broadly, the effect of cancellation is that the cancelled loss could be used up until ET-1 joins but cannot be used thereafter. The choice to cancel a loss is contained in section 719-325. The choice to cancel a loss may be revoked where the revocation takes place before 1 January 2006.

Calculation – utilisation

A. Work out the amount of loss from bundle GL that can be utilised with reference to the pre-joining period.

Table 2: Categories of group income or gains (bundle GL utilisation)

Category of income or gains	Gross amount ($)	*Less:* other allowable deductions/ reductions ($)	*Less:* group/ concessional losses of that kind($)	Income/gains available for the bundle ($)
Other assessable income	975	178	–	797

Table 3 Fraction of income/gains (bundle GL utilisation)

Category of income or gains	Loss bundle	Step 1 amount	*Multiplied by:* available fraction (AF)	*Multiplied by:* apportionment fraction	AF amount for the bundle
Other assessable income	Bundle GL	$797	1.000	184/366	$401

B. Apply the 3-step available fraction method to each bundle

Step 1 – *Work out the categories of group income or gains – subsection 707-310(3)*

Table 4: Categories of group income or gains (bundle ACo utilisation) (step 1)

Category of income or gains	Gross amount ($)	*Less:* other allowable deductions/ reductions ($)	*Less:* group/ concessional losses of that kind($)	Income/gains available for the bundle ($)
Other assessable income	975	178	401	396

Step 2 – Calculate the fraction of the income/gains that is attributable to each bundle – subsection 707-310(3)

Table 5: Fraction of income/gains attributable to each bundle (step 2)

Category of income or gains	Loss bundle	Step 1 amount	*Multiplied by:* available fraction (AF)	*Multiplied by:* apportionment fraction	AF amount for the bundle	
Other assessable income	Bundle GL	$797	1.000	184/366	$401	$585
		$797	0.465	182/366	$184	
	Bundle ACo	$396	0.223	92/366	$22	$63
		$396	0.194	92/366	$19	
		$396	0.112	182/366	$22	

Note: Bundle GL loss utilised with reference to the pre-joining period is not subtracted from income when determining the post-joining period utilisation amount for that bundle.

Step 3(a) *– Work out a notional taxable income for bundle GL – subsection 707-310(2)*

Table 6: Taxable income (step 3a)

Assessable income	$	Deductions/losses	$
Other assessable income	585	Group/transferred tax loss	480
Total	**585**	**Total**	**480**

The (notional) taxable income for bundle GL is $105 ($585 – $480).

The entire unutilised loss of $480 in bundle GL can be used by PHC when it determines its actual taxable income for the 2004 income year.

Step 3(b) *– Work out a notional taxable income for bundle ACo – subsection 707-310(2)*

Table 7: Taxable income (step 3b)

Assessable income	$	Deductions/losses	$
Other assessable income	63	Transferred tax loss	63
Total	**63**	**Total**	**63**

The (notional) taxable income for bundle ACo is $0 ($63 – $63).

$63 of the loss in bundle ACo can be used by PHC when it determines its actual taxable income for the 2004 income year.

C. Determine the group's actual taxable income

Table 8: Taxable income

Assessable income	$	Deductions/losses	$
Other assessable income	975	Deductions	178
		Group/transferred tax losses (bundle GL)	480
		Transferred tax losses (bundle ACo)	63
Total	**975**	**Total**	**721**

The group's taxable income is $254 ($975 – $721).

As at the start of the 2005 income year PHC will hold the bundle shown in table 9.

Table 9: PHC bundle held at start of 2005 income year

Bundle	Loss	Available fraction	Sort
ACo	$57 ($120 – $63)	0.112	Tax loss (not film)

Bundle GL ceases to exist as the loss contained in it is fully utilised in the 2004 income year.

References

Income Tax Assessment Act 1997, sections 707-310, 707-320, 707-325, 707-335; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Income Tax Assessment Act 1997, Subdivision 719-F; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 8

Income Tax Assessment Act 1997, paragraph 707-335(3)(e); as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 6, Part 2 ('Utilising losses head company transfers to itself')

Income Tax (Transitional Provisions) Act 1997, Subdivision 719-F; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 10

Income Tax (Transitional Provisions) Act 1997, Subdivision 707-C; as amended by *Tax Laws Amendment (2005 Measures No. 5) Act 2005* (162 of 2005), Schedule 3, Part 2

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, Chapter 3

Revision history

Section C10-2-320 first published 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
26.10.05	Government announces extension of time for head companies to make or revoke certain elections.	Proposed legislative amendment.
12.9.06	Extension of time to revoke election to cancel a loss, footnote 4.	Legislative amendment.
15.4.10	Changes to Calculation – utilisation	To reflect correct application of law.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

High-level worked example

MEC groups and losses – determining whether the focal company satisfies the continuity of ownership test

Description

The head company of a MEC group that is seeking to utilise a loss transferred to it from another company in the group is known as the focal company. It is considered to have satisfied the continuity of ownership test (COT) if the company defined as the test company satisfies that test based on certain assumptions outlined in this example.

This example shows how the test company is identified and explains the application of the COT to MEC groups. The example relates specifically to two different losses transferred to the head company of a MEC group under Subdivision 707-A of the *Income Tax Assessment Act 1997* (ITAA 1997):

- a loss transferred as a COT transfer,[259] and
- a loss transfer that is not a COT transfer.

Commentary

In recognition of the special characteristics of MEC groups, Subdivision 719-F of the ITAA 1997 modifies the rules about transferring and utilising losses within those groups. It also covers the application of the COT under section 165-12 of the ITAA 1997, which helps to establish whether a loss can be utilised. These special rules apply (with one exception) when the focal company is the head company of a MEC group at any time in its ownership test period.[260]

The focal company is considered to have made the loss because either:

- the loss was transferred to it under Subdivision 707-A, or
- the loss is a group loss (i.e. it was generated by a consolidated group or MEC group headed by the focal company).

The focal company is considered to meet the conditions in section 165-12 if the test company, as determined by section 719-265, would meet those

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[259] A COT transfer of a loss is defined in subsection 707-210(1A) as a transfer of a loss from a company that occurs because:

- the transferor meets the conditions in section 165-12, and
- none of the conditions in paragraphs 165-15(1)(a), (b) and (c) apply to the transferor.

[260] Subdivision 719-F does not apply if the MEC group has converted to a consolidated group during the ownership test period, where the conversion took place:

- on or after 27 October 2006, or
- before 27 October 2006 and a choice in writing is made within the prescribed time for Subdivision 719-BA to apply from 1 July 2002.

→ section 719-140, ITAA 1997; paragraphs 5.92, 5.105 and 5.106, Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010

conditions based on the assumptions in sections 719-270, 719-275 and 719-280.

In order to apply the COT to the test company, it is necessary to assume that the test company made the loss, even if it actually did not (e.g. because the test company is also the top company).

The COT is applied to the test company for the period from the start of the test company's loss year (as determined by section 719-270) until the end of the income year in which the focal company seeks to utilise the loss. If any of the events defined in section 719-275 occur within this period, this triggers freezing of part of the ownership structure. This means it is assumed that there is no change in membership interests or voting power in entities in these frozen parts of the group structure.

Under Subdivision 719-F, the test company is considered to have failed the COT in relation to a loss if any of the events defined in section 719-280 occur after the start of the focal company's ownership test period for the loss.

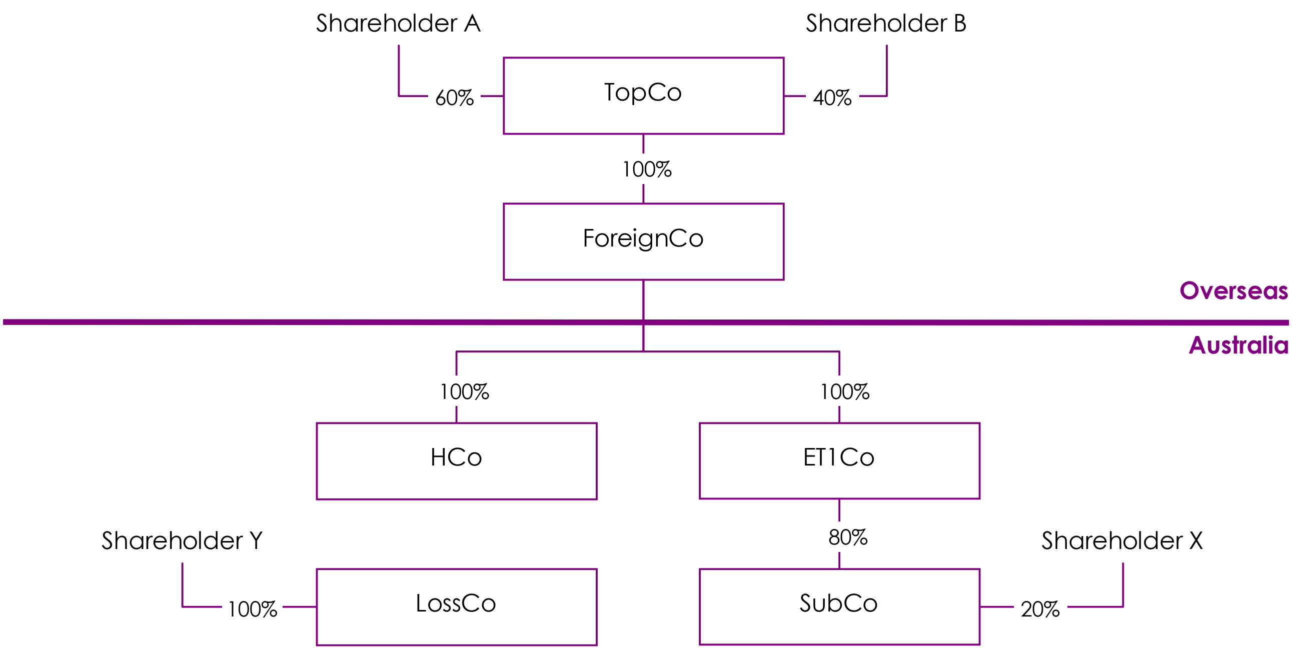
Example

Facts

SubCo makes a net capital loss in the income year ended 30 June 2001. On 1 July 2000, 80% of its shares are held by ET1Co and 20% of its shares are held by shareholder X (an individual). LossCo also makes a net capital loss in the income year ended 30 June 2001. On 1 July 2000, all of its shares are held by shareholder Y (an individual).

ET1Co and HCo are both wholly-owned subsidiaries of the foreign-resident company TopCo. On 1 July 2000, TopCo is owned by two individual shareholders (A and B). Note that there is a foreign-resident company, ForeignCo, interposed between TopCo and ET1Co and HCo.

Figure 1: Ownership structure at 1 July 2000



On 30 June 2002, the following events take place:

- ET1Co purchases the remaining 20% of membership interests in SubCo from shareholder X, making SubCo a wholly-owned subsidiary of ET1Co, and
- HCo purchases all the membership interests in LossCo from shareholder Y, making LossCo a wholly-owned subsidiary of HCo.

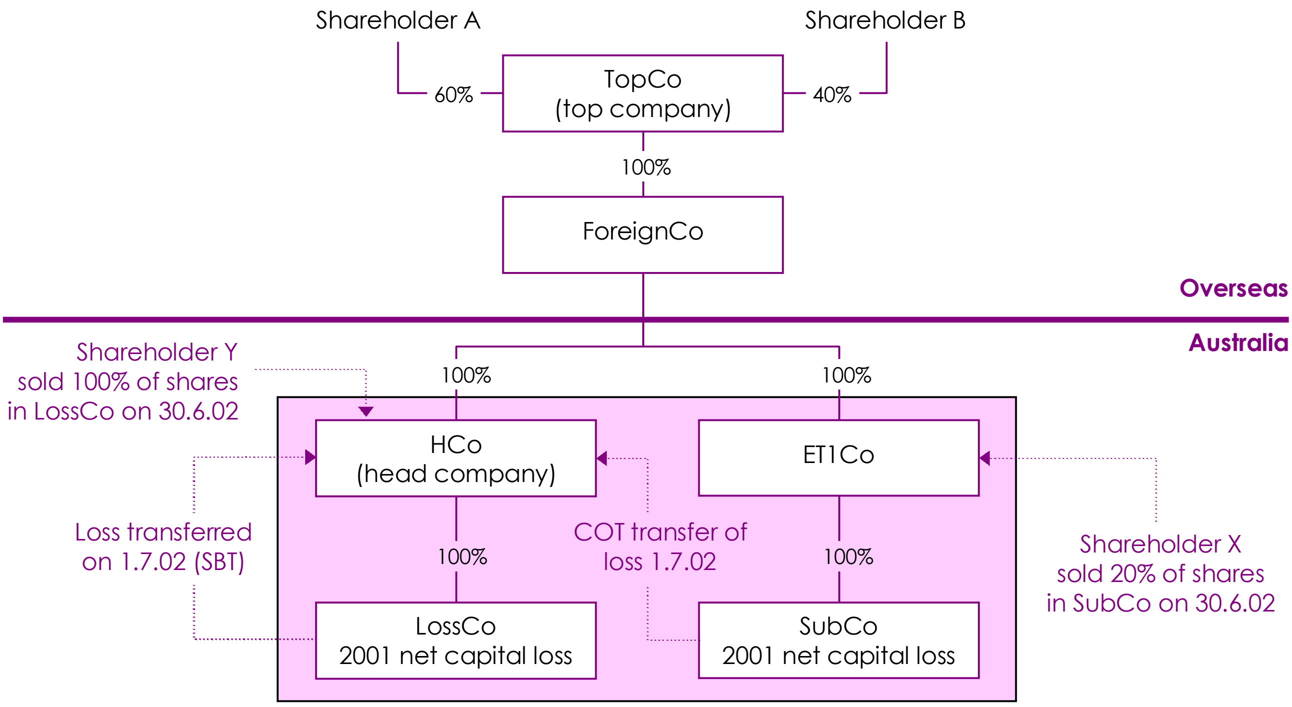
There are no other ownership changes in any of the companies up to 1 July 2002.

ET1Co and HCo are TopCo's first level of investment in Australia. TopCo meets the requirements to be a top company. ET1Co and HCo are eligible tier-1 companies and they form a MEC group on 1 July 2002, with HCo as head company. On 1 July 2002:

- the net capital loss, incurred in the income year ended 30 June 2001 by SubCo, is transferred from SubCo to HCo under Subdivision 707-A as a COT transfer, and
- the net capital loss incurred in the income year ended 30 June 2001 by LossCo, is transferred from LossCo to HCo under Subdivision 707-A because LossCo satisfies the same business test (SBT).[261]

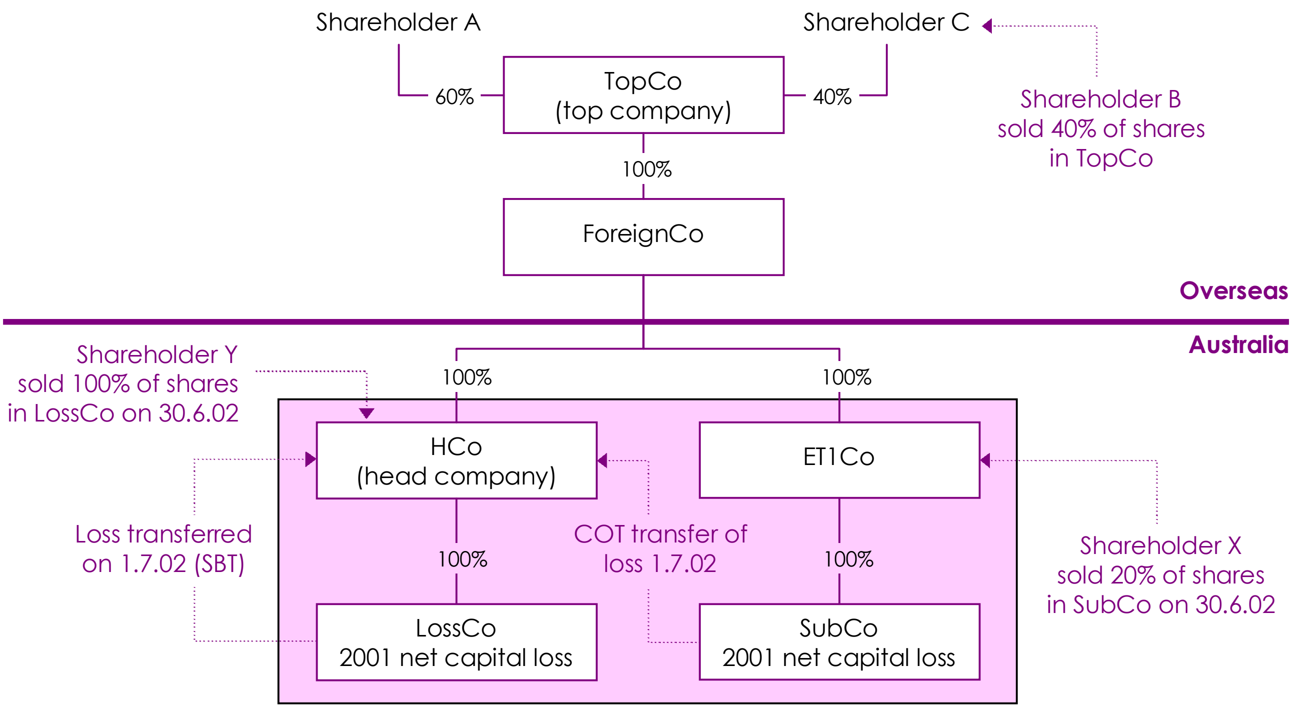
[261] LossCo experiences a change in its majority ownership on 30 June 2002 and is therefore unable to satisfy the COT as a transfer test. As the loss is made for an income year starting after 30 June 1999, the modified SBT in section 707-125 determines whether the loss can be transferred to HCo.

Figure 2: MEC group at 1 July 2002



On 12 September 2002, shareholder C (an individual) purchases shareholder B's 40% interest in TopCo.

Figure 3: MEC group at 12 September 2002, after the sale of membership interests in TopCo

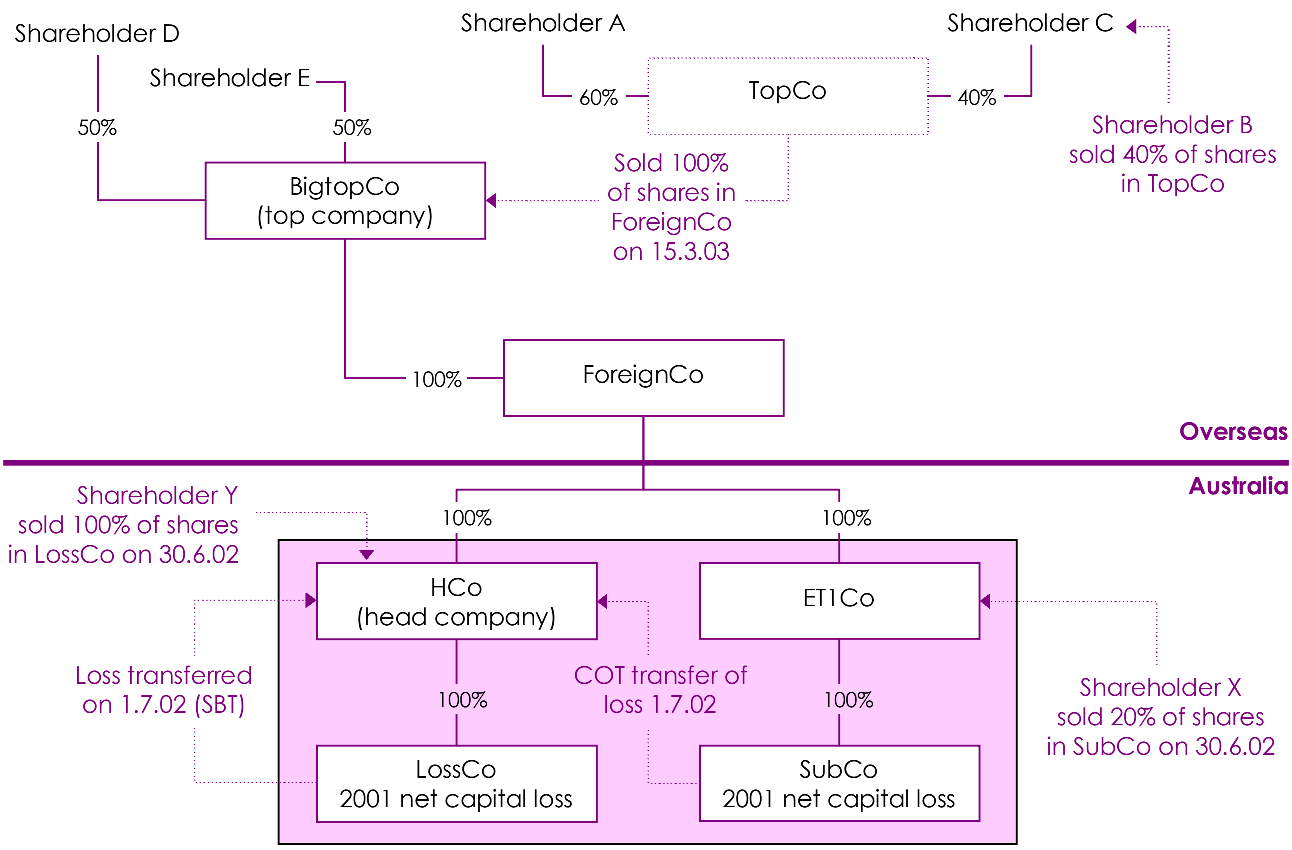


On 15 March 2003, BigtopCo, a foreign-resident company, purchases all of the membership interests in ForeignCo from TopCo. As a result, BigtopCo becomes top company of HCo's MEC group.[262]

BigtopCo's membership interests are owned by two individuals, shareholder D and shareholder E, who each have a 50% share.

