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