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.[1] 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.

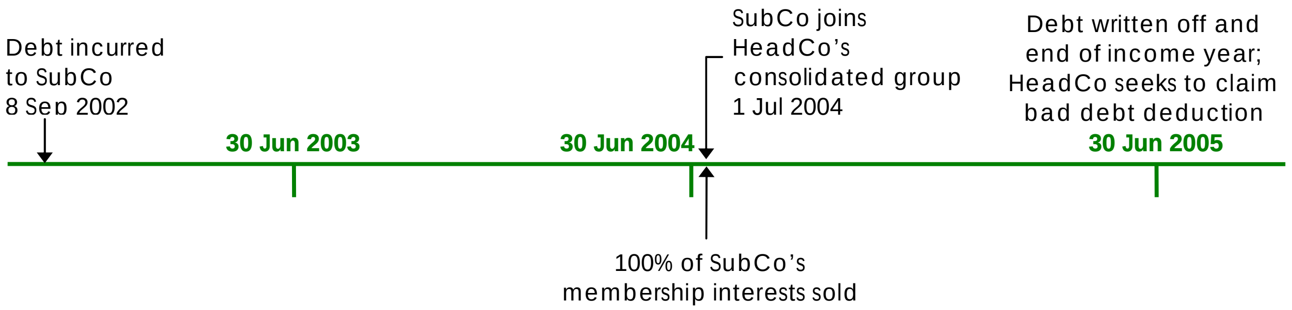
[1] Subsection 709-205(3).

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.[2]

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.

[2] 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

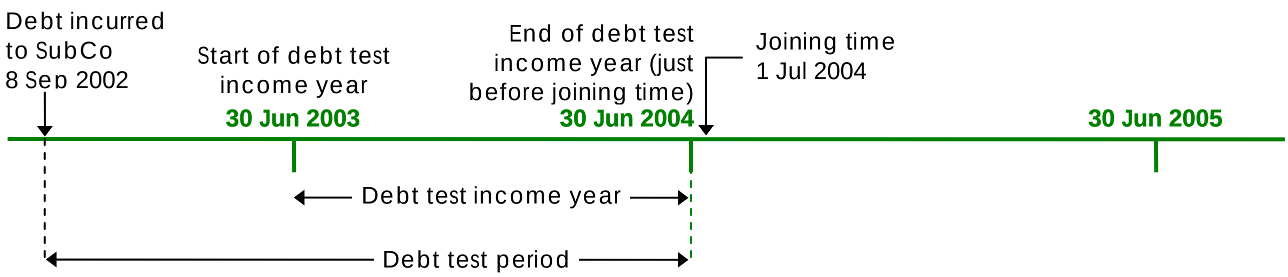
Step 1: Identify the debt test period

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.

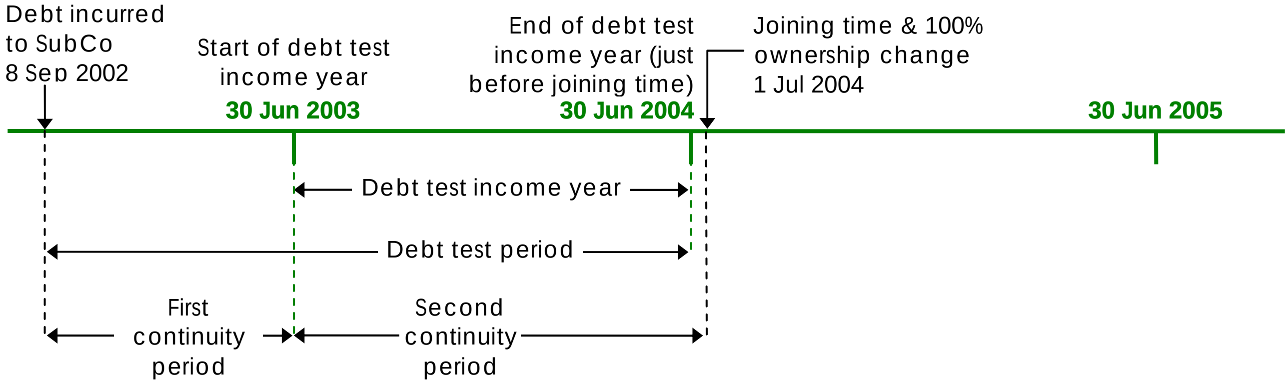
The start of the first continuity period is the start of the debt test period, which is 8 September 2002.