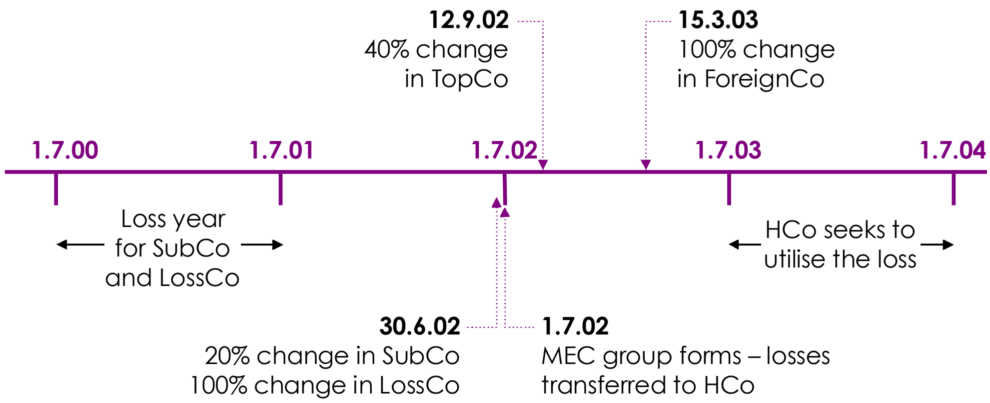
HCo seeks to utilise both losses in the income year ended 30 June 2004 as the MEC group has made a capital gain in that year.

Figure 4: MEC group at 15 March 2003, after the sale of membership interests in ForeignCo



[262] The MEC group continues to exist. Although the identity of the top company changes, the eligible tier-1 companies of the MEC group do not become members of another MEC group immediately after the change (therefore paragraph 719-5(7)(b) does not apply).

Figure 5: Timeline of events



To determine whether HCo, as the focal company, satisfies the conditions in section 165-12 in relation to each of the losses, Subdivision 719-F must be applied.

Under section 719-260, the focal company is taken to have met the conditions in section 165-12 for the claim year (the year in which the focal company seeks to utilise the loss) and the loss, provided the test company identified in section 719-265 would have met the conditions for that year under:

- section 719-270 (the test company makes the loss for an income year starting at a specified time)
- section 719-275 (nothing happens to membership interests of specified entities if certain events take place), and
- section 719-280 (the test company fails to meet the conditions in section 165-12 if certain events take place).

In other words, in relation to each loss, a test company must be identified under section 719-265. It is then necessary to determine whether the test company satisfies the COT in relation to the loss, based on the assumptions in sections 719-270, 719-275 and 719-280.

Calculation

The loss transferred from SubCo

Step 1: Identify the test company

Because the net capital loss was made by the focal company (HCo) as a result of a COT transfer, the table in subsection 719-265(2) is used to identify the test company in relation to the loss. Item 2 in the table applies because the focal company (HCo) and the transferor (SubCo) are different companies.

In accordance with paragraph 719-265(1)(b), section 719-265 is re-applied assuming the focal company is the transferor, SubCo. In this re-application, the table in subsection 719-265(4) applies as the loss was not transferred under

Subdivision 707-A from a company to the (deemed) focal company (SubCo). Item 3 in the table identifies the test company as the (deemed) focal company, SubCo.

Step 2: Assume the test company made the loss

SubCo is therefore the test company in relation to HCo, the focal company. If SubCo satisfies the COT (based on the relevant assumptions) for the income year ended 30 June 2004 (the year in which HCo seeks to utilise the loss), then HCo is considered to satisfy the COT in relation to the loss for that year.

Step 3: Identify the start of the test company's loss year

Section 719-270 is used to determine the start of the income year in which SubCo is considered to have made the loss. Because SubCo is neither the top company of the MEC group, nor the focal company, nor the first head company, subsection 719-270(4) applies.

Item 1 in the table in subsection 719-270(4) identifies the start of the loss year as the start of the income year in which SubCo made the loss (i.e. 1 July 2000).

Step 4: Identify events that freeze the ownership structure

The focal company, HCo, seeks to utilise the loss in the income year ending on 30 June 2004. This means the period in which the events described in section 719-275 can trigger freezing of the ownership structure is from 1 July 2000 to 30 June 2004.

The COT transfer of the loss from SubCo to HCo on 1 July 2002, when the MEC group forms, is one of these triggering events → item 1 of the table, subsection 719-275(2). After this event, it is assumed that the ownership of SubCo and all entities interposed between SubCo and TopCo remains unchanged, for the purposes of determining whether SubCo satisfies the COT in relation to the loss. The only relevant ownership changes after this event are changes to the ownership of TopCo.

For the period 1 July 2000–30 June 2004, the only ownership changes that are relevant to determining whether SubCo satisfies the COT for the year ended 30 June 2004 are:

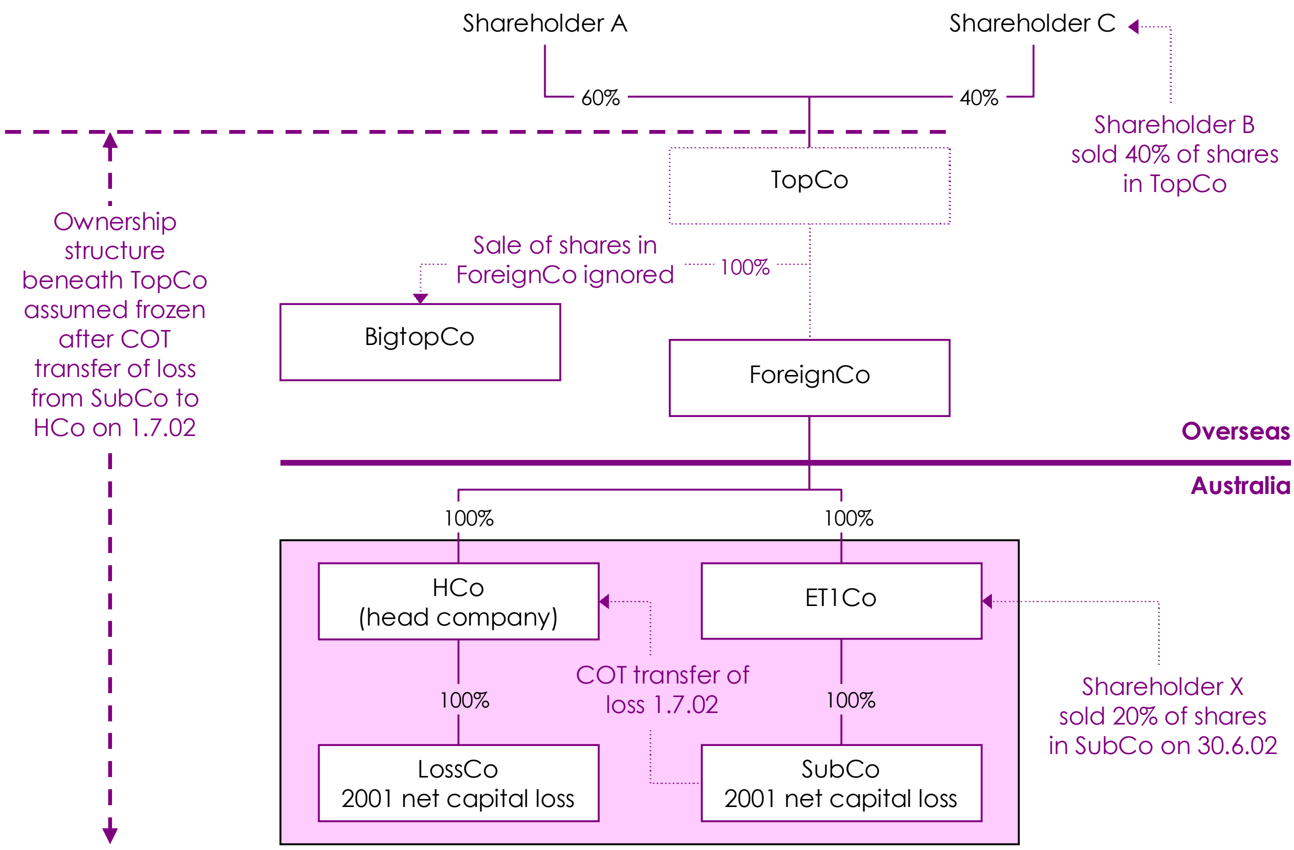
- the change in SubCo's ownership on 30 June 2002 (when ET1Co purchases the remaining 20% membership interests in SubCo from shareholder X, making SubCo a wholly-owned subsidiary of ET1Co),[263] and
- the change in TopCo's ownership on 12 September 2002 (when shareholder C purchases the 40% membership interest in TopCo from shareholder B).[264]

[263] This ownership change occurs before the COT transfer of the loss from SubCo to HCo triggers the freezing of the ownership structure.

[264] This ownership change occurs above the frozen part of the ownership structure.

The ownership change in ForeignCo is ignored because it occurs after the freezing of the ownership structure between SubCo and TopCo.

Figure 6: Freezing of ownership structure – examining SubCo's ownership



There is a 52% change in the underlying ownership of SubCo (the test company) on 12 September 2002 (compared to the start of the loss year).[265] This majority change in the ownership of SubCo means that SubCo does not meet the conditions in section 165-12 for the period 1 July 2000–30 June 2004.

Under subsection 719-260(2), the focal company (HCo) is considered to have failed to meet the conditions in section 165-12 on the first occasion that the test company (SubCo) fails to meet those conditions.

Step 5: Identify events that cause a deemed COT failure to occur

Section 719-280 must be applied to determine whether this is the first time SubCo fails to meet the conditions. (Section 719-280 applies as there is a change in the identity of the top company when BigtopCo takes over on 15 March 2003.)

[265] Calculated as 20% + (40% x 80%). Based on the ownership structure in figure 6, the only continuing underlying shareholder is shareholder A, who has held a continuous indirect interest in SubCo of 48% (i.e. 60% x 80%) since 1 July 2000.

Under subsection 719-280(3), the test company is considered to have failed to meet the conditions in section 165-12[266] if:

- the change in the identity of the top company results from changes in the membership interests of:
  - an eligible tier-1 company of the MEC group, or
  - an entity interposed between the eligible tier-1 company of a MEC group and the top company of the MEC group (just before the change in the membership interests), and
- the change does not cause the potential MEC group to cease to exist.[267]

This means SubCo is considered to have failed the COT on 15 March 2003 under section 719-280. However, as this is later than the change in majority ownership of SubCo (12 September 2002), HCo is considered to have failed to meet the conditions in section 165-12 in relation to the loss transferred from SubCo on 12 September 2002.

For HCo to be able to utilise the loss in the income year ended 30 June 2004, it would need to satisfy the SBT (section 165-13) in relation to:

- the business conducted in the income year ended 30 June 2004, and
- the business conducted just before the time that HCo is considered to have failed to meet the conditions in section 165-12 (i.e. just before 12 September 2002).

The loss transferred from LossCo

Step 1: Identify the test company

As the net capital loss was transferred under Subdivision 707-A from Loss Co to the focal company (HCo) because LossCo satisfied the SBT, the table in subsection 719-265(3) is used to identify the test company in relation to the loss. Item 1 in the table applies because the focal company (HCo) was the head company of a MEC group at the time of the transfer. The test company is identified as the top company of the MEC group at the time of the transfer (in this case, TopCo).

Step 2: Assume the test company made the loss

If the test company, TopCo, satisfies the COT (based on the relevant assumptions) for the income year ended 30 June 2004 (the year in which HCo seeks to utilise the loss), then HCo is considered to have satisfied the COT in relation to the loss for that year.

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[266] Subsection 719-280(1) states that the test company is considered to have failed to meet the conditions in section 165-12 if any of the events described in subsections 719-280(2), (3) or (4) occurs.

[267] Under subsection 719-10(8), a potential MEC group continues to exist after a change in the identity of the top company provided the same eligible tier-1 companies are members of the group immediately before and after the change.

Step 3: Identify the start of the test company's loss year

Section 719-270 is used to determine the start of the income year in which TopCo is considered to have made the loss. Subsection 719-270(1) applies because the test company (TopCo) is the top company of a MEC group and the focal company (HCo) is the head company of that group. Item 2 in the table in subsection 719-270(1) applies because the loss is transferred to the focal company (HCo) under Subdivision 707-A. TopCo is considered to have made the loss at the time of that transfer (i.e. in the income year starting 1 July 2002).

Step 4: Identify events that freeze the ownership structure

The focal company, HCo, seeks to utilise the loss in the income year ending 30 June 2004. This means the period in which the events described in section 719-275 can trigger freezing of the ownership structure is from 1 July 2002 to 30 June 2004.

In this instance, the focal company (HCo) is not the test company, but subsection 719-275(3) provides that, for the purposes of section 719-275, HCo is considered to have made the loss at the time the loss is transferred to it under Subdivision 707-A (1 July 2002).

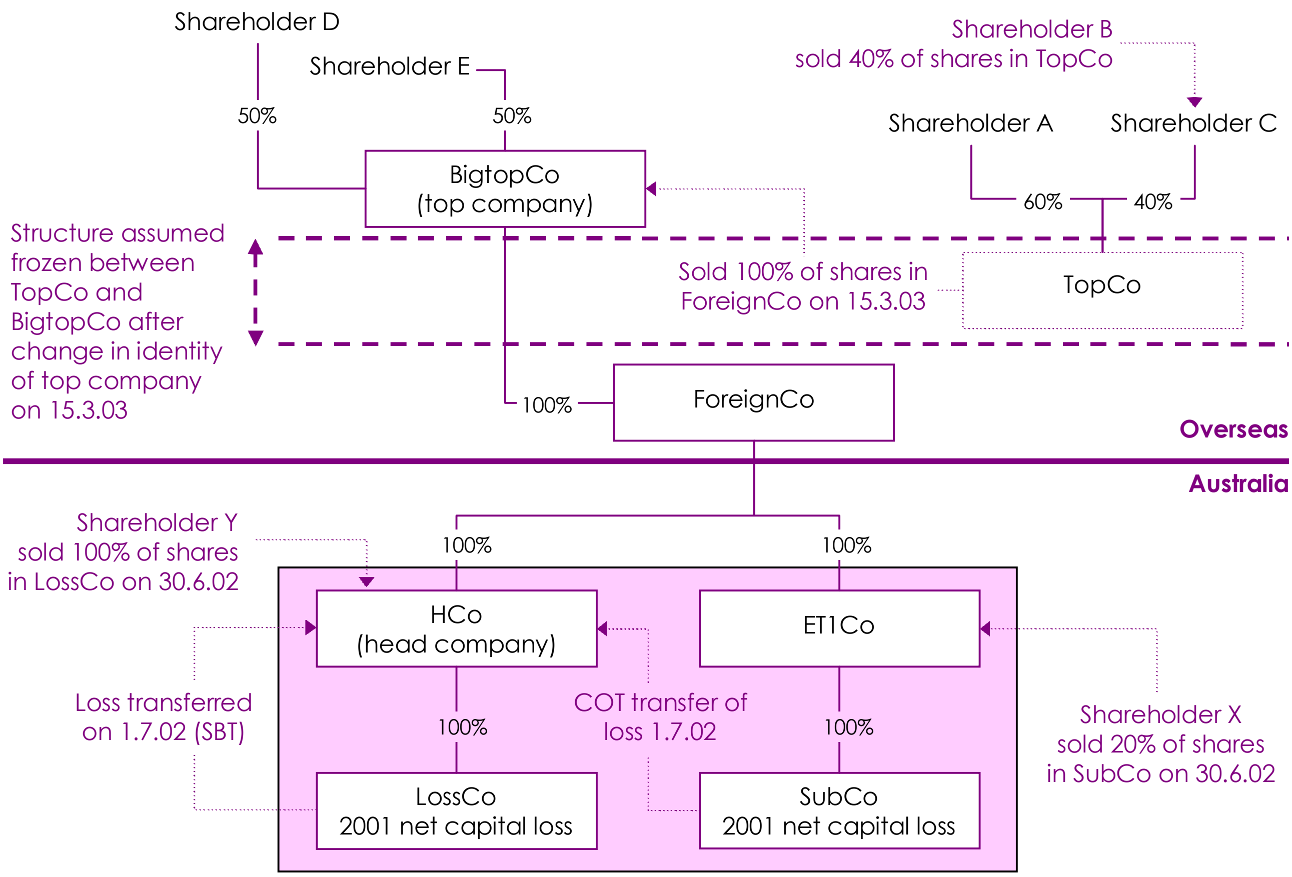
When BigtopCo becomes the top company of the MEC group on 15 March 2003, this triggers the freezing of the ownership structure between TopCo and BigtopCo → item 3 of the table in subsection 719-275(2). However, because BigtopCo does not hold any direct or indirect ownership interest in TopCo, this will not affect whether TopCo satisfies the conditions in section 165-12.

For the period 1 July 2002–30 June 2004, the only ownership change that is relevant to determining whether TopCo satisfies the COT for the year ended 30 June 2004 is:

- the change in TopCo's ownership on 12 September 2002 (when shareholder C purchases 40% of TopCo from shareholder B).

All other ownership changes are irrelevant because they do not involve a change in the underlying ownership of TopCo. As the majority ownership in TopCo does not change over the period, the company appears so far to have satisfied the conditions in section 165-12. However, before a final determination can be made, section 719-280 must also be considered because there is a change in the identity of the top company (when BigtopCo takes over on 15 March 2003).

Figure 7: Freezing of ownership structure – examining TopCo's ownership



Step 5: Identify events that cause a deemed COT failure to occur

Under subsection 719-280(3), the test company is considered to have failed to meet the conditions in section 165-12 if:

- the change in the identity of the top company results from changes in the membership interests of:
  - an eligible tier-1 company of the MEC group, or
  - an entity interposed between the eligible tier-1 company of a MEC group and the top company of the MEC group (just before the change in the membership interests), and
- this change does not cause the potential MEC group to cease to exist.

This means TopCo is considered to have failed to meet the conditions in section 165-12 on 15 March 2003 under section 719-280.

Under subsection 719-260(2), the focal company, HCo, is considered to have failed to meet a condition in section 165-12 on the first occasion that the test company, TopCo, fails to meet the condition. HCo therefore fails the COT in relation to the loss on 15 March 2003, when BigtopCo becomes the top company of the MEC group.

For HCo to be able to utilise the loss in the income year ended 30 June 2004, it needs to satisfy the SBT in relation to:

- the business conducted in the income year ended 30 June 2004, and
- the business conducted just before the time that HCo is considered to have failed to meet the conditions in section 165-12 (i.e. just before 15 March 2003).

References

Income Tax Assessment Act 1997:

- sections 165-12, 165-13
- paragraph 719-5(7)(b)
- subsection 719-10(8)
- section 719-140; as inserted by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 2

Income Tax Assessment Act 1997, Subdivision 719-F, subsection 707-210(1A); as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 13

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 3

Income Tax Assessment Act 1997, Subdivision 707-A; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Tax Laws Amendment (2010 Measures No. 1) Act 2010, item 17

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5

Revision history

Section C10-2-325 first published 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
6.5.11	Addition of footnote p. 1 to reflect changes to group conversion provisions.	Legislative amendments.

Worked example

Identifying the test company to determine continuity of ownership of the focal company in a MEC group (COT transfer of losses)

Description

This example shows how the test company is identified when a loss has been transferred to the head company of a MEC group in a series of continuity of ownership test (COT) transfers. → ''MEC groups and losses – determining whether the focal company satisfies the continuity of ownership test ', C10-2-325 (high-level worked example)

Commentary

In recognition of the special characteristics of MEC groups, Subdivision 719-F of the *Income Tax Assessment Act 1997* (ITAA 1997) modifies the rules about transferring and utilising losses within those groups.

The head company of a MEC group that is seeking to utilise a loss transferred to it from another company in the group is known as the focal company. It is considered to have satisfied the continuity of ownership test (COT) if the company defined as the test company satisfies that test. The tables in section 719-265 are used to identify the test company based on how the focal company made the loss.

When the COT transfer involves different companies, section 719-265 must be re-applied on the assumption that the transferor was the focal company (taking into account only things that happened before the transfer). The section is not re-applied if the COT transfer is from a company to itself as head company.

Example

Facts

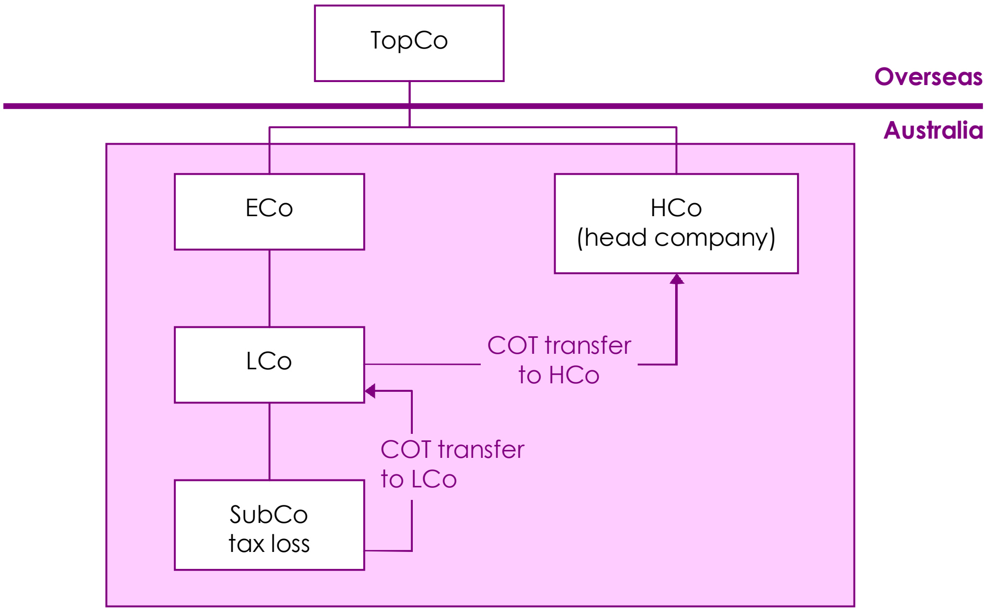
A tax loss made by SubCo in the year ended 30 June 2000 is transferred as a COT transfer under Subdivision 707-A to LCo, the head company of a consolidated group, on 1 July 2002.

