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

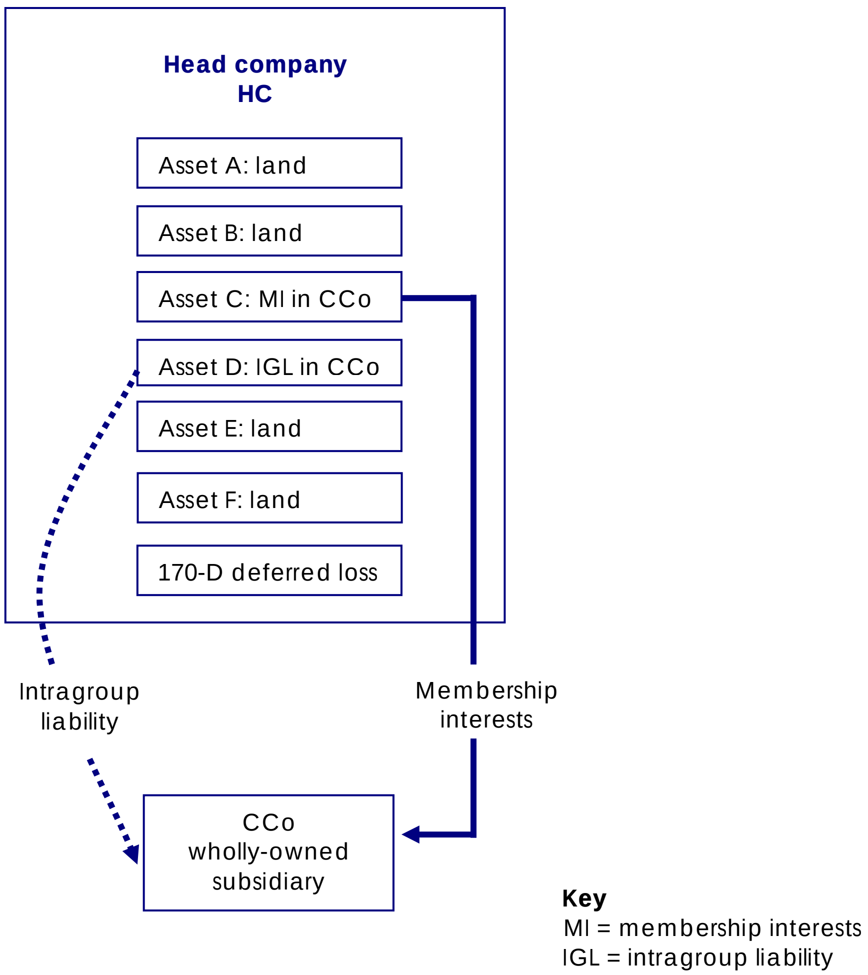

Table 1: Calculation of the pre-consolidation changeover time unrealised net loss ($)

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

Income Tax Assessment Act 1997, Subdivisions 165-CC, 170-D and 152-A

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