

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.