On 1 July 2003, LCo becomes a wholly-owned subsidiary of ECo, an eligible tier-1 company of a MEC group. HCo, the head company of the MEC group notifies the Commissioner that LCo and SubCo have become members of the MEC group. The tax loss is transferred from LCo to HCo as a COT transfer.

HCo, the focal company, seeks to claim a deduction for the transferred tax loss in the year ended 30 June 2004. At all times since the MEC group formed, HCo has been the head company and TopCo has been the top company of the group.

Figure 1 shows the loss transfers within the group.

Figure 1: Loss transfers within the group



Calculation

The test company is SubCo, as it is the first to transfer the tax loss.

First application of section 719-265 – focal company is HCo

The table in subsection 719-265(2) applies as the tax loss is considered to have been made by HCo, the focal company, because of a COT transfer.

Item 2 in the table applies as HCo, the focal company, and LCo, the transferor, are different companies.

Column 2 of item 2 in the table states that the test company is the company that is the test company for the transferor.

Re-application of section 719-265 – assumed focal company is LCo

In accordance with paragraph 719-265(1)(b), section 719-265 is re-applied assuming the focal company is the transferor, LCo.

In this re-application, the table in subsection 719-265(2) applies as the tax loss is considered to have been made by LCo, the assumed focal company, because of a COT transfer to LCo.

Item 2 in the table applies as LCo, the assumed focal company, and SubCo, the transferor, are different companies.

Column 2 of item 2 in the table states that the test company is the company that is the test company for the transferor.

Second re-application of section 719-265 – assumed focal company is SubCo

In accordance with paragraph 719-265(1)(b), section 719-265 is again re-applied assuming the focal company is the first transferor, SubCo.

In this re-application, the table in subsection 719-265(4) applies as the tax loss was not transferred under Subdivision 707-A from a company to SubCo, the assumed focal company.

Item 3 in the table applies as items 1 and 2 do not apply. SubCo is not the head company of a MEC group when it makes the loss (item 1) and the loss has not been transferred to SubCo from a trust (item 2).

Column 2 of item 3 in the table states that the test company is the focal company. The assumed focal company in this application of section 719-265 is SubCo. This means that SubCo is the test company for the actual focal company, HCo.

References

Income Tax Assessment Act 1997, section 165-12

Income Tax Assessment Act 1997, Subdivision 719-F, subsection 707-210(1A); as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 13

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 3

Revision history

Section C10-2-330 first published 28 May 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Identifying the test company to determine continuity of ownership of the focal company in a MEC group (SBT satisfied)

Description

This example shows how the test company is identified when a loss is transferred to the head company of a MEC group because the same business test (SBT) is satisfied. → ''MEC groups and losses – determining whether the focal company satisfies the continuity of ownership test ', C10-2-325 (high-level worked example)

Commentary

In recognition of the special characteristics of MEC groups, Subdivision 719-F of the *Income Tax Assessment Act 1997* (ITAA 1997) modifies the rules about transferring and utilising losses within those groups.

The head company of a MEC group that is seeking to utilise a loss transferred to it from another company in the group is known as the focal company. It is considered to have satisfied the continuity of ownership test (COT) if the company defined as the test company satisfies that test. The tables in section 719-265 are used to identify the test company based on how the focal company made the loss. Subsection 719-265(3) applies when the loss is transferred to the focal company under Subdivision 707-A because the same business test is satisfied.

Example

Facts

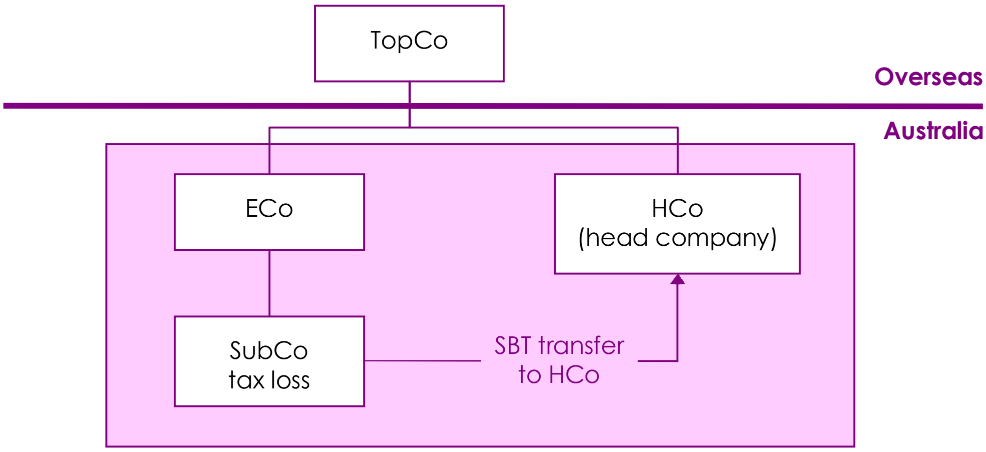
A MEC group consisting of ECo and HCo forms on 1 July 2002. On 30 September 2002, ECo acquires 100% of the share capital of SubCo. HCo, as head company of the MEC group, notifies the Commissioner that SubCo has become a member of the MEC group.

A tax loss made by SubCo in the year ended 30 June 2000 is transferred to HCo under Subdivision 707-A because the same business test is satisfied.

The focal company, HCo, seeks to claim a deduction for the tax loss transferred to it. At all times since the MEC group formed, HCo has been the head company and TopCo has been the top company.

The structure of the MEC group is shown in figure 1.

Figure 1: Structure of the MEC group



Calculation

The table in subsection 719-265(3) applies as the loss was transferred to HCo from SubCo under Subdivision 707-A because the same business test was satisfied.

Item 1 in the table applies as the focal company, HCo, was the head company of the MEC group at the time of the transfer on 30 September 2002.

Column 2 of item 1 in the table states that the test company is the top company of the MEC group at the time of the transfer. In this case, the test company is therefore TopCo which has been the top company at all times since the MEC group formed on 1 July 2002.

References

Income Tax Assessment Act 1997, section 165-12

Income Tax Assessment Act 1997, Subdivision 719-F; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 13

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 3

Income Tax Assessment Act 1997, Subdivision 707-A; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Revision history

Section C10-2-340 first published 28 May 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Determining the start of a test company's loss year to assess the continuity of ownership of the focal company in a MEC group (COT transfer of a loss)

Description

This example shows how to determine the start of the test company's loss year when a loss is transferred to the head company of a MEC group as a continuity of ownership test (COT) transfer from another company. This is part of the process of assessing the continuity of ownership of the group's focal company (the company that seeks to utilise the loss). → 'MEC groups and losses – determining whether the focal company satisfies the continuity of ownership test', C10-2-325

Commentary

In recognition of the special characteristics of MEC groups, Subdivision 719-F of the *Income Tax Assessment Act 1997* (ITAA 1997) modifies the rules about transferring and utilising losses within those groups.[268]

In order to apply the COT to the test company, it is necessary to assume that the test company made the loss, even if it actually did not (e.g. because the test company is also the top company).

The COT is applied to the test company for its ownership test period – the period from the start of the test company's loss year until the end of the income year in which the focal company seeks to utilise the loss.

The tables in section 719-270 are used to determine the start of the test company's loss year based on the identity of the test company and how the loss was made.

[268] Subdivision 719-F does not apply if the MEC group has converted to a consolidated group during the ownership test period, where the conversion took place:

- on or after 27 October 2006, or
- before 27 October 2006 and a choice in writing is made within the prescribed time for Subdivision 719-BA to apply from 1 July 2002.

→ section 719-140, ITAA 1997; paragraphs 5.92, 5.105 and 5.106, Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010

Example

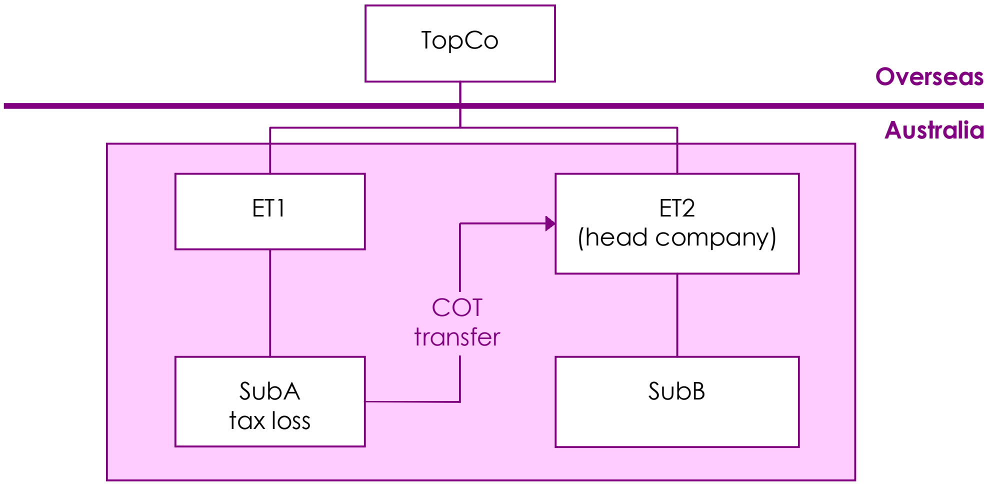
Facts

SubA makes a tax loss in the income year ended 30 June 2002. On 1 July 2002, a MEC group forms and the loss is transferred to ET2, the head company of the MEC group, as a COT transfer.

ET2, the focal company, seeks to utilise the loss in the income year ended 30 June 2004. ET2 has been the head company at all times since the MEC group formed.

The structure of the group is shown in figure 1.

Figure 1: COT transfer of a loss to the head company of a MEC group



Calculation

Under section 719-265, the test company is SubA. → subsections 719-265(2) (item 2 in the table) and 719-265(4) (item 3 in the table); 'MEC groups and losses – determining whether the focal company satisfies the continuity of ownership test', C10-2-325

Subsection 719-270(1) applies when the test company is also the top company. Subsection 719-270(2) applies when the test company is also the focal company (or the first head company, when the head company has changed and the income tax history of the first head company has been transferred to the new head company under section 719-90).[269]

Because subsections 719-270(1) and (2) do not apply in this case, the table in subsection 719-270(4) does apply.

Item 1 in the table applies because SubA, the test company, is the original maker of the loss. Column 2 of item 1 in the table states that the start of the test company's loss year is the start of the income year in which it made the loss. Therefore, for the purpose of applying the COT, the income year in

[269] Under section 719-90, when the head company of a MEC group is replaced, its income tax history is transferred to the new head company of the group.

which SubA (the test company) is assumed to have made the loss starts on 1 July 2001.

References

Income Tax Assessment Act 1997, sections 165-12 and 719-90

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, paragraphs 3.117 to 3.129

Income Tax Assessment Act 1997, Subdivision 719-F, subsection 707-210(1A); as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 13

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 3

Income Tax Assessment Act 1997, section 719-140; as inserted by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 2

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5

Revision history

Section C10-2-350 first published 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
6.5.11	Addition of footnote p. 1 to reflect changes to group conversion provisions.	Legislative amendment.

Worked example

Determining the start of a test company's loss year to assess continuity of ownership of the focal company in a MEC group (special conversion event)

Description

This example shows how to determine the start of the test company's loss year when the loss is transferred to the head company of a consolidated group because the same business test is met and when a MEC group is subsequently created from the consolidated group. This is known as a special conversion event.

Determining the start of the test company's loss year is part of the process of assessing the continuity of ownership of the group's focal company (the company that seeks to utilise the loss). → 'MEC groups and losses – determining whether the focal company satisfies the continuity of ownership test', C10-2-325

Commentary

In recognition of the special characteristics of MEC groups, Subdivision 719-F of the *Income Tax Assessment Act 1997* (ITAA 1997) modifies the rules about transferring and utilising losses within those groups.[270]

In order to apply the continuity of ownership test (COT) to the test company, it is necessary to assume that the test company made the loss, even if it actually did not (e.g. because the test company is also the top company).

The COT is applied to the test company for its ownership test period – the period from the start of the test company's loss year until the end of the income year in which the focal company seeks to utilise the loss.

The tables in section 719-270 are used to determine the start of the test company's loss year based on the identity of the test company and how the loss was made.

[270] Subdivision 719-F does not apply if the MEC group has converted to a consolidated group during the ownership test period, where the conversion took place:

- on or after 27 October 2006, or
- before 27 October 2006 and a choice in writing is made within the prescribed time for Subdivision 719-BA to apply from 1 July 2002.

→ section 719-140, ITAA 1997; paragraphs 5.92, 5.105 and 5.106, Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010

Example

Facts

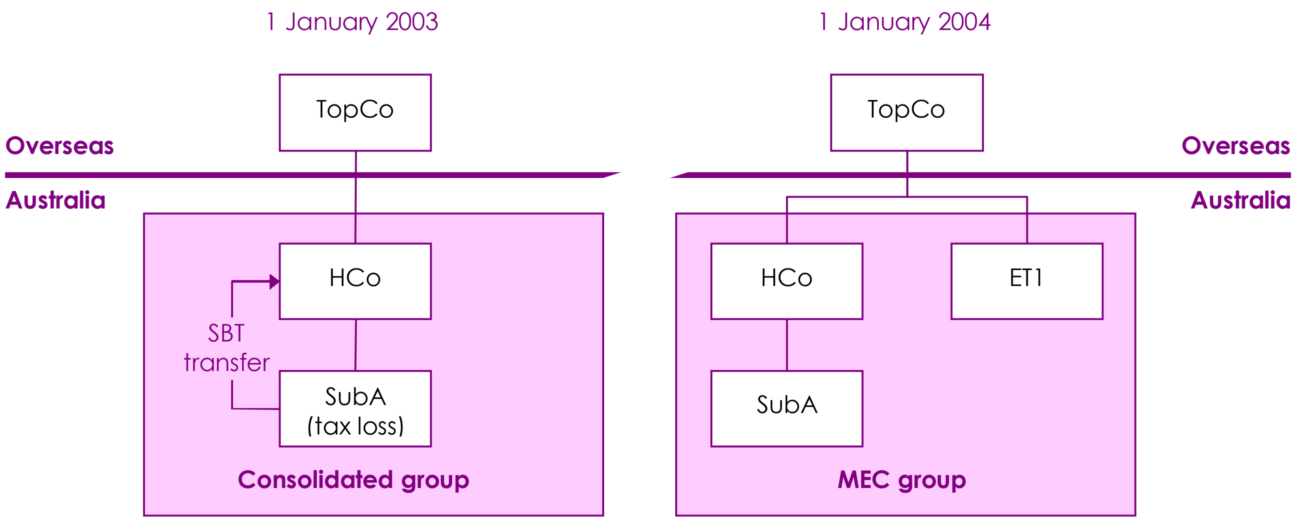
HCo is a wholly-owned subsidiary of TopCo (a non-resident company). HCo forms a consolidated group with SubA as its subsidiary member on 1 January 2003. A tax loss made by SubA in an earlier income year is transferred to HCo because the same business test is satisfied.

On 1 January 2004, TopCo acquires another eligible tier-1 company, ET1, and HCo makes the choice in writing under paragraph 719-40(1)(e) of the ITAA 1997 to create a MEC group from its consolidated group as a result of ET1 becoming an eligible tier-1 company of TopCo (a special conversion event). HCo, the head company group notifies the Commissioner of this choice in the approved form within the prescribed period.

→ 'MEC groups – notices to be given to the Commissioner', C10-1-110; 'Choice on formation, special conversion events and acquisition of new eligible tier-1 companies', C10-2-110

HCo, the focal company, seeks to utilise the loss in the income year ending 30 June 2004. At all times since the MEC group formed, HCo has been its head company.

Figure 1: Sequence of events



Calculation

The test company is HCo. → subsection 719-265(3), table item 2; 'MEC groups and losses – determining whether the focal company satisfies the continuity of ownership test', C10-2-325; 'Identifying the test company to determine continuity of ownership of the focal company in a MEC group (COT transfer of losses)', C10-2-330; 'Identifying the test company to determine continuity of ownership of the focal company in a MEC group (SBT satisfied)', C10-2-340

The table in subsection 719-270(2) applies as the test company is also the focal company.

Item 2 in the table applies as HCo, the test company, is considered to have made the loss because it was transferred to HCo under Subdivision 707-A in a transfer other than a COT transfer → subsection 707-210(1A).

Column 2 of item 2 in the table states that the start of the income year in which the test company is assumed to have made the loss is the time of the transfer.

Therefore, for the purpose of applying the COT, the income year in which HCo (the test company) is assumed to have made the loss starts on 1 January 2003, i.e. at the time of the transfer.

References

Income Tax Assessment Act 1997, section 165-12

Income Tax Assessment Act 1997, Subdivision 719-F, subsection 707-210(1A); as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 13

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 3

Income Tax Assessment Act 1997, Subdivision 719-BA; as inserted by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 2

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.65 – 5.110

Revision history

Section C10-2-360 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
6.5.11	Revisions to reflect changes to group conversion provisions.	Legislative amendments.

Worked example

Freezing the ownership of the test company – COT transfer of a loss to the head company of a MEC group

Description

This example shows how the ownership structure of a MEC group is considered to be frozen after there is a continuity of ownership test (COT) transfer of a loss to the head company of the group. → ''Multiple entry consolidated (MEC) groups', C10-1; ''MEC groups and losses – determining whether the focal company satisfies the continuity of ownership test ', C10-2-325 (high-level worked example)

Commentary

In recognition of the special characteristics of MEC groups, Subdivision 719-F of the *Income Tax Assessment Act 1997* (ITAA 1997) modifies the rules about transferring and utilising losses within those groups.

The focal company (i.e. the company that is seeking to utilise the loss) is considered to meet the continuity of ownership conditions in section 165-12 of the ITAA 1997 if the test company, as determined by section 719-265, would meet those conditions based on the assumptions in sections 719-270, 719-275 and 719-280.

In order to apply the COT to the test company, it is necessary to assume that the test company made the loss, even if it actually did not (e.g. because the test company is also the top company).

The COT is applied to the test company for the period from the start of the test company's loss year (as determined by section 719-270) until the end of the income year in which the focal company seeks to utilise the loss.

If any of the events defined in section 719-275 occur within this period, they trigger freezing of part of the ownership structure. This means it is assumed that there is no change in membership interests or voting power in entities in these frozen parts of the group structure. The COT transfer of a loss to the head company of a MEC group is one event that triggers freezing of the ownership structure between the transferor and the top company.
→ item 1 of the table in subsection 719-275(2)

Example

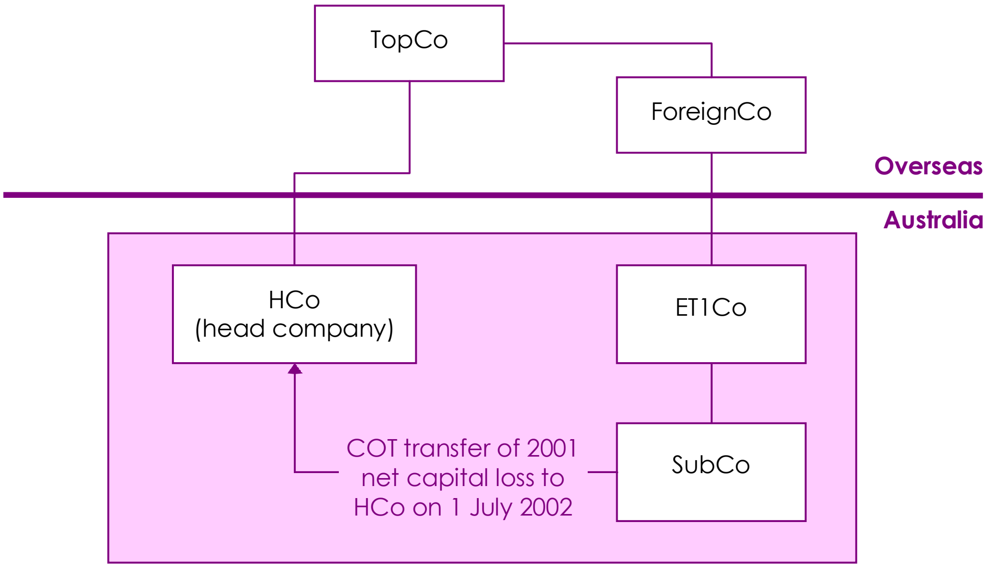
Facts

SubCo makes a net capital loss in the income year ended 30 June 2001. It is a wholly-owned subsidiary of ET1Co. ET1Co and HCo are both wholly-owned subsidiaries of the foreign-resident company, TopCo, and are TopCo's first level of investment into Australia. TopCo meets the conditions to be a top company.

ET1Co and HCo are eligible tier-1 companies and they choose to form a MEC group on 1 July 2002. HCo is chosen to be the head company of the MEC group. The net capital loss incurred in the income year ended 30 June 2001 by SubCo is transferred from SubCo to HCo at the time the MEC group is formed. The transfer is a COT transfer as defined by subsection 707-210(1A) of the ITAA 1997.

HCo seeks to utilise the loss in the income year ended 30 June 2004, as the MEC group has made a capital gain in that year.

Figure 1: MEC group at 1 July 2002



Calculation

The test company is SubCo.[271] The start of SubCo's loss year is the start of the income year in which it made the loss (i.e. SubCo is considered to have made the loss in the income year starting 1 July 2000).

