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).