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.[3]

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:

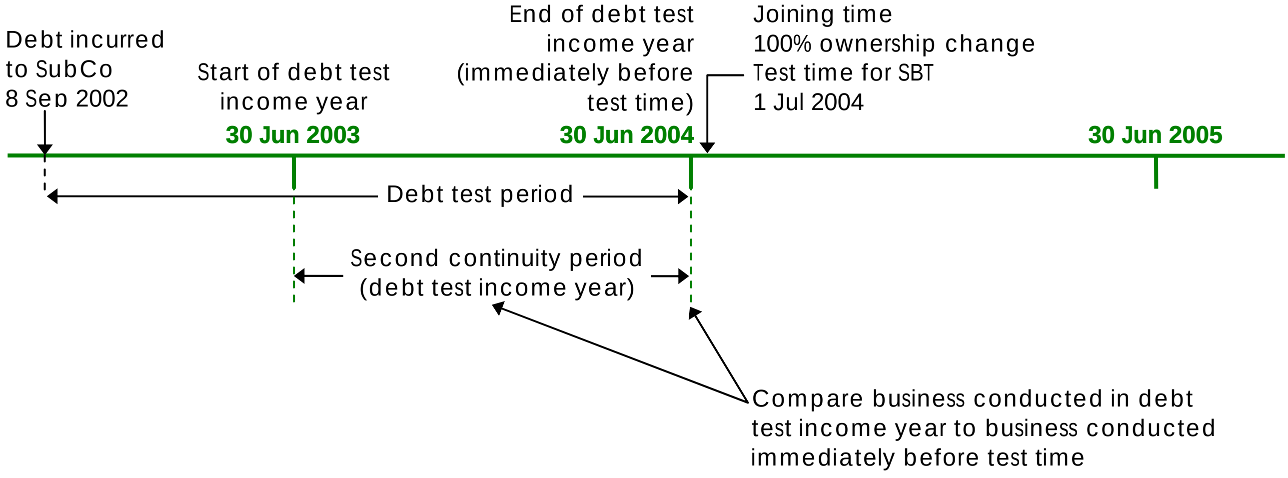
- the first time that it was not practicable to show that the company had met the conditions in section 165-123 (effectively, the first time that it could not be shown that it had maintained majority ownership), and
- the time just after the start of the debt test period.

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).

[3] 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

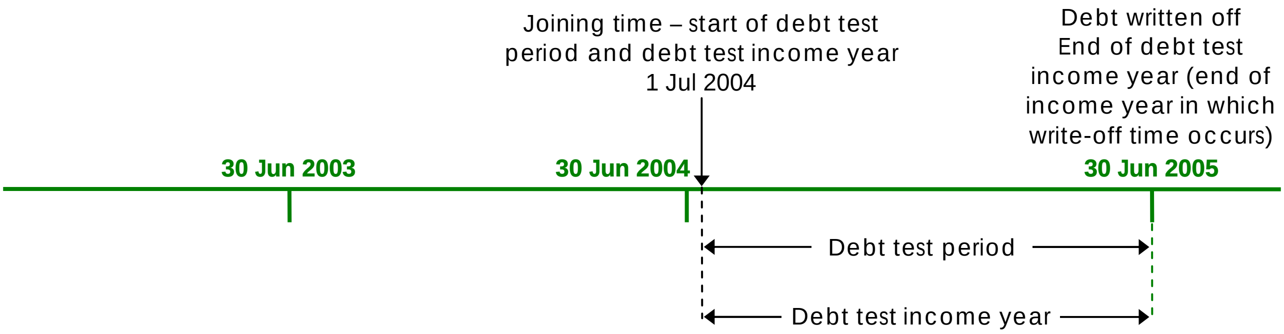
Step 1: Identify the debt test period

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



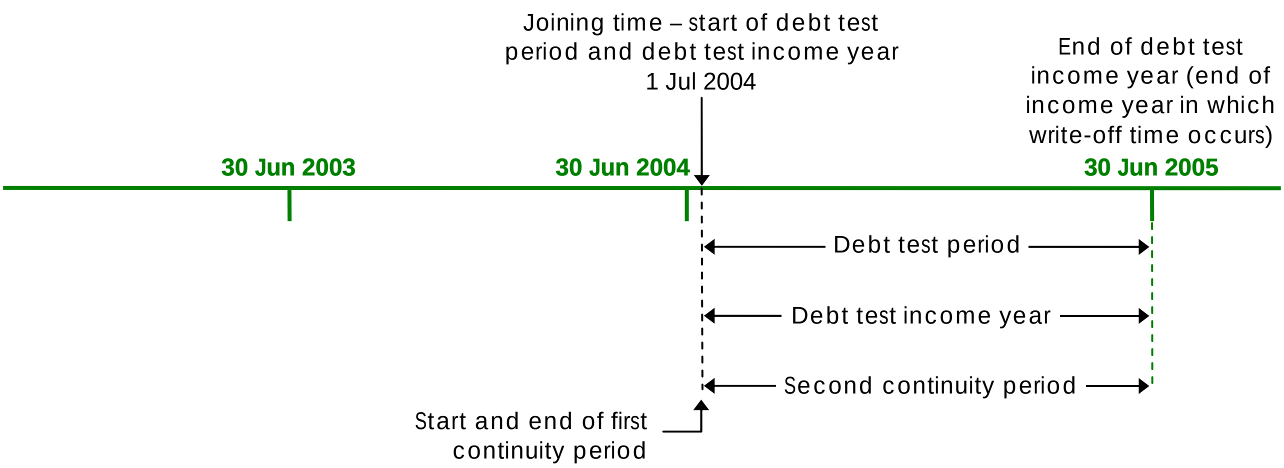
Step 3: Identify the continuity periods

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[4] (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

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).

[4] Assuming that the discretion in paragraph 165-120(1)(b) is not favourably exercised by the Commissioner of Taxation.