→ item 1 in the table, subsection 719-270(4); 'Determining the start of a test company's loss year to assess the continuity of ownership of the focal company in a MEC group (COT transfer of a loss)', C10-2-350 (worked example)

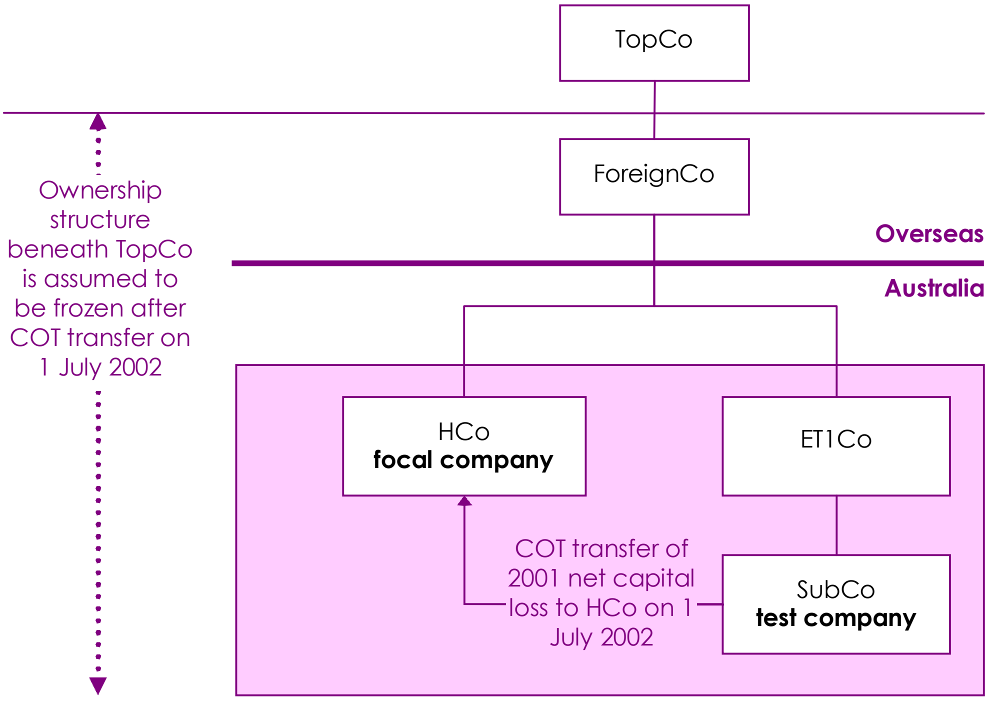
The focal company, HCo, seeks to utilise the loss in the income year ending 30 June 2004. HCo will satisfy the continuity of ownership test (COT) in section 165-12, for the income year ended 30 June 2004, if SubCo satisfies the test for the period 1 July 2000–30 June 2004.

During this period, certain events can trigger freezing of the group's ownership structure. The COT transfer of the loss from SubCo to HCo on 1 July 2002,

[271] The table in subsection 719-265(2) applies as the tax loss was made by the focal company (HCo) because of a COT transfer. Item 2 in the table applies as the focal company (HCo) and the transferor (SubCo) are different companies. In accordance with paragraph 719-265(1)(b), section 719-265 is re-applied assuming the focal company is the transferor, SubCo. In this re-application, the table in subsection 719-265(4) applies as the loss was not transferred under Subdivision 707-A from a company to the (deemed) focal company (SubCo). Item 3 in the table identifies the test company as the (deemed) focal company, SubCo. → 'Identifying the test company to determine continuity of ownership of the focal company in a MEC group (COT transfer of losses)', C10-2-330 (worked example)

when the MEC group forms, is one such event → item 1 of the table in subsection 719-275(2). After this event, for the purpose of determining if SubCo satisfies the continuity of ownership provisions in section 165-12 in relation to the loss, it is assumed that the ownership of SubCo and all entities interposed between SubCo and TopCo remains unchanged. After this freezing of the membership interests in SubCo, and all entities interposed between SubCo and TopCo, the only relevant ownership changes are changes in the ownership of TopCo.

Figure 2: Freezing of ownership structure



References

Income Tax Assessment Act 1997, section 165-12

Income Tax Assessment Act 1997, Subdivision 719-F, subsection 707-210(1A); as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 13

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 3

Revision history

Section C10-2-370 first published 28 May 2003.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Freezing the ownership structure of a MEC group – when a loss-making company becomes head company of the group

Description

This example shows how parts of the ownership structure of a MEC group are considered to be frozen in certain circumstances. It relates specifically to the situation where a loss-making company (that has not previously transferred the loss under Subdivision 707-A) becomes the first head company of a MEC group. This is combined with the situation where there is a continuity of ownership test (COT) transfer of a loss to the head company of a consolidated group from another company.

Both situations require assumptions to be made about the ownership structure.

→ 'MEC groups and losses – determining whether the focal company satisfies the continuity of ownership test', C10-2-325

Commentary

In recognition of the special characteristics of MEC groups, Subdivision 719-F of the *Income Tax Assessment Act 1997* (ITAA 1997) modifies the rules about transferring and utilising losses within those groups.

When a loss-making company (that has not previously transferred the loss under Subdivision 707-A) becomes the head company of a MEC group, this event triggers freezing of the ownership structure between that company and the top company. This means it is assumed that there is no change in ownership of the loss-making company or of any entity interposed between it and the top company of the MEC group.

→ item 4 of the table in subsection 719-275(2)

For this freezing of the ownership structure to take place, it is necessary to apply subsection 719-275(3), which reinstates the head company of the MEC group as the loss-making company for the purposes of section 719-275. This is necessary, when the test company is not the head company, because section 719-270 assumes that the test company made the loss for an income year starting at a specified time.

Item 5 of the table in subsection 719-275(2) applies when there is a COT transfer of a loss to the head company of a consolidated group. This event also triggers freezing of the ownership structure, this time between the transferring company and the head company.

Example

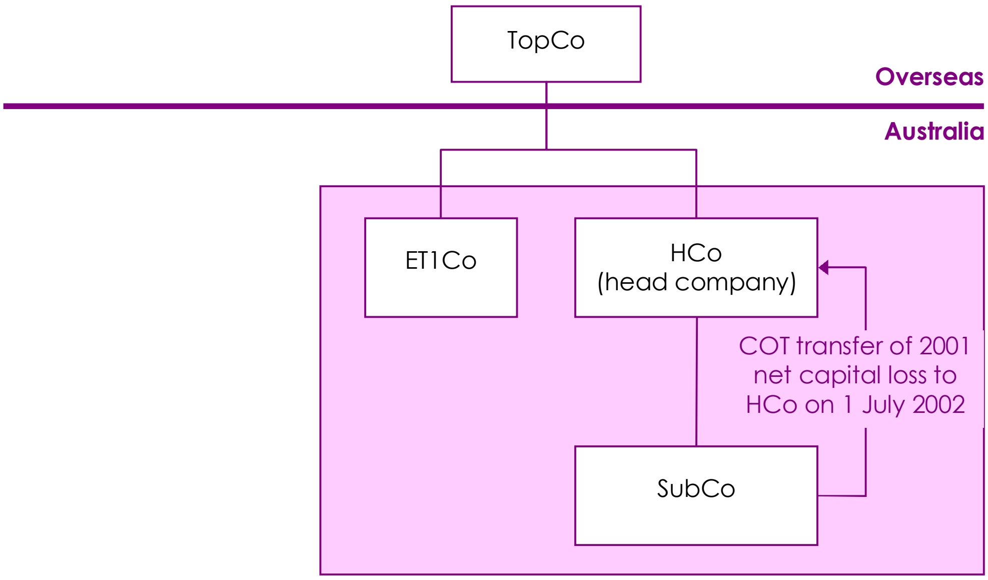
Facts

HCo is the head company of a consolidated group that forms on 1 July 2002. A net capital loss, incurred in the income year ended 30 June 2001 by SubCo, is transferred from SubCo to HCo at the time the group forms. The transfer from SubCo to HCo is a COT transfer as defined by subsection 707-210(1A).

HCo is a wholly-owned subsidiary of TopCo (a foreign-resident company). On 25 October 2002, TopCo acquires another wholly-owned subsidiary, ET1Co, an Australian-resident company. TopCo meets the conditions to be a top company, and both HCo and ET1Co are eligible tier-1 companies of TopCo.

On 25 October 2002, HCo makes a choice in writing to create at that time a MEC group from its consolidated group. HCo notifies the Commissioner in the approved form of its choice to create a MEC group from its consolidated group with ET1Co as another eligible tier-1 company. This is a special conversion event, as defined in section 719-40 → 'Choice on formation, special conversion events and acquisition of new eligible tier-1 companies', C10-2-110. At the time of the special conversion event, HCo is taken to be appointed as the provisional head company of the MEC group. In the income year ending 30 June 2003, HCo, as the head company of the MEC group, seeks to utilise the loss transferred from SubCo.

Figure 1: MEC group at 25 October 2002



Calculation

The test company is SubCo.[272] The start of its loss year is the start of the income year in which it made the loss (i.e. 1 July 2000) → item 1 in the table in subsection 719-270(4); 'Determining the start of a test company's loss year to assess the continuity of ownership of the focal company in a MEC group (COT transfer of a loss)', C10-2-350; 'Determining the start of a test company's loss year to assess continuity of ownership of the focal company in a MEC group (special conversion event)', C10-2-360.

The focal company, HCo, is seeking to utilise the loss in the income year ending 30 June 2003. HCo will satisfy the test in section 165-12 of the ITAA 1997 in the income year ending 30 June 2003 if SubCo satisfies the test for the period 1 July 2000–30 June 2003. This is the period in which certain events can trigger freezing of the ownership structure.

In this case, the focal company (HCo) is not the test company, but subsection 719-275(3) provides that, for the purposes of section 719-275, HCo is considered to have made the loss at the time the loss is transferred to it from SubCo under Subdivision 707-A (1 July 2002).

This means the event in item 4 of the table in subsection 719-275(2) – which refers to the company that has made the loss – applies. The item 4 event occurs at the time that HCo (the company considered to have made the loss) becomes the head company of the MEC group, i.e. when the MEC group was created from the consolidated group.

When HCo becomes head company of the MEC group on 25 October 2002, this triggers freezing of the ownership structure between it and TopCo.

Event 5 of the table in subsection 719-275(2) also applies to this scenario. The COT transfer of the loss from SubCo to HCo on 1 July 2002 (when SubCo joins HCo's consolidated group) also triggers freezing of the ownership structure, this time between SubCo and HCo.

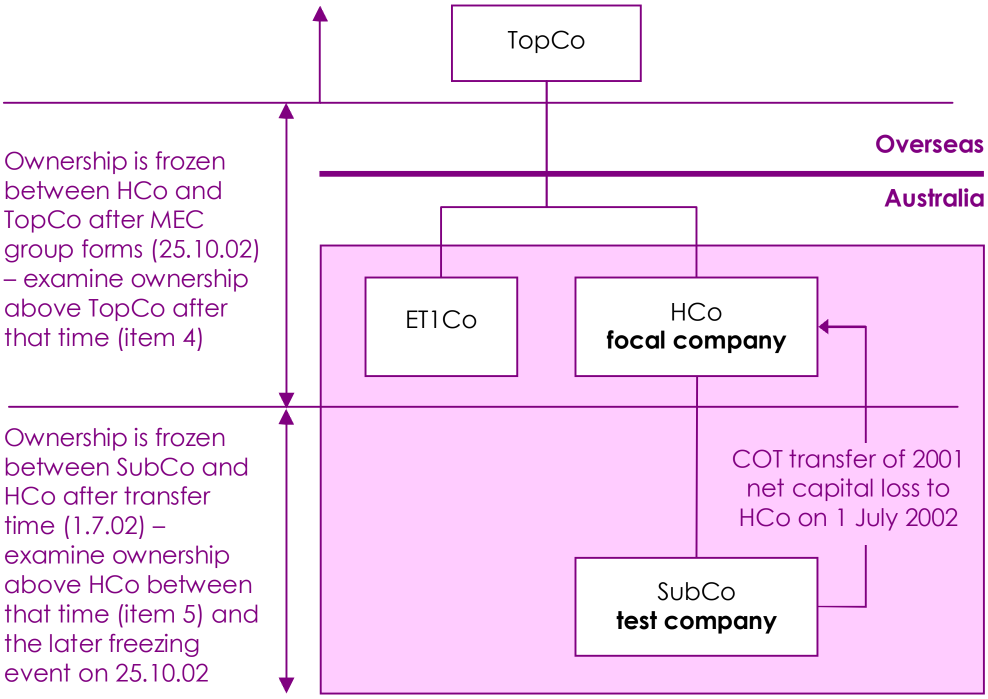
If HCo seeks to utilise the loss in the income year ended 30 June 2003, these two trigger events will freeze the ownership structure as shown in figure 2.

[272] The table in subsection 719-265(2) applies as the tax loss was made by the focal company (HCo) because of a COT transfer. Item 2 in the table applies as the focal company (HCo) and the transferor (SubCo) are different companies. In accordance with paragraph 719-265(1)(b), section 719-265 is re-applied assuming the focal company is the transferor, SubCo. In this re-application, the table in subsection 719-265(4) applies as the loss was not transferred under Subdivision 707-A from a company to the (deemed) focal company, SubCo. Item 3 in the table identifies the test company as the (deemed) focal company, SubCo. → 'Identifying the test company to determine continuity of ownership of the focal company in a MEC group (COT transfer of losses)', C10-2-330; 'Identifying the test company to determine continuity of ownership of the focal company in a MEC group (SBT satisfied)', C10-2-340

This means the ownership of SubCo (the test company) must be examined from 1 July 2000 to 30 June 2003 to determine whether HCo satisfies section 165-12, on the basis that:

- the ownership structure between SubCo and HCo is considered frozen from 1 July 2002, when the loss is transferred from SubCo to HCo as a COT transfer → item 5 of the table in subsection 719-275(2), and
- the ownership structure between HCo and TopCo is considered frozen after HCo becomes head company of the MEC group on 25 October 2002 → item 4 of the table in subsection 719-275(2).

Figure 2: Freezing of ownership structure



References

Income Tax Assessment Act 1997, sections 165-12 and 719-40

Income Tax Assessment Act 1997, Subdivision 719-F, subsection 707-210(1A); as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 13

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 3

Income Tax Assessment Act 1997, Subdivision 719-BA as inserted by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010 Schedule 5, Part 2

Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5, paragraphs 5.65 to 5.100

Revision history

Section C10-2-380 first published 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
6.5.11	Revisions to reflect changes to group conversion provisions.	Legislative amendments.

Worked example

Continuity of a potential MEC group when the identity of the top company changes – assumptions about the test company failing the COT

Description

This example describes a case in which the test company is deemed to have failed the continuity of ownership test (COT). In this example, the potential MEC group continues to exist despite a change in the top company arising from a change in ownership of the membership interests in the group's eligible tier-1 companies. → 'MEC groups and losses – determining whether the focal company satisfies the continuity of ownership test', C10-2-325

Commentary

In recognition of the special characteristics of MEC groups, Subdivision 719-F of the *Income Tax Assessment Act 1997* (ITAA 1997) modifies the rules about transferring and utilising losses within those groups.

The focal company (the company seeking to utilise the loss) is considered to have met the continuity of ownership conditions in section 165-12 of the ITAA 1997 if the test company would have met those conditions based on the assumptions in sections 719-270, 719-275 and 719-280.[273]

Under section 719-280, the test company is deemed to have failed the COT (section 165-12) in relation to a loss in certain circumstances. Broadly, those circumstances are when one of the following events happens to the focal company's MEC group, or potential MEC group, after the start of the focal company's ownership test period for the loss:[274]

- the potential MEC group ceases to exist
- the potential MEC group continues to exist but the identity of the top company changes as a result of the acquisition of membership interests in certain entities below the group's original top company (the relevant entities are the group's eligible tier-1 companies or any entities interposed between the eligible tier-1 companies and the original top company), or

[273] The assumptions contained in sections 719-270 and 719-275 relate to determining whether the test company has satisfied the COT. If the conditions in section 719-280 are satisfied, however, the test company is deemed to have failed the COT.

[274] Section 719-280 does not apply where the event occurs because the MEC group has converted to a consolidated group, where the conversion took place:

- on or after 27 October 2006, or
- before 27 October 2006 and a choice in writing is made within the prescribed time for Subdivision 719-BA to apply from 1 July 2002.

→ section 719-140, item 17, *Tax Laws Amendment (2010 Measures No.1) Act 2010;* paragraphs 5.92, 5.105 and 5.106 of the Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010

- there ceases to be a provisional head company for the group.

The test company will also fail the conditions in section 165-12 when those conditions are not met based on the assumptions in sections 719-270 and 719-275. When this actual COT failure occurs in addition to a deemed COT failure (under section 719-280), the COT failure time will be the earlier of the two. Under section 719-260, the focal company is considered to have failed to meet a condition in section 165-12 only at the first time that the test company would have failed to meet the condition.

Example

Facts

TopCo1 is a foreign-resident company that owns all the membership interests in the Australian-resident companies, ET1Co and HCo. ET1Co, in turn, owns all the membership interests in the Australian-resident company, SubCo.

A MEC group consisting of SubCo and the eligible tier-1 companies, ET1Co and HCo, forms on 1 July 2002, with HCo being nominated as the provisional head company.[275] On that date, Ben holds 55% of the membership interests in TopCo1 and the remaining membership interests are held by Bill. These membership interests in TopCo1 are held continuously from 1 July 2002 to 30 June 2004.

HCo is the provisional head company of the MEC group at the end of the income year ended 30 June 2003 and is therefore considered to be the head company of the MEC group for that income year (section 719-75). HCo makes a tax loss (in this case, a group loss) for the income year ended 30 June 2003.

On 1 August 2003, TopCo2 acquires all the membership interests in both ET1Co and HCo. On this date, Tom holds 70% of the membership interests in TopCo2 and Jerry holds the remaining 30%. These shareholdings in TopCo2 do not change during the income year ended 30 June 2004.

HCo seeks to utilise the group loss (made in the income year ended 30 June 2003) in the income year ended 30 June 2004.

Calculation

HCo, the focal company, will be considered to have satisfied the continuity of ownership conditions in section 165-12 if the test company would have met those conditions based on the assumptions in sections 719-270, 719-275 and 719-280. In addition to establishing whether there has been a deemed COT failure under section 719-280 (step 5 below), it is also necessary to determine whether the COT has been satisfied in relation to the assumptions set out in sections 719-270 and 719-275 (steps 1 to 4 below).

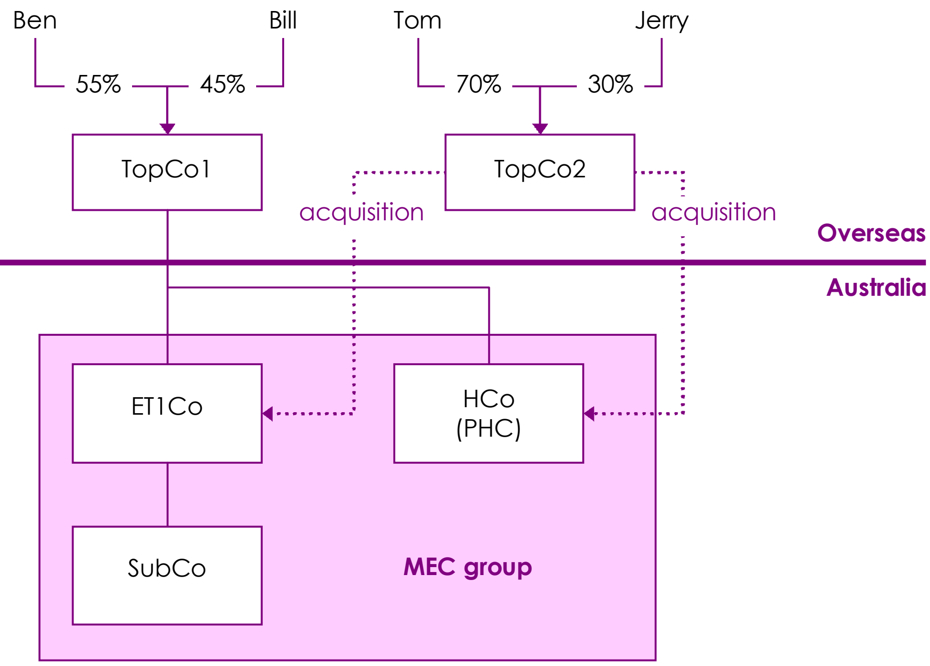
Step 1: Identify the test company

Applying section 719-265, the test company is TopCo1.

[275] Under subsection 719-60(1), the appointment of a provisional head company must be included in the written choice to form a MEC group made under section 719-50.

Item 1 in the table in subsection 719-265(4) applies because the tax loss is a group loss and HCo, the focal company, was the head company of the MEC group at the beginning of the income year in which it made the loss (1 July 2002). TopCo1 is the test company because it was the top company at that time. HCo is the focal company because it is the company that is seeking to utilise the loss. → section 719-255

Figure 1: MEC group and changes in membership interests



Step 2: Assume that the test company made the loss

Applying section 719-270, TopCo1 is considered to have made the loss.

Subsection 719-270(1) applies as the test company, TopCo1, was the top company of the MEC group and the focal company, HCo, was the head company of the group.

Step 3: Identify the start of the income year in which the test company is considered to have made the loss

Applying section 719-270, the test company, TopCo1, is considered to have made the loss at the start of the income year ended 30 June 2003.

Item 1 in the table in subsection 719-270(1) applies, as the loss is a group loss. Under this item, the start of the test company's (TopCo1) loss year is the start of the income year in which the focal company (HCo) made the loss (in this case, 1 July 2002).

Step 4: Apply the COT to the test company, ignoring ownership and voting changes below the top company

Applying section 719-275, the ownership structure between TopCo1 and TopCo2 is considered frozen after TopCo2 becomes the new top company of the MEC group (for the purposes of determining whether the continuity of ownership conditions in section 165-12 are met).[276] In this case, the freezing of the ownership structure does not affect whether TopCo1 satisfies the COT because TopCo2 does not hold any direct or indirect membership interests in TopCo1.

Taking into account the assumptions in sections 719-270 and 719-275, the test company, TopCo1, passes the COT. It satisfies the conditions in section 165-12 because 100% of TopCo1's ownership has remained unchanged from the start of the income year ended 30 June 2003 (the start of the loss year) to 30 June 2004 (the end of the loss claim year).

However, Top Co1 will fail to satisfy the conditions in section 165-12 if the deemed COT failure in section 719-280 applies.

Step 5: Determine whether the deemed COT failure applies

Section 719-280 applies to deem the test company, TopCo1, to have failed the continuity of ownership conditions in section 165-12 because a specified 'failing' event in subsection 719-280(3) occurred on 1 August 2003, which is after the start of the focal company, HCo's, ownership test period (1 July 2002). The specified 'failing' event in this instance occurs when TopCo2 acquires all of the membership interests in ET1Co and HCo. This event satisfies the conditions in subsection 719-280(3) because:

- there was a change in the membership interests in ET1Co and HCo (they were acquired by another entity, TopCo2)
- immediately before the time of the change, ET1Co and HCo were members of the MEC group and eligible tier-1 companies of TopCo1, the top company of the group, and
- the acquisition of the membership interests in ET1Co and HCo by TopCo2 does not cause the potential MEC group to cease to exist but it does change the identity of the top company of the potential MEC group from TopCo1 to TopCo2[277] (the potential MEC group does not cease to exist because the eligible tier-1 companies that were members of the group

[276] Section 719-275 applies because the identity of the top company changes from TopCo1 to TopCo2 (the event described in item 3 of the table in subsection 719-275(2)) between 1 July 2002 (the start of the income year in which the test company, TopCo1, is considered to have made the loss under section 719-270) and 30 June 2004 (the end of the loss claim year). Note that, in this example, subsection 719-275(3) treats the head company, HCo, as having made the loss for the purposes of establishing whether the item 3 event in subsection 719-275(3) has occurred.

[277] See item 1 in the table in subsection 719-20(1) for details on what constitutes a top company.

immediately before the change in the top company – ET1Co and HCo – have not changed). → subsection 719-10(8); for details on what constitutes a potential MEC group, see section 719-10

Step 6: Determine whether the focal company meets the conditions in section 165-12

Under subsection 719-260(1), the focal company is considered to meet the continuity of ownership conditions in section 165-12 if the test company meets those conditions (based on the relevant assumptions).

In this case, therefore, the focal company, HCo, does not meet the conditions in section 165-12 because the test company, TopCo1, does not meet those conditions based on all the assumptions in sections 719-270, 719-275 and 719-280. In particular, TopCo1 fails to meet the conditions in section 719-280.

HCo is considered to fail the conditions in section 165-12 on 1 August 2003, at the time that TopCo1 is deemed to fail them based on the assumptions in section 719-280. → subsection 719-260(2)

References

Income Tax Assessment Act 1997

- section 165-12
- Subdivision 719-A
- section 719-140; as inserted by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 2

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 4

Income Tax Assessment Act 1997, Subdivision 719-F; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 13

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 3

Tax Laws Amendment (2010 Measures No.1) Act 2010, item 17

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.92, 5.105 and 5.106

Revision history

Section C10-2-390 first published 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
6.5.11	Addition of footnote p. 1 to reflect changes to the group conversion provisions.	Legislative amendment.

Worked example

Assumptions about the test company failing the COT – potential MEC group ceases to exist[278]

Description

This example outlines a case in which the test company is deemed to have failed the continuity of ownership test (COT) because the potential MEC group ceases to exist. → 'MEC groups and losses – determining whether the focal company satisfies the continuity of ownership test', C10-2-325

Commentary

In recognition of the special characteristics of MEC groups, Subdivision 719-F of the *Income Tax Assessment Act 1997* (ITAA 1997) modifies the rules about transferring and utilising losses within those groups.

The focal company (the company seeking to utilise the loss) is considered to have met the continuity of ownership conditions in section 165-12 of the ITAA 1997 if the test company would have met those conditions based on the assumptions in sections 719-270, 719-275 and 719-280.[279]

Under section 719-280, the test company is deemed to have failed the COT (section 165-12) in relation to a loss in certain circumstances. Broadly, those circumstances are where one of the following events happens to the focal company's MEC group, or potential MEC group, after the start of the focal company's ownership test period for the loss:

- the potential MEC group ceases to exist
- the potential MEC group continues to exist but the identity of the top company changes as a result of the acquisition of membership interests in certain entities below the group's original top company (the relevant entities are the group's eligible tier-1 companies or any entities interposed between the eligible tier-1 companies and the original top company), or
- there ceases to be a provisional head company for the group.

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[278] This worked example is not applicable where the MEC group converted to a consolidated group:

- on or after 27 October 2006, or
- where the conversion to a consolidated group took place before 27 October 2006 and a choice in writing is made within the prescribed time for Subdivision 719-BA to apply from 1 July 2002.

→ section 719-140, item 17 of *Tax Laws Amendment (2010 Measures No.1) Act 2010*; paragraphs 5.92, 5.105 and 5.106 of the Explanatory Memorandum to Tax Laws Amendment (2010 Measures No.1) Bill 2010

[279] The assumptions contained in sections 719-270 and 719-275 relate to determining whether the test company has satisfied the COT. If the conditions in section 719-280 are satisfied, however, the test company is deemed to have failed the COT.

The test company will also fail the conditions in section 165-12 where those conditions are not met based on the assumptions in section 719-270 and section 719-275. Where this actual COT failure occurs in addition to a deemed COT failure (under section 719-280), the COT failure time will be the earlier of the two. Under section 719-260, the focal company is considered to have failed to meet a condition in section 165-12 only at the first time that the test company would have failed to meet the condition.

Example

Facts

A wholly-owned group of entities comprising TopCo, HCo, SubCoA, SubCoB, FRCo and ET1Co exists throughout the income year ended 30 June 2003. TopCo is a foreign-resident company that owns all of the membership interests in FRCo (another foreign-resident company) and HCo (an Australian-resident company). In turn, FRCo owns all the membership interests in ET1Co (an Australian-resident company). HCo owns all of the membership interests in the Australian-resident companies SubCoA and SubCoB.

As shown in figure 1, a MEC group forms on 1 July 2003, consisting of SubCoA, SubCoB and the eligible tier-1 companies HCo and ET1Co. HCo is nominated as the provisional head company. On that date, Rod holds 72% of the membership interests in TopCo and Ray holds the remaining membership interests. These membership interests are held continuously from 1 July 2002 to 30 June 2006.

At formation, a loss made by ET1Co for the income year ended 30 June 2003 is transferred to HCo as a COT transfer. HCo is the head company of the MEC group for the income year in which the loss is transferred as it is the provisional head company at the end of that income year. → section 719-75

On 9 October 2003, XCo, an Australian-resident company, acquires all of the membership interests in FRCo (figure 2). As ET1Co is then no longer a wholly-owned subsidiary of the top company, TopCo,[280] it ceases to be a member of the MEC group.

On 1 September 2004, Jenny acquires 5% of the membership interests in HCo. Consequently, HCo ceases to be an eligible tier-1 company[281] and the potential MEC group consisting of HCo, SubCoA and SubCoB ceases to exist.[282] However, the conditions in section 703-55 are satisfied[283] and as such, a

[280] A requirement for being a tier-1 company (and thus an eligible tier-1 company) is that the company must be a wholly-owned subsidiary of the top company: see item 2 in the table in subsection 719-20(1).

[281] HCo ceases to be an eligible tier-1 company because it ceases to be a wholly-owned subsidiary of the top company.

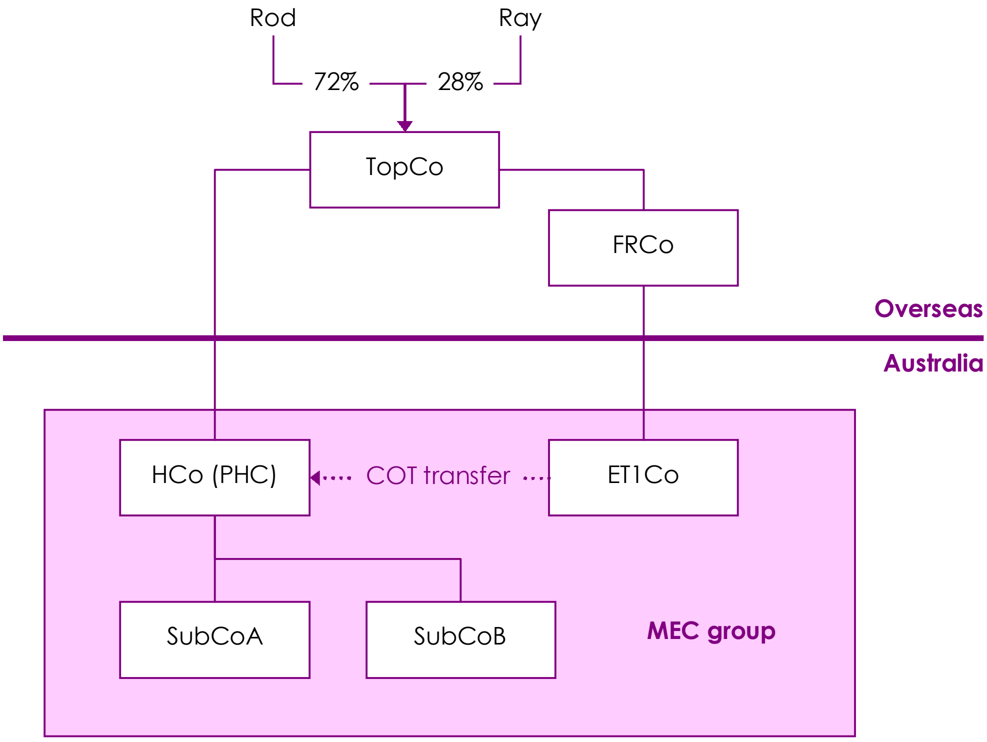
[282] The potential MEC group ceases to exist because there are no longer any eligible tier-1 companies: see paragraph 719-10(7)(a).

[283] Section 703-55 is satisfied as the MEC group ceased to exist because HCo, the sole eligible tier-1 company of the MEC group, ceased being an eligible tier-1 company and immediately

consolidated group is created from the MEC group. The consolidated group will consist of HCo, as the head company, and SubCoA and SubCoB as subsidiary members.

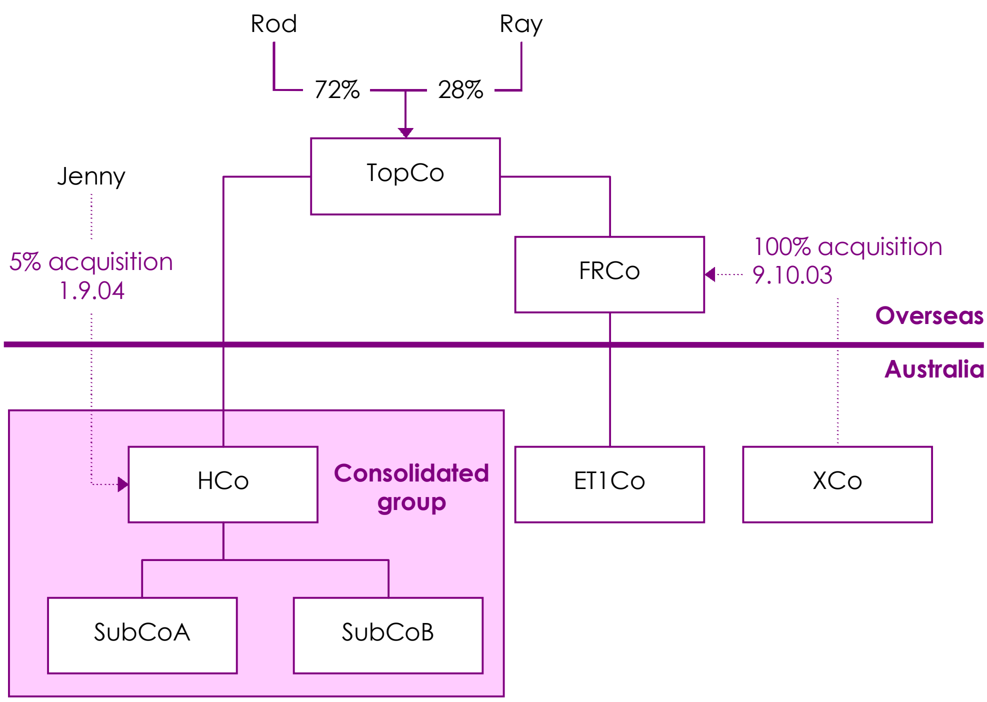
HCo, now the head company of a consolidated group, seeks to utilise the transferred COT loss in the income year ended 30 June 2006.

Figure 1: MEC group as at 1 July 2003 (formation time)



after this time met the conditions for being a head company of a consolidated group (in section 703-15).

Figure 2: Post-formation changes in membership interests



Calculation

HCo, the focal company, will be considered to have satisfied the continuity of ownership conditions in section 165-12 if the test company would have met those conditions based on the assumptions in sections 719-270, 719-275 and 719-280. In addition to establishing whether there has been a deemed COT failure under section 719-280 (step 5 below), it is also necessary to determine whether the COT has been satisfied in relation to the assumptions set out in sections 719-270 and 719-275 (steps 1 to 4 below).

Step 1: Identify the test company

Applying section 719-265, the test company is ET1Co.

Item 2 in the table in subsection 719-265(2) applies because the loss is a transferred COT loss and HCo (the focal company) and ET1Co (the transferor) are different entities. On a re-application of the rules in section 719-265 (as required by paragraph 719-265(1)(b)), item 3 in the table in subsection 719-265(4) applies to determine that ET1Co is the test company.

Step 2: Assume that the test company made the loss

Applying section 719-270, ET1Co is considered to have made the loss.

Subsection 719-270(4) applies as neither subsection 719-270(1) or (2) applies. That is, ET1Co (the test company) was not the top company for HCo's (the focal company's) MEC group. Also, it was not the focal company or the first head company.

Step 3: Identify the start of the income year for which the test company is taken to have made the loss

Applying section 719-270, ET1Co (the test company) is taken to have made the loss in an income year starting on 1 July 2002.

Item 1 in the table in subsection 719-270(4) applies because ET1Co is the original loss-maker. Under this item, the start of the test company's loss year is the start of the income year in which it made the loss (in this case, 1 July 2002).

Step 4: Apply the COT to the test company, ignoring ownership and voting changes below the top company

Applying section 719-275, the ownership structure between TopCo and ET1Co is considered 'frozen' from 1 July 2003, when the loss was transferred to HCo, the head company of the MEC group. Changes in the membership interests in ET1Co and FRCo after this event are ignored for the purposes of determining whether the continuity of ownership conditions in section 165-12 are met. This includes the acquisition of FRCo's interests by XCo on 9 October 2003.

Note that item 1 in subsection 719-275(2) applies because there was a COT transfer of a loss (made by ET1Co) to HCo (the head company of the MEC group) within the period beginning 1 July 2002 (the start of the income year in which ET1Co is taken to have made the loss under section 719-270) and ending 30 June 2006 (the end of the loss claim year).

Taking into account the assumptions in sections 719-270 and 719-275, the test company, ET1Co, passes the COT. It satisfies the conditions in section 165-12 because 100% of ET1Co's ultimate ownership remains unchanged from the start of its loss year (1 July 2002) to the time that the loss is transferred to HCo as a COT transfer. Further, after the transfer time and until the end of the loss claim year (30 June 2006), 100% of TopCo's ownership remains constant.

However, ET1Co will fail to satisfy the conditions in section 165-12 if the deemed COT failure in section 719-280 applies.

Step 5: Determine whether the deemed COT failure applies

Section 719-280 applies to deem the test company, ET1Co, to have failed the continuity of ownership conditions in section 165-12 because a specified 'failing' event in subsection 719-280(2) occurs on 1 September 2004, which is after the start of HCo's (the focal company's) ownership test period (1 July 2003[284]). The specified 'failing' event in this instance is the cessation of the potential MEC group, which occurs on 1 September 2004 as a result of Jenny acquiring 5% of the shares in HCo.

[284] As the focal company, HCo, made the loss because of a transfer under Subdivision 707-A, section 707-205 has the effect that the ownership test period for HCo starts at the time of the transfer (i.e 1 July 2003).

Step 6: Determine whether the focal company meets the conditions in section 165-12

Under subsection 719-260(1), the focal company is considered to meet the continuity of ownership conditions in section 165-12 if the test company meets those conditions (based on the relevant assumptions).

In this case, therefore, the focal company, HCo, does not meet the conditions in section 165-12 because the test company, ET1Co, does not meet those conditions based on all the assumptions in sections 719-270, 719-275 and 719-280. In particular, ET1Co fails to meet the conditions in section 719-280.

HCo is considered to have failed the conditions in section 165-12 on 1 September 2004, at the time that ET1Co is deemed to have failed them based on the assumptions in section 719-280.

References

Income Tax Assessment Act 1997:

- section 165-12
- subdivision 719-A
- section 719-140; as inserted by *Tax Laws Amendment (2010 Measures No.1) Act 2010* (No. 56 of 2010), Schedule 5, Part 2

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 4

Income Tax Assessment Act 1997, Subdivision 719-F; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 13

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 3

Tax Laws Amendment (2010 Measures No.1) Act 2010, item 17

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No.1) Bill 2010, paragraphs 5.92, 5.105 and 5.106

Revision history

Section C10-2-391 first published 2 October 2003.

Further revisions are described below.

Date	Application	Reason
6.5.11	Addition of footnote p. 1 to reflect changes to the group conversion provisions.	Legislative amendment.

Worked example

Assumptions about the test company failing the COT – MEC group ceases to exist because there ceases to be a provisional head company

Description

This example outlines a case in which the test company is deemed to have failed the continuity of ownership test (COT). Specifically, it illustrates a case where a MEC group ceases to exist because there ceases to be a provisional head company. → 'MEC groups and losses – determining whether the focal company satisfies the continuity of ownership test', C10-2-325

Commentary

In recognition of the special characteristics of MEC groups, Subdivision 719-F of the *Income Tax Assessment Act 1997* (ITAA 1997) modifies the rules about transferring and utilising losses within those groups.

The focal company (the company seeking to utilise the loss) is considered to have met the continuity of ownership conditions in section 165-12 of the ITAA 1997 if the test company would have met those conditions based on the assumptions in sections 719-270, 719-275 and 719-280.[285]

Under section 719-280, the test company is deemed to have failed the COT (section 165-12) in relation to a loss in certain circumstances. Broadly, those circumstances are where one of the following events happens to the focal company's MEC group, or potential MEC group, after the start of the focal company's ownership test period for the loss:[286]

- the potential MEC group ceases to exist
- the potential MEC group continues to exist but the identity of the top company changes as a result of the acquisition of membership interests in certain entities below the group's original top company (the relevant entities are the group's eligible tier-1 companies or any entities interposed between the eligible tier-1 companies and the original top company), or
- there ceases to be a provisional head company for the group.

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[285] The assumptions contained in sections 719-270 and 719-275 relate to determining whether the test company has satisfied the COT. If the conditions in section 719-280 are satisfied, however, the test company is deemed to have failed the COT.

[286] Section 719-280 does not apply where the event occurs because the MEC group has converted to a consolidated group, where the conversion to a consolidated group took place:

- on or after 27 October 2006; or
- before 27 October 2006 and a choice is made within the prescribed time for Subdivision 719-BA to apply from 1 July 2002.

→ section 719-140, item 17, *Tax Laws Amendment (2010 Measures No.1) Act 2010*; paragraphs 5.92, 5.105 and 5.106, Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010

The test company will also fail the conditions in section 165-12 where those conditions are not met based on the assumptions in section 719-270 and section 719-275. Where this actual COT failure occurs in addition to a deemed COT failure (under section 719-280), the COT failure time will be the earlier of the two. Under section 719-260, the focal company is considered to have failed to meet a condition in section 165-12 only at the first time that the test company would have failed to meet the condition.

Example

Facts

TopCo is a foreign-resident company that owns all of the membership interests in ET1CoA, an Australian-resident company. TopCo also owns 90% of the membership interests in Australian-resident company ET1CoB, with the remaining interests being owned by ET1CoA. ET1CoB in turn is the sole beneficiary of Australian resident fixed trust SubTrustA.

As shown in figure 1, a MEC group forms on 1 July 2002, consisting of SubTrustA and the eligible tier-1 companies ET1CoA and ET1CoB. ET1CoA is appointed as the provisional head company.[287] On that date, TopCo's shares are held by Sam (30%), Simone (30%) and Sonia (40%). These membership interests are held continuously from 1 July 2002 to 30 June 2005.

At formation, a loss made by ET1CoB for the income year ending 30 June 2002 (hereafter referred to as the 'SBT loss') is transferred to ET1CoA because ET1CoB satisfies the SBT. ET1CoA is the provisional head company at the end of the income year in which the loss is transferred and is therefore treated as the head company of the MEC group for that income year. → section 719-75

On 12 October 2003, TopCo acquires all of the membership interests in ET1CoC, an Australian resident company that then qualifies as an eligible tier-1 company of TopCo (figure 2). ET1CoC owns all of the membership interests in the Australian-resident company SubCoB.

A choice is made for ET1CoC to become a member of the MEC group.[288] As a result, SubCoB also becomes a member of the MEC group.[289]

On 5 December 2003, John purchases 100% of the membership interests in ET1CoA. As a result, ET1CoA, ET1CoB and SubTrustA cease to be members of the MEC group. ET1CoC is ineligible to be a provisional head company because it has not been a member of the MEC group since the start of the income year → subsection 719-65(3). Also, SubCoB cannot be nominated as the

[287] Under subsection 719-60(1), the appointment of a provisional head company must be included in the choice in writing to form a MEC group made under section 719-50.

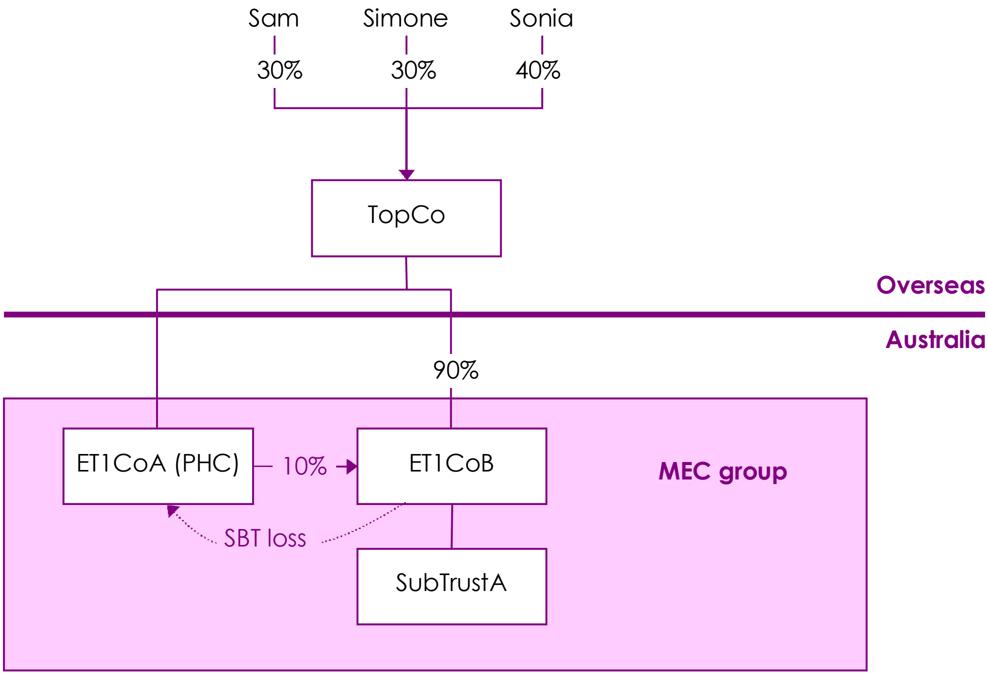
[288] Subsection 719-5(4) allows the provisional head company of a MEC group to make a choice in writing for certain entities that become eligible tier-1 companies of the top company of a pre-existing MEC group to become members of the MEC group.

[289] SubCoB satisfies the requirements in the table in subsection 719-10(1), which in conjunction with subsection 719-5(4) means that it qualifies as a member of the MEC group.

replacement provisional head company as it is not an eligible tier-1 company of the top company, TopCo → subsection 719-65(1). Therefore, the MEC group ceases to exist.[290]

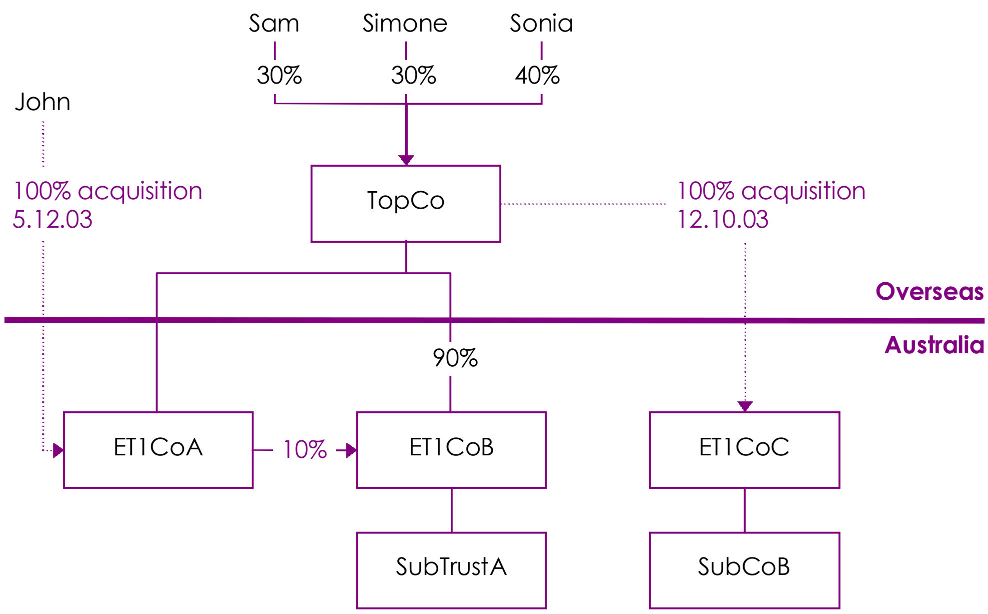
ET1CoA seeks to utilise the transferred SBT loss in the income year ending 30 June 2005.

Figure 1: MEC group at formation (1 July 2002)



[290] Under subsection 719-5(7), a MEC group ceases to exist where there ceases to be a provisional head company of the group.

Figure 2: Post-formation changes in membership interests



Calculation

ET1CoA, the focal company, will be considered to have satisfied the continuity of ownership conditions in section 165-12 if the test company would have met those conditions based on the assumptions in sections 719-270, 719-275 and 719-280. In addition to establishing whether there has been a deemed COT failure under section 719-280 (step 5 below), it is also necessary to determine whether the COT has been satisfied in relation to the assumptions set out in sections 719-270 and 719-275 (steps 1 to 4 below).

Step 1: Identify the test company

Applying section 719-265, TopCo is the test company.

Item 1 in the table in subsection 719-265(3) applies as the loss was transferred because the same business test was satisfied and ET1CoA (the focal company) was the head company of the MEC group at the time of the transfer. TopCo is the test company because it was the top company of the MEC group at the transfer time.

In this example, ET1CoA is the focal company because it is the company that seeks to utilise the loss.

Step 2: Assume that the test company made the loss

Applying section 719-270, TopCo is considered to have made the loss.

Subsection 719-270(1) applies as TopCo (the test company) was the top company of the MEC group and ET1CoA (the focal company) was the head company of the MEC group.

Step 3: Identify the start of the income year for which the test company is taken to have made the loss

Applying section 719-270, TopCo is assumed to have made the loss for an income year starting on 1 July 2002.

Item 2 in the table in subsection 719-270(1) applies because ET1CoA (the focal company) made the loss because it was transferred to it under Subdivision 707-A. Under this item, the test company (TopCo) is taken to have made the loss for an income year starting at the time of transfer (in this case, 1 July 2002).

Step 4: Apply the COT to the test company ignoring ownership and voting changes below the top company level

Section 719-275 does not apply. Therefore, there are no assumptions that apply for section 165-12 purposes in relation to 'freezing' the ownership structure below the top company.

Taking into account the assumptions in section 719-270, the test company, TopCo, passes the COT. It satisfies the conditions in section 165-12 because 100% of TopCo's ownership remains constant from 1 July 2002 (the start of the income year in which TopCo is taken to have made the loss) to 30 June 2005 (the end of the loss claim year).

However, TopCo will fail to satisfy the conditions in section 165-12 if the deemed COT failure in section 719-280 applies.

Step 5: Determine whether the deemed COT failure applies

Section 719-280 applies to deem the test company, TopCo, to fail the continuity of ownership conditions in section 165-12 because a specified 'failing' event in subsection 719-280(4) occurs on 5 December 2003, which is after the start of ET1CoA's (the focal company's) ownership test period (1 July 2002[291]). The specified 'failing' event in this instance is the cessation of the MEC group that occurred because there ceased to be a provisional head company of the group.

Step 6: Determine whether the focal company meets the conditions in section 165-12

Under subsection 719-260(1), the focal company is considered to meet the continuity of ownership conditions in section 165-12 if the test company meets those conditions (based on the relevant assumptions).

In this case, therefore, the focal company, ET1CoA, does not meet the conditions in section 165-12 because the test company, TopCo, does not meet those conditions based on all the assumptions in sections 719-270, 719-275

[291] As the focal company, ET1CoA, made the loss because of a transfer under Subdivision 707-A, section 707-205 has the effect that the ownership test period for ET1CoA starts at the time of the transfer (i.e. 1 July 2002).

and 719-280. In particular, TopCo fails to meet the conditions in section 719-280.

ET1CoA is considered to have failed the conditions in section 165-12 on 5 December 2003, at the time that TopCo is deemed to have failed them based on the assumptions in section 719-280.

References

Income Tax Assessment Act 1997:

- section 165-12
- Subdivision 719-A
- section 719-140; as inserted by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 2

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 4

Income Tax Assessment Act 1997, Subdivision 719-F; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 13

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 3

Tax Laws Amendment (2010 Measures No. 1) Act 2010, item 17

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.92, 5.105 and 5.106

Revision history

Section C10-2-392 first published 2 October 2003.

Further revisions are described below.

Date	Amendment	Reason
6.5.11	New footnote p. 1. Minor amendments to footnotes p. 2.	Legislative amendment.

Worked example

Acquisition of part of a MEC group – transfer of losses to newly formed consolidated group

Description

This example shows how the losses of a multiple entry consolidated (MEC) group may be transferred to a consolidated group in a situation where:

- the provisional head company of the MEC group is acquired by a resident company
- the MEC group ceases to exist as the remaining eligible tier-1 companies do not make a written choice to appoint a replacement provisional head company → subsection 719-60(3), and
- the consolidatable group comprising the resident company and the former head company of the MEC group make a choice in writing to form a consolidated group immediately → section 703-50.

Note

For more information about:

- MEC groups and their members → 'Multiple entry consolidated (MEC) groups', C10-1
- provisional head company rules → 'Provisional head company', C10-2-130
- transfer of losses → 'Treatment of losses', C3-1 and worked examples C3-3-210 to C3-3-270
- determining whether the head company (or former head company) of a MEC group satisfies the continuity of ownership test → worked examples C10-2-325 to C10-2-392
- making a choice in writing → 'Choice in writing', C7-1-110

Commentary

Cessation of a MEC group

Where the provisional head company of a MEC group ceases to be an eligible tier-1 company of the top company, a cessation event (→ subsection 719-60(6)) happens to the provisional head company as it ceases to meet the requirements to be the provisional head company of the MEC group → section 719-65. This would occur, for example, where the provisional head company is acquired by a resident company.

Where a cessation event happens to the provisional head company of a MEC group, the remaining eligible tier-1 companies may make a choice in writing to jointly appoint one of those companies to be the new provisional head company. The appointment is taken to be effective immediately after the cessation event.

Failure to appoint a replacement provisional head company results in the cessation of the MEC group → paragraph 719-5(7)(c). It is taken to have ceased to exist at the time there ceases to be a provisional head company.

The provisional head company is taken to be the head company of the MEC group for the period in the income year ending just before the cessation of the MEC group → subsection 719-75(3).

Formation of a consolidated group

The head company of a consolidatable group can make a choice in writing under section 703-50 to form a consolidated group from the date specified in the choice. Notification of the choice must be given to the Commissioner in the approved form within the period specified in subsection 703-58(2).

The group is taken to be consolidated on and after the date specified in the written choice. If a consolidatable group comes into existence on a particular day, because an entity becomes beneficially owned on that day (or is taken to become beneficially owned at that time under section 703-33), a consolidated group can be formed beginning from that day.[292]

Therefore, if a cessation event happening to a provisional head company of a MEC group results in the creation of a consolidatable group that includes the former provisional head company, it is possible for that latter group to immediately form a consolidated group. This means the former head company would go directly from being a member of the MEC group to being a member of the consolidated group without there being any period in which it is a stand-alone entity.

Transfer of losses to consolidated group

Under subsection 707-120(1), a loss is transferred to the head company of a consolidated group at the joining time if the loss could have been utilised by the joining entity in the trial year. The trial year generally begins 12 months before the joining time and ends just after the joining time.

Where the joining entity is a company, the transfer of a loss requires either the continuity of ownership test (COT) or the same business test (SBT) to be satisfied. These tests are modified in Subdivision 707-A so that they apply appropriately in a transfer testing context.

In addition, Subdivision 719-F modifies the rules for the transfer and utilisation of losses in relation to MEC groups. For example, the company seeking to utilise or transfer the loss will be taken to have satisfied the COT if the company identified as the test company (→ section 719-265) is taken to have satisfied the COT based on certain assumptions → sections 719-270, 719-275 and 719-280.

Where a cessation event happens to a provisional head company and the MEC group ceases to exist because of failure to appoint a replacement provisional

[292] In some circumstances, a consolidated group can come into existence at some time during a day. → Taxation Determination TD 2006/74

head company, any losses of the MEC group are retained by the former head company.

If all the membership interests in the former head company are acquired by a resident company that immediately forms a consolidated group, there is no period that the former head company exists as a stand-alone entity prior to joining the consolidated group. The consequences for the losses held by the former head company are as follows:

- Transfer tests need to be satisfied by the former head company before the losses can be transferred to the head company of the consolidated group.
- The test company for each loss is deemed to have failed the COT at the joining time as a result of the cessation of the MEC group → subsection 719-280(4). The former head company is taken to have failed the COT for these losses at this time (assuming it had not failed the COT at an earlier time → subsection 719-260(2)).
- The modified SBT in section 707-125 needs to be satisfied by the former head company for the losses to be transferred.

The single entity rule and the SBT

The single entity rule in section 701-1 applies when examining the business of the former head company for the period that it was the head company of the MEC group. Under this rule, subsidiary members are taken to be part of the head company. This means the business of the head company consists of one overall business that includes all the activities conducted by subsidiary members of the group.

Subsection 707-120(3) provides that the business of the former head company at and just after the joining time is the business it carried on just before the joining time. This means the SBT period effectively ends just before the joining time.

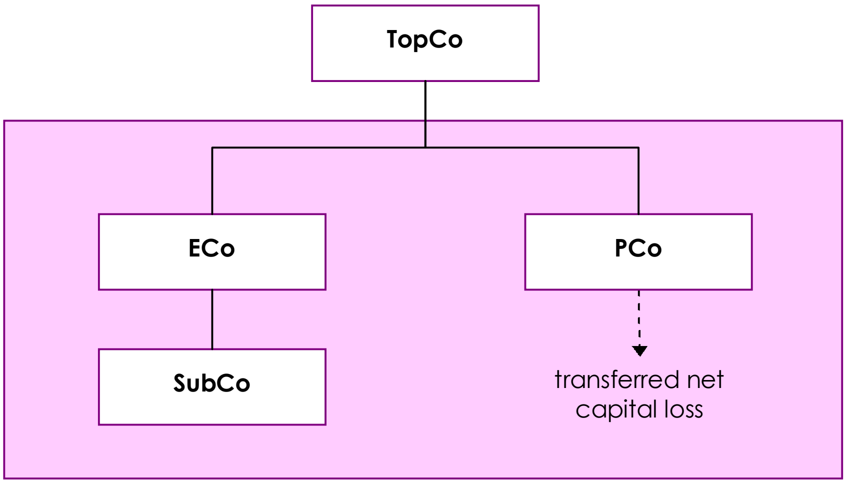
Provided the former head company's business at the relevant testing times is unchanged, losses it holds may be transferred to the head company of the consolidated group.

Example

Facts

PCo, ECo and SubCo, which are wholly owned by the non-resident company TopCo, form a MEC group on 1 July 2003 with PCo as the provisional head company (figure 1). At formation, losses are transferred from ECo and SubCo to PCo. A group loss is incurred in the year ended 30 June 2004.

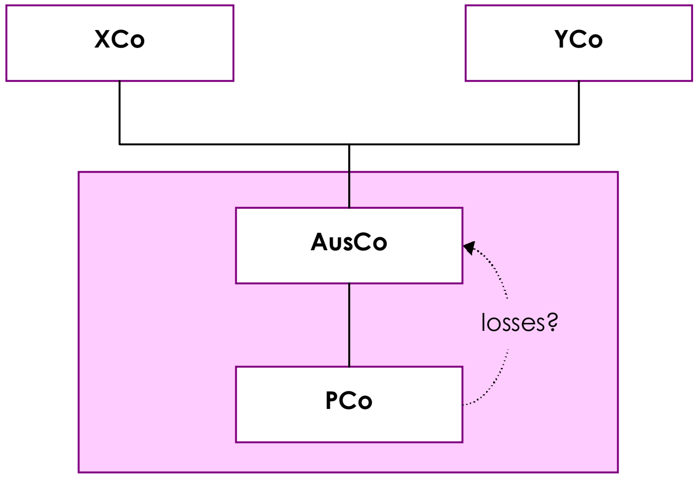
Figure 1: The PCo MEC group (1 July 2003 to 30 June 2004)



AusCo, a resident company, acquires 100% of the shares in PCo (figure 2). This is the only ownership change that has impacted on the MEC group since its formation. The change in beneficial ownership of the shares, for the purposes of the consolidation membership rules, occurs at the start of 1 July 2004. At that time, AusCo and PCo become a consolidatable group. AusCo makes a valid choice in writing to form a consolidated group with effect from 1 July 2004. The consolidated group comes into existence at the start of that day.

ECo, the remaining eligible tier-1 company of the MEC group, does not make a choice in writing to appoint itself as the provisional head company. The MEC group therefore ceases to exist from 1 July 2004 and losses remain with PCo for potential transfer to AusCo as head company of the consolidated group.

Figure 2: The AusCo consolidated group (1 July 2004)



Calculation

Loss transfer test

Subdivision 707-A determines whether the losses held by PCo are transferred to AusCo at the joining time. The losses will be transferred under section 707-120 if PCo could have utilised the losses in the trial year. The trial year in this case is from 1 July 2003 to just after the joining time on 1 July 2004.

The cessation of the MEC group, as a result of the change in beneficial ownership of PCo at the joining time on 1 July 2004, means the relevant test company for each loss is deemed to have failed the COT. Therefore PCo fails the COT at this time for each loss. The losses held by PCo can only transfer to AusCo if the modified SBT in section 707-125 is satisfied.

The SBT must be satisfied where:

- the SBT period is the trial year,[293] and
- the test time is just before the end of the income year ended 30 June 2004, that is, the year that both the transferred losses and the group loss are made.[294]

Figure 3 illustrates the testing points for PCo.

[293] The SBT period also includes the income year that included the test time worked out under section 165-13 if that income year started before the trial year. In this case, this income year does not start before the trial year.

[294] The losses transferred to PCo on 1 July 2003 are taken to be made in the income year in which they were transferred – subsection 707-140(1).

Figure 3: The same business test points

The business carried on by PCo on and just after the joining time is taken to be the business it carried on just before the joining time. Therefore the business of PCo is examined only in that part of the trial year to just before the joining time. In that period, PCo is always the head company of the MEC group and, pursuant to the single entity rule, the business of the entire MEC group (comprising PCo, ECo and SubCo) is examined.

Similarly, the test time is just before the end of the income year ended 30 June 2004, which again is a time when PCo is the head company of the MEC group and its business is the business of the entire MEC group.

If the business of the MEC group for these testing times has remained unchanged, the modified SBT in section 707-125 can be satisfied and the losses held by PCo are able to transfer to AusCo.

References

Income Tax Assessment Act 1997:

- sections 165-13, 701-1, 703-33, 707-120, 707-125, 707-140
- subsections 719-5(7), 719-60(6)
- subsections 719-75(3), 719-260(2)
- sections 719-265, 719-270, 719-275, 719-280
- section 703-50, as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 18
- section 719-65, as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 2
- subsections 703-58(2), 719-60(3), as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 18

Tax Laws Amendment (2010 Measures No. 1) Act 2010, Parts 2 and 18

Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.101 to 5.104, 5.369 to 5.373 and 5.418 to 5.421

Taxation Determination TD 2006/74

Revision history

Section C10-2-395 first published 26 June 2007.

Further revisions are described below.

Date	Amendment	Reason
6.5.11	Revisions to reflect changes to the choice and notification provisions.	Legislative amendments.

Worked example

Events that trigger pooling in a MEC group

Description

This example explains how the cost setting amount (cost) for certain membership interests in an eligible tier-1 company held by an entity outside the multiple entry consolidated (MEC) group ('pooled' interests) is recalculated each time one or both of two 'trigger events' happen to the membership interest.

Broadly, these trigger events are:

- an eligible tier-1 company leaves the group
- a CGT event happens to one or more pooled interests in the company.

Note

This example does not consider the effect of the value shifting or loss integrity measures in Divisions 727 and 715 and Subdivision 719-T of the *Income Tax Assessment Act 1997* (ITAA 1997) on resetting the cost of membership interests. The effect of those provisions is considered in:

- 'Effect of Subdivision 165-CC for MEC groups', C2-6-140
- 'Effect of Subdivision 165-CD for MEC groups', C2-6-150
- 'General value shifting regime (GVSR)', C2-6-170
- 'All assets in head company's loss denial pool become assets of leaving entity', C2-6-540.

Commentary

A membership interest in an eligible tier-1 company held by an entity outside the MEC group is a pooled interest, provided it is not:

- an employee share scheme interest, or
- held only as a nominee for members of the MEC group.

Each time a pooled interest is affected by an event that triggers the pooling rules, the cost of all the pooled interests is recalculated (reset) using the pooling rules in Subdivision 719-K of the ITAA 1997, provided the market value of the pooled interests as a whole – including the market value of synergies arising from the combination of those interests – is more than nil just before the trigger time. The recalculation is made just before the trigger time using the formulas in that Subdivision.

For more details about how the pooling rules and formulas are applied:
→ 'Pooling of external membership interests', C10-2-420.

Events that trigger pooling

The cost of all the pooled interests in all of the eligible tier-1 companies in a MEC group is reset when:

- an eligible tier-1 company leaves the group (trigger event 1), and/or
- a CGT event happens in relation to one or more pooled interests in the company (trigger event 2),

providing the market value of the reset interests as a whole – including the market value of synergies arising from the combination of those interests – is more than nil just before trigger time.

The eligible tier-1 company affected by the trigger event is referred to as a trigger company. Not all the eligible tier-1 companies in a MEC group are necessarily trigger companies when a trigger event happens. However, both trigger companies and non-trigger companies have the cost of their pooled interests reset when a trigger event happens.

Where all the shares in an eligible tier-1 company are sold, both trigger events apply because there is a CGT event and the eligible tier-1 company leaves the group at the same time.

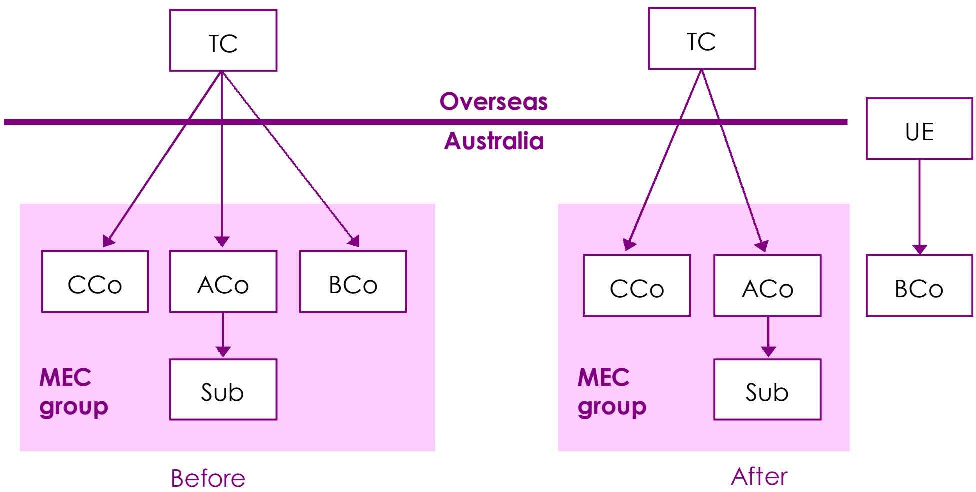
Example: Trigger event 1

An eligible tier-1 company ceases to be a member of the MEC group

Example 1

In figure 1, companies ACo, BCo and CCo (all eligible tier-1 companies) together with ACo's subsidiary form a MEC group. Later, top company (TC) sells all its shares in BCo to UE (an unrelated entity outside the group), so trigger event 1 happens. BCo ceases to be eligible to be a member of the group. The pooling calculation in Subdivision 719-K ensures that the pooled interests are given an appropriate cost by resetting the cost of the membership interests. The difference between the selling price and the cost of the reset interest (calculated using the pooling rules in Subdivision 719-K) is the capital (or revenue) gain or loss to TC.

Figure 1: An eligible tier-1 company leaves the group



It is also important to note that a company may leave the group and trigger the pooling provisions without a CGT event happening.

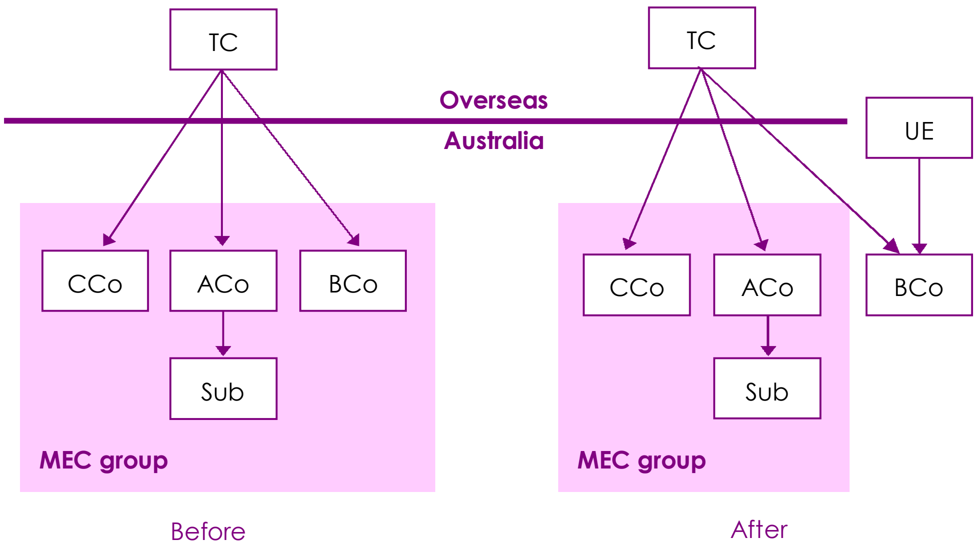
Events that are not CGT events that will trigger pooling include:

- An eligible tier-1 company issues shares to entities outside the foreign wholly-owned group. The eligible tier-1 company ceases to be wholly-owned by the top company of the MEC group and leaves the group.
- An eligible tier-1 company fails the membership eligibility rules after joining or formation time. In this instance the eligible tier-1 company ceases to be eligible to be a member of the MEC group.

Example 2

In figure 2, companies ACo, BCo and CCo (all eligible tier-1 companies) together with ACo's subsidiary form a MEC group. Later BCo issues some shares to unrelated entity UE. Trigger event 1 happens but there is no CGT event. BCo ceases to be eligible to be a member of the group. The pooling calculation in Subdivision 719-K ensures that the pooled interests are given an appropriate cost by resetting the cost of the membership interests.

Figure 2: An eligible tier-1 company leaves the group without a CGT event



Example: Trigger event 2

A CGT event happens to a pooled interest in an eligible tier-1 company without the eligible tier-1 company leaving the group

Example 1

In figure 3, companies ACo and BCo (both eligible tier-1 companies) together with ACo's subsidiary are members of a MEC group. The top company (TC) sells 40% of the membership interests in BCo to ACo but BCo continues to be a member of the MEC group. When the trigger event happens, a pooling calculation will ensure that the reset interests will have an appropriate cost just before the trigger event happens in relation to the membership interests in BCo. This reset cost is used to determine any capital (or revenue) gain or loss that TC makes on disposal of 40% of the membership interests in BCo.

Figure 3: CGT event

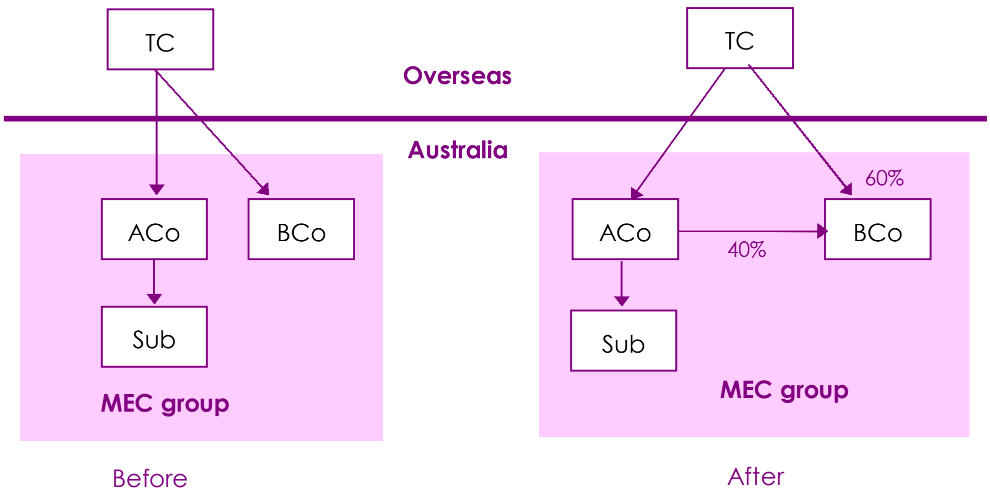


Table 1: Examples of CGT events that will trigger pooling

CGT event	Brief description
A1 section 104-10, ITTA 1997	Disposal of a pooled interest
G1 section 104-135, ITTA 1997	A company makes a capital payment in relation to a pooled interest
G3 section 104-145, ITTA 1997	Liquidator declares the pooled interests worthless
I1 section 104-160, ITTA 1997	Australian residency ends

References

Income Tax Assessment Act 1997, Subdivision 719-K; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 8

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, paragraphs 3.50 to 3.58

Income Tax Assessment Act 1997, Division 104

Income Tax Assessment Act 1997, Subdivision 719-T; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003)

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 11

Revision history

Section C10-2-410 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
26.10.05	Extensive changes throughout.	For clarification.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

Pooling of external membership interests

Description

This example shows how pooling rules and formulas are applied to reset the cost setting amounts of certain membership interests held in eligible tier-1 companies by entities that are not members of a multiple entry consolidated (MEC) group.

Note

This example does not consider the effect of the value shifting or loss integrity provisions in Divisions 715 and 727 and Subdivision 719-T of the *Income Tax Assessment Act 1997* (ITAA 1997). Adjustments required by those provisions are considered in:

- 'Effect of Subdivision 165-CC for MEC groups', C2-6-140
- 'Effect of Subdivision 165-CD for MEC groups', C2-6-150
- 'General value shifting regime (GVSR)', C2-6-170
- 'All assets in head company's loss denial pool become assets of leaving entity', C2-6-540.

Commentary

A pooled interest is a membership interest in an eligible tier-1 company that is held by an entity outside the MEC group, provided it is not:

- an employee share scheme interest, or
- held by an entity only as a nominee for members of the MEC group.

'Pooling' describes the method used to reset the cost of pooled interests.

The cost of pooled interests is reset each time the events that trigger pooling (trigger events) happen to pooled membership interests. (For an explanation of events that trigger pooling see 'Events that trigger pooling in a MEC group', C10-2-410.) The time at which a trigger event occurs is referred to as the trigger time. The market value of the pooled interests (reset interests) as a whole must be more than nil just before the trigger time for the pooling rules to apply.

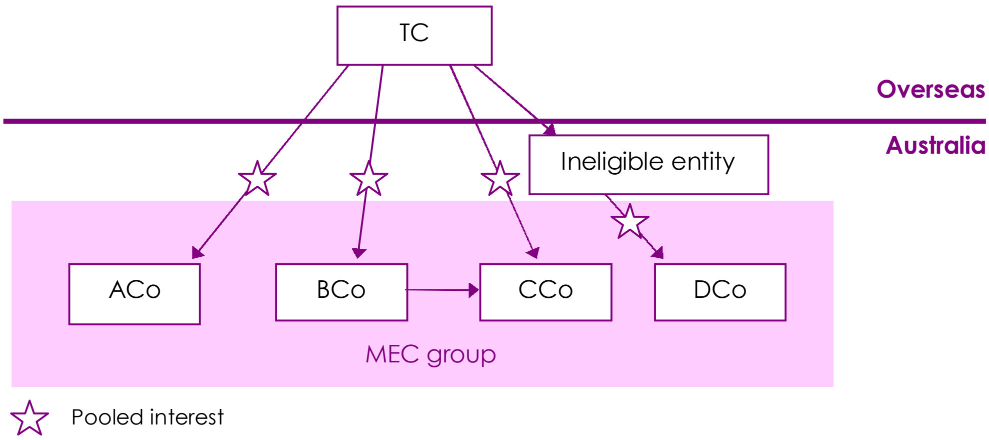
The formula used to reset each pooled interest will depend on whether the membership interest is held in a trigger company – the eligible tier-1 company that undergoes the trigger event – or in one of the other eligible tier-1 companies (non-trigger companies) in the MEC group when the trigger event occurs.

Examples of pooled interests

Examples of pooled interests are:

- where a non-resident member of a wholly-owned group holds membership interests in an eligible tier-1 company
- where the membership interests in an eligible tier-1 company are held by a resident interposed entity that is not a member of the MEC group (such as a pooled development fund), as in figure 1.

Figure 1: Membership interest in eligible tier-1 company held by a resident interposed entity



For more examples of pooled interests → page 10 in this worked example.

For an explanation of the method used to reset the tax cost of membership interests held in a leaving entity by members of the MEC group → 'An eligible tier-1 company leaving a MEC group', C10-2-430.

Pooling facilitates the tax-free transfer of assets within a MEC group by removing the need for value shifting adjustments at the eligible tier-1 company level.

How the pooling rules operate

Very broadly, the cost of membership interests (reset interests) held in eligible tier-1 companies by entities that are not members of the MEC group are pooled and an allocation made from the pool according to the market value of each reset interest. The reset amount is calculated in accordance with the formulas set out below.

An eligible tier-1 company that undergoes a trigger event is referred to as a trigger company. → 'Events that trigger pooling in a MEC group', C10-2-410

Where a company *is* a trigger company, the pool is allocated according to the trigger company's share of the market value of the MEC group.

Where the eligible tier-1 company *is not* a trigger company, the cost setting amount for each reset interest will, very broadly, equal the balance of the pool not allocated to reset interests in trigger companies divided by the number of reset interests in the remaining eligible tier-1 companies.

The tax cost of pooled interests is reset just before trigger time. A trigger event may happen to one or more eligible tier-1 companies at the same time and one or more trigger events may occur at the same time. For example, membership interests in one or more eligible tier-1 companies may be sold outside the wholly-owned group, which may cause all of those companies to leave the group.

Formula for calculating the tax cost of reset interests in trigger companies

$$\text{Cost setting amount} = \frac{\text{Market value of the reset interest}}{\text{Market value of the group}} \times \text{Pooled cost amount}$$

where:

- the **market value of the reset interest** is the market value (just before the trigger time) of all reset interests in that trigger company in the same class as the interest, divided by the number of reset interests in that company in that class
- the **market value of the group** is either:
  - the sum of the market value (just before the trigger time) of all reset interests in each of the trigger companies – this applies when every eligible tier-1 company that is a member of the MEC group just before the trigger time is a trigger company, or
  - the market value of the reset interests as a whole (including the market value of synergies arising from the combination of those interests) just before trigger time – this applies when only one or some of the eligible tier-1 companies are trigger companies. (The market value in this situation is not simply the sum of the market values of the eligible tier-1 companies. → paragraph 719-555(1)(c) of the *Income Tax Assessment Act 1997;* paragraph 3.65 Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002)

  However, if the market value of the pooled interests as a whole (including the market value of synergies arising from the combination of those interests) just before the trigger time is nil, the existing cost base or reduced cost base of the pooled interests is retained

  → paragraph 719-555(1)(c) of the *Income Tax Assessment Act 1997*.
- the **pooled cost amount** is the sum of the cost bases (just before the trigger time) of all reset interests.

Formula for calculating the tax cost of reset interests in non-trigger companies

$$\frac{\text{Pooled cost amount} - \text{Amount allocated to trigger company interests}}{\text{Number of non-trigger company interests}}$$

Where:

- the **pooled cost amount** is the sum of the cost bases (just before the trigger time) of all reset interests
- the **amount allocated to trigger company interests** is the sum of all cost setting amounts worked out for the reset interests held in trigger companies under the trigger company formula, and
- the **number of non-trigger company interests** is the number of reset interests held in non-trigger companies.

Formula where the cost base is the reduced cost base

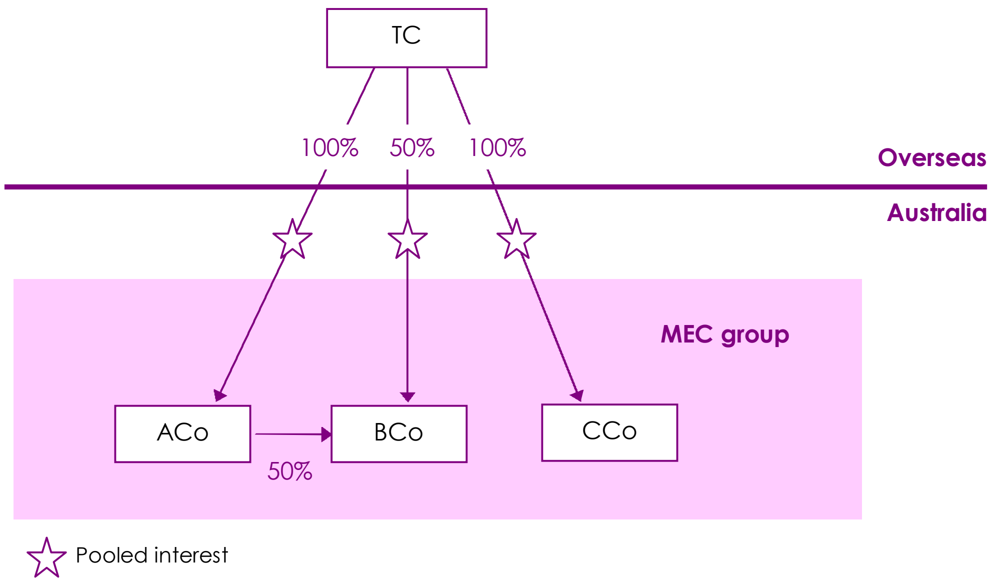
To work out the cost setting amount for a reset interest that has a reduced cost base, apply the formulas as if every reference to cost base were a reference to reduced cost base → subsection 719-570(3), ITAA 1997.

Example

Top Company (TC), a foreign resident company, has three wholly-owned Australian subsidiaries, companies ACo, BCo and CCo. One hundred membership interests in each of these three companies have been issued. TC owns only 50 of the membership interests in BCo, with ACo owning the other 50. ACo, BCo and CCo are all eligible tier-1 companies and comprise a MEC group.

The cost base of the 100 membership interests in each of ACo and CCo is $100. The cost base of the 50 membership interests in BCo held by TC is $50.

Figure 2: MEC group membership interests



Scenario 1 An eligible tier-1 leaves the MEC group

Assume that CCo issues membership interests outside the wholly-owned group. In these circumstances, a trigger event occurs to CCo. Even though there is no CGT event and no disposal of the membership interests, CCo leaves the MEC group. The tax cost of the membership interests in CCo must be reset using the pooling rules.

Note that:

- CCo is a trigger company
- CCo leaves the MEC group as it is no longer eligible to be a member of the MEC group
- CCo is owned 100% outside the MEC group. This means that when the company leaves the group, pooling is applied to determine the cost of each reset interest in each eligible tier-1 company in the group. The trigger company formula is applied.

To calculate TC's reset interest in CCo, assume that:

- the market value of CCo is $290, and
- the market value of the reset interests as a whole is $850.

The cost setting amount for each reset interest in CCo is worked out using the formula for trigger companies:

$$\frac{\text{Market value of the reset interest}}{\text{Market value of the group}} \times \text{Pooled cost amount}$$

Market value of each reset interest just before trigger time is:

$290/100 = $2.90

The pooled cost amount is:

(100 x 2) + 50 = $250 [or 100 + 100 + 50 = $250]

Therefore, the cost setting amount for each reset interest in CCo will be:

$$\frac{\$2.90}{\$850} \times \$250 = \$0.85 \text{ (rounded down) per reset interest}$$

This amount is the cost base that will be used if a CGT event happens to the membership interests in CCo. The cost setting amount for each reset interest in the remaining non-trigger eligible tier-1 companies of the MEC group will be worked out under the formula:

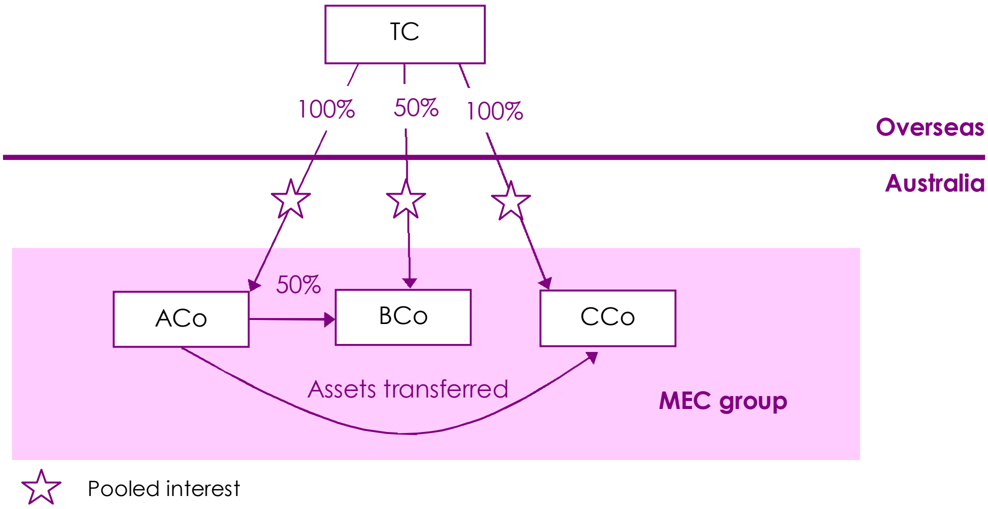
$$\frac{\text{Pooled cost amount} - \text{Amount allocated to trigger company interests}}{\text{Number of non-trigger company interests}}$$

$$\frac{\$250 - (\$0.85 \times 100 \text{ shares in CCo})}{150 \text{ shares in ACo and BCo}} = \$1.10 \text{ per reset interest}$$

The new cost base for the remaining interests TC holds in ACo and BCo is $1.10 per reset interest, and is the cost to be used in subsequent pooling calculations for the pooled cost amount.

Scenario 2 A CGT event happens and the eligible tier-1 company leaves the MEC group following an asset transfer

Figure 3: CGT event – eligible tier-1 company leaves group following asset transfer



Assume that following formation of the MEC group assets were transferred from ACo to CCo. These transactions are ignored for income tax purposes under the single entity rule until the assets leave the group. However, the market value of the membership interests in each eligible tier-1 company may be affected.

Following the asset transfer, Top Company (TC) disposes of all its membership interests in CCo to a company that is not a member of the same wholly-owned group.

Note that:

- Pooling is triggered by the disposal of membership interests in CCo, which is a CGT event, and in this instance, CCo leaves the MEC group as it is no longer eligible to be a member.
- CCo is a trigger company.
- CCo is owned 100% outside the MEC group. This means that when CCo leaves the group, the cost of pooled interests is reset just before the trigger event.
- TC will be required to calculate any capital gain or loss.
- It is necessary to reset the cost of pooled interests in the remaining eligible tier-1 companies of the MEC group.
- The formula that applies will depend on whether the entity is a trigger company or not.

The cost base of the 100 membership interests in each of ACo and CCo is \$100. The cost base of the 50 membership interests in BCo held by TC is \$50.

Assume that market value of the assets transferred from ACo to CCo is $17 for which no consideration was paid.

Assume the market value of CCo just before trigger time (that is, just before CCo is sold) is $307 – i.e. $290 (market value from Scenario 1) + $17 – and the market value of the reset interests as a whole is $850. The cost setting amount for each reset interest in CCo is calculated using the formula for trigger companies.

Step 1

Apply the trigger company formula:

$$\frac{\text{Market value of the reset interest}}{\text{Market value of the group}} \times \text{Pooled cost amount}$$

Market value of reset interests is:

$307/100 = $3.07

The pooled cost amount is:

($100 x 2) + $50 = $250 [or 100 + 100 + 50 = $250]

Therefore, the cost setting amount for each reset interest in CCo is:

$$\frac{\$3.07}{\$850} \times \$250 = \$0.90 \text{ (rounded down) per reset interest}$$

Step 2

Calculate the capital gain or capital loss (in this instance the cost base as reset in step 1 is used).

Cost base (reset interest) of membership interests in CCo:

$0.90 x 100 membership interests = $90

Capital proceeds: $307

Capital gain to TC:

$307 – $90 = $217

Step 3

The cost setting amount for each reset interest that is held in the remaining eligible tier-1 companies of the MEC group will be worked out under the non-trigger company formula:

$$\frac{\text{Pooled cost amount} - \text{Amount allocated to trigger company interests}}{\text{Number of non-trigger company interests}}$$

Pooled cost amount:

($100 x 2) + $50 = $250

Amount allocated to trigger company interests:

($0.90 x 100 shares in CCo) = $90

Number of non-trigger company interests:

(250 – 100 = 150)   150 shares in ACo and BCo

Therefore, the cost setting amount for each reset interest in ACo and BCo is $1.07:

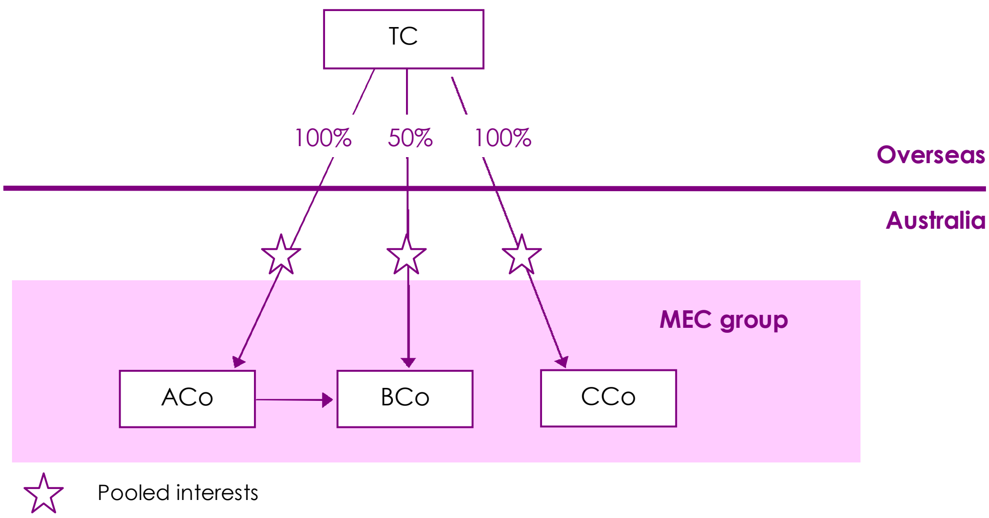
$$\frac{\$250 - 90}{150} = \$1.07 \text{ (rounded up) per reset interest}$$

These membership interests are still owned by TC and there is no CGT event. This amount ($1.07) becomes the new cost base of reset interests still held by TC in ACo and BCo and is the cost to be used in subsequent pooling calculations for the pooled cost amount.

Scenario 3

A CGT event happens and the eligible tier-1 company does not leave the MEC group

Figure 4: CGT event – eligible tier-1 company does not leave group



The cost base of the 100 membership interests in each of ACo and CCo is $100. The cost base of the 50 membership interests TC holds in BCo is $50.

Assume TC disposes of its 50% interest in BCo to ACo, an entity that is a member of the wholly-owned group, for $90. Assume the market value of the reset interests is ACo $160, BCo $90 and CCo $100, but the market value of the reset interests as a whole at this time is $400, which includes synergies arising from the combination of those interests.

Also assume that prior to the disposal of the membership interests no CGT assets were transferred between group members.

The disposal of the membership interests in BCo is a trigger event. In addition, BCo remains eligible to be a member of the MEC group.

To calculate TC's capital gain or capital loss:

Step 1

Apply the trigger company formula:

$$\frac{\text{Market value of the reset interest}}{\text{Market value of the group}} \times \text{Pooled cost amount}$$

Market value of reset interests is:

$90/50 = $1.80

The pooled cost amount is:

100 + 100 + 50 = $250

Therefore the cost setting amount for each reset interest in BCo will be:

$$\frac{1.80}{400} \times \$250 = \$1.12 \text{ (rounded down) per reset interest}$$

Step 2

Calculate the capital gain or capital loss (in this instance the cost base as reset in step 1 is used):

Cost base (reset interest) of membership interests in BCo:

50 x $1.12 = $56

Capital proceeds: $90

Capital gain to TC:

$90 – $56 = $34

Step 3

The cost setting amount for each reset interest that is held in the remaining eligible tier-1 company of the MEC group will be worked out under the formula:

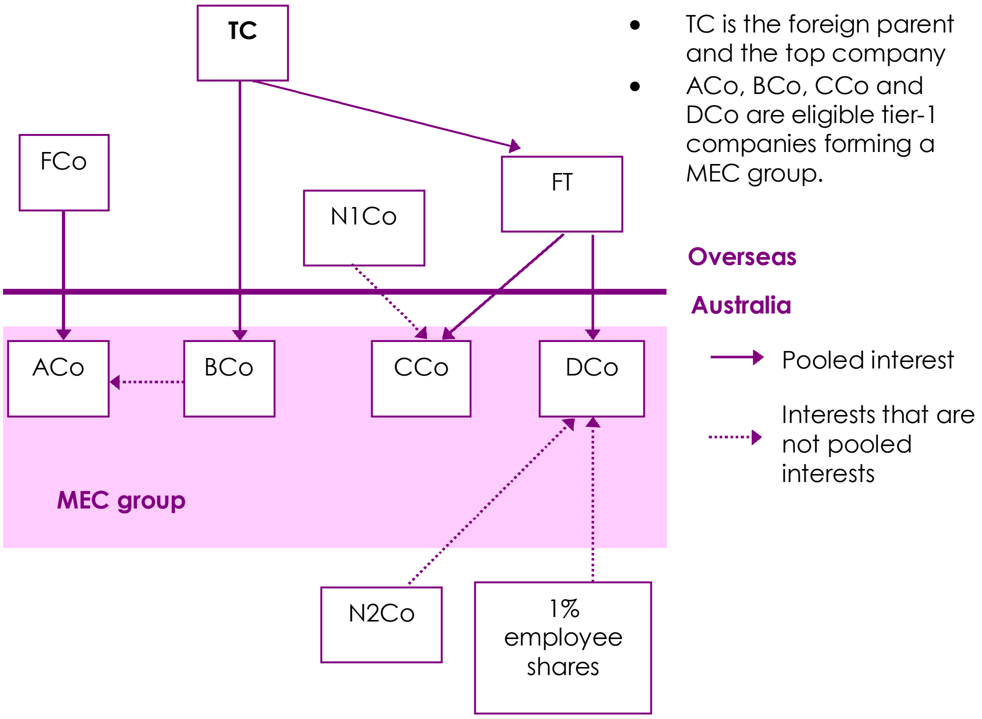
$$\frac{\text{Pooled cost amount} - \text{Amount allocated to trigger company interests}}{\text{Number of non-trigger company interests}}$$

$$\frac{\$250 - (\$1.12 \text{ X } 50)}{100+100} = \$0.97 \text{ (rounded up) per reset interest}$$

This amount ($0.97) becomes the new cost base of reset interests still held by TC in ACo and CCo and is the cost to be used in subsequent pooling calculations for the pooled cost amount.

Pooled interests – examples

Figure 5: Examples of pooled interests in eligible tier-1 companies of a MEC group



- TC is the foreign parent and the top company
- ACo, BCo, CCo and DCo are eligible tier-1 companies forming a MEC group.

Pooled interests	TC's interests in ACo	FCo is a non-resident company holding membership interests in ACo as nominee for TC.
	TC's interests in BCo	
	FT's interests in CCo and DCo	FT is a non-resident trust interposed between TC and DCo and TC and CCo.
Interests that are not pooled interests	BCo's interests in ACo	A member of the MEC group holding membership interests in another member.
	BCo's interests in CCo	N1Co is a non-resident company holding some of the membership interests in CCo as nominee for BCo.
	CCo's interests in DCo	N2Co is a resident company holding the membership interests in DCo as nominee for CCo.
	The 1% employee interests in DCo	

References

Income Tax Assessment Act 1997, Subdivision 719-K; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 8

Income Tax Assessment Act 1997, Subdivision 719-T; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003)

Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, paragraphs 3.50 to 3.71

Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, paragraphs 11.94 to 11.145

Revision history

Section C10-2-420 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
26.10.05	Extensive changes throughout.	For clarification.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

Worked example

An eligible tier-1 company leaving a MEC group

Description

This example shows how to calculate the cost setting amount of membership interests in an eligible tier-1 company that leaves a multiple entry consolidated (MEC) group.

Note

This example does not consider the application of the loss integrity provisions in Division 715 and Subdivision 719-T of the *Income Tax Assessment Act 1997* (ITAA 1997). Adjustments required by those provisions are considered in:

- 'Effect of Subdivision 165-CC for MEC groups', C2-6-140
- 'Effect of Subdivision 165-CD for MEC groups', C2-6-150
- 'All assets in head company's loss denial pool become assets of leaving entity', C2-6-540.

(The cost setting rules for other subsidiaries are the same as for consolidated groups → 'Treatment of assets', C2-1.)

Commentary

Entities that leave a MEC group will fall into the following broad categories:

- the eligible tier-1 company that is the head company of the MEC group
- companies that are eligible tier -1 companies whose membership interests are wholly held outside the MEC group
- companies that are eligible tier-1 companies in which some of the membership interests are held by members of the group
- wholly-owned subsidiaries of eligible tier-1 companies, and
- companies that are subsidiary members of the MEC group through the interposed foreign resident entity rules.

When one of the above entities leaves a MEC group, it is necessary to calculate, for capital gains tax (CGT) and revenue purposes, the leaving tax cost setting amount for each membership interest in the leaving entity. The method used to calculate the leaving cost setting amount depends firstly on whether the entity is a wholly-owned subsidiary of an eligible tier-1 company or an eligible tier-1 company within the MEC group and secondly, if the entity is an eligible tier-1 company, the extent to which membership interests are held outside the group (pooled interests) or by group members.

The provisions that apply to particular membership interests in the leaving entity are outlined in table 1.

Table 1: Provisions applying to membership interests in leaving entities

Leaving entity	Membership interests held by members of the MEC group	Pooled interests*
An eligible tier-1 company wholly owned outside the MEC group	Not applicable	Pooling rules (Subdivision 719-K)
An eligible tier-1 company partly owned outside the MEC group	Leaving entity rules in Divisions 701 and 711 as modified by Subdivision 719-J	Pooling rules (Subdivision 719-K)
A subsidiary member of the MEC group other than an eligible tier-1 company	Leaving entity rules in Divisions 701and 711	Not applicable
A subsidiary member of the MEC group through the interposed foreign resident entity rules	Divisions 701 and 711 as modified by sections 701C-40 and 701C-50 of the Income Tax (Transitional Provisions) Act 1997	Not applicable

*Pooled interests are specific membership interests held in an eligible tier-1 company by entities other than members of the MEC group.

Pooled interests are membership interests that are not:

- employee share scheme interests
- any membership interests held by an entity only as a nominee for other members of the MEC group.

→ 'Events that trigger pooling in a MEC group', C10-2-410

Note

The tax cost setting amount for the membership interests in each of the leaving subsidiary members (other than eligible tier-1 companies) is worked out on a 'bottom-up' basis. → section 711-55 of the Income Tax Assessment Act 1997 (ITAA 1997) and paragraph 5.142 of the Explanatory Memorandum to New Business Tax System (Consolidation) Bill (no 1) 2002

Eligible tier-1 companies leaving a MEC group

A) An eligible tier-1 company that is wholly owned outside the MEC group

The pooling rules in Subdivision 719-K of the ITAA 1997 are used to determine the cost setting amount for pooled interests in eligible tier-1 companies that are wholly owned outside the MEC group. For the calculation and pooling rules see → 'Pooling of external membership interests', C10-2-420.

(Note that the pooling rules in Subdivision 719-K are triggered by more than one event. An entity leaving the group is only one example.)

The calculation of the capital gain or loss to the top company under this event is discussed at part B (next page).

Note

CGT event L5

Where the eligible tier-1 company leaving the MEC group is wholly owned by entities that are not members of the MEC group and where no other entity ceases to be a subsidiary member of the group at the time the ET-1 company leaves the group, CGT event L5 in section 104-520 of the ITAA 1997 does not happen to the head company of the MEC group.

CGT event L5 will only happen if, in working out the group's ACA for the leaving subsidiary member, the amount remaining after applying step 4 of the table in section 711-20 is negative.

However, where the membership interests in a leaving eligible tier-1 company are wholly owned by entities outside the MEC group, i.e. pooled interests, section 711-20 is not applicable. The tax cost of pooled interests is set by Subdivision 719-K of the ITAA 1997 and not Division 711. Therefore, while other CGT events may apply, L5 will not happen in the situation discussed above.

B) An eligible tier-1 company that is partly owned by members of the MEC group

The calculation of the cost setting amount for an eligible tier-1 company partly owned by members of a MEC group and partly owned outside the MEC group is determined by combining two separate provisions:

- the consolidation leaving entity provisions (Divisions 701 and 711, ITAA 1997 as modified by Subdivision 719-J), and
- the MEC pooling cases provisions (Subdivision 719-K).

The tax cost setting amount for the membership interests held by members of the MEC group is calculated in the same way as the cost setting amount for membership interests in a subsidiary leaving a consolidated group.

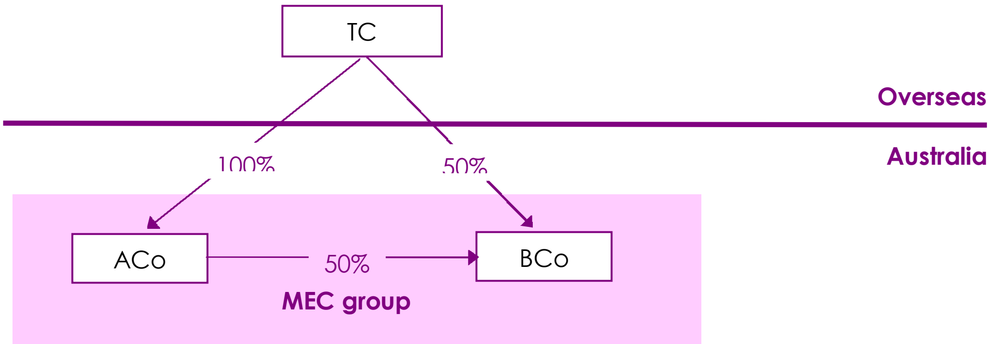
→ 'The cost setting process on exit', C2-2-210

Broadly, the tax cost setting amount is calculated with reference to Divisions 701 and 711 of the ITAA 1997. The calculation of the ACA for the leaving entity is not affected by the fact that some of the membership interests are pooled interests. Once calculated, the allocable cost amount (ACA) is allocated to all membership interests, including both those held by members of the group, and all those held outside the group, in proportion to the market value of the interests. However, only the ACA allocated to the membership interests held by members of the group is relevant to calculating the tax cost setting amounts (cost bases) of those interests. The cost bases of the pooled interests are calculated using the pooling rules in Subdivision 719-K as modified by Subdivision 719-J, so the ACA calculated for those interests under Division 711 is ignored.

Example

The following is an example of an eligible tier-1 company that is partly owned outside the MEC group (BCo below).

Figure 1: Eligible tier-1 company partly owned by members of the MEC group



A foreign parent company, TC, owns 100% of the 100 membership interests in Australian resident ACo and 50% of the 100 membership interests in Australian resident BCo. The membership interests are held as CGT assets. The remaining 50% of the membership interests in BCo are held by ACo (they are also CGT assets).

ACo and BCo are eligible tier-1 companies.

ACo's membership interests in BCo were acquired in two tranches. The first tranche of 20 membership interests was acquired on 1 July 2002 at $10 each and the second tranche of 30 membership interests was acquired on 1 July 2003 at $20 each.

There is only one class of membership interests in BCo.

Assume that the 50 membership interests acquired by the foreign parent company in BCo are acquired at the same time as ACo acquired its second tranche of membership interests in BCo (50 x $20 = $1,000).

ACo and BCo choose to form a MEC group on 1 July 2004. The foreign parent will be the top company (TC).

On 1 July 2005, TC and ACo sell their membership interests in BCo to an unrelated party, causing BCo to leave the MEC group. A CGT event happens to the membership interests held by both TC and ACo and it will be necessary for both entities to calculate their capital gain or capital loss.

To calculate the capital gain or capital loss made by both TC and ACo, it is necessary to reset the cost bases (the tax cost setting amount) of the membership interests in BCo.

Calculating the tax cost setting amount for ACo's interests in BCo when BCo leaves the MEC group

The cost of the 50% membership interests owned by ACo in BCo is determined by working out the group's exit ACA for all the membership interests in BCo in accordance with Division 711 as modified by Subdivision 719-J. → 'The cost setting process on exit', C2-2-210

For example, if the sum of the terminating values of BCo's assets just before the leaving time is $2,000 (assuming that steps 2 to 4 of section 711-20 for calculating the ACA do not apply), the exit ACA is $2,000. This ACA amount is divided by the number of membership interests in the class in leaving company BCo. As the total number of membership interests in BCo is 100, the new cost base of each membership interest is $20 ($2,000/100).

Even though the exit ACA is calculated and allocated across the 100 membership interests in BCo, only the ACA for the membership interests held by members of the MEC group is relevant for the calculation of ACo's cost bases for the membership interests in BCo.

The capital gain ACo derives on the sale of the membership interests ACo held in BCo is the capital proceeds less the cost base of each membership interest in each class. In this instance, assume the capital proceeds for the 50 membership interests is $1,600 (market value). ACo's capital gain from the sales of 50 membership interests is:

$$\$1{,}600 - \$1{,}000\ (50 \times \$20) = \$600$$

Calculating the cost setting amount for TC's interests in BCo using the pooling rules

For the purpose of this example assume:

- the market value of TC's pooled interests in BCo is $1,600
- the cost base of TC's interest in ACo is $1,000, and
- the market value of the group is $5,000 just before the trigger time (that is, just before BCo is sold) → paragraph 719-501(1)(c).

Market value of the reset interests in BCo is:

$$\frac{\$1{,}600}{50} = \$32$$

The pooled cost amount is $2,000 (the sum of the cost bases of all the reset interests: (ACo = $1,000) + (BCo = $1,000)).

Each pooled interest held in trigger company BCo is reset using the formula:

$$\frac{\text{Market value of the reset interest}}{\text{Market value of the group}} \times \text{Pooled cost amount}$$

Therefore, the cost setting amount for each reset interest in BCo will be:

$$\frac{32}{5{,}000} \times 2{,}000 = \$12.80$$

The capital gain/loss from selling 50 membership interests by TC is calculated by:

Capital proceeds – reset cost base = Capital gain

(where the reset cost base = $640 [$12.80 x 50])

$1,600 – $640 = $960

Therefore, TC makes a capital gain of $960 on the sale of its membership interests in BCo.

Calculating the cost setting amount for the reset interests in the non-trigger company

Once BCo has left the MEC group, it is necessary to calculate the tax cost setting amount for the reset interests in the remaining eligible tier-1 company. This tax cost setting amount will be used in future pooling calculations.

$$\frac{\text{Pooled cost amount} - \text{Amount allocated to trigger company interests}}{\text{Number of non-trigger company interests}}$$

where:

- the pooled cost amount = $2,000
  (The sum of the cost bases of all the reset interests
  (ACo = $1,000) + (BCo = $1,000))
- the amount allocated to trigger company interests = $640
  (The amount of reset interests in the trigger company)

The number of non-trigger company interests is the number of pooled (reset) membership interests in the non-trigger company.

Therefore, the cost base of the non-trigger company reset interest is:

$$\frac{\$2{,}000 - \$640}{100} = \$13.60 \text{ per reset interest}$$

This amount is the cost base that is used in future pooling calculations.

References

Income Tax Assessment Act 1997, Subdivisions 719-J and 719-K; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 8

Explanatory Memorandum to New Business Tax system (Consolidation and Other Measures) Bill (No. 1) 2002, paragraphs 3.40–49

Income Tax Assessment Act 1997, Division 701

Income Tax Assessment Act 1997, Division 711; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002)

Income Tax Assessment Act 1997, sections 711-20 and 711-25; as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 7, Division 1

Explanatory Memorandum to New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 5

Income Tax Assessment Act 1997, Subdivision 719-T; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003)

Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 11

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.188 – 5.197

Revision history

Section C10-2-430 first published 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
26.10.05	Extensive revisions throughout.	For clarification.
15.11.06	Note on CGT event L5, p. 3.	For clarification.
6.5.11	Minor revision to reflect changes that clarify the time when the leaving time cost setting provisions in Division 711 apply, p. 5.	Legislative amendment.