High-level worked example

A trust joins a consolidated group

Description

This high-level example shows how the cost setting process applied to set the tax costs of the assets of an entity joining a consolidated group is modified for a trust, in particular a discretionary trust.

Commentary

Due to inherent differences between trusts and companies, the basic case rules that apply to entry into a consolidated group are modified for trusts so as to achieve a comparable outcome to other entry circumstances → Subdivision 713-A, *Income Tax Assessment Act 1997* (ITAA 1997). Specifically, there are modifications to steps 1 and 3 in the allocable cost amount (ACA) calculation.

Note

Proposed changes to consolidation rules

Proposed changes to the consolidation rules will ensure that cost is allocated to the assets of bare trusts and other trusts with absolutely entitled beneficiaries on joining a consolidated group – see Treasury Position Paper No. 30, *Minor technical amendments* at **www.treasury.gov.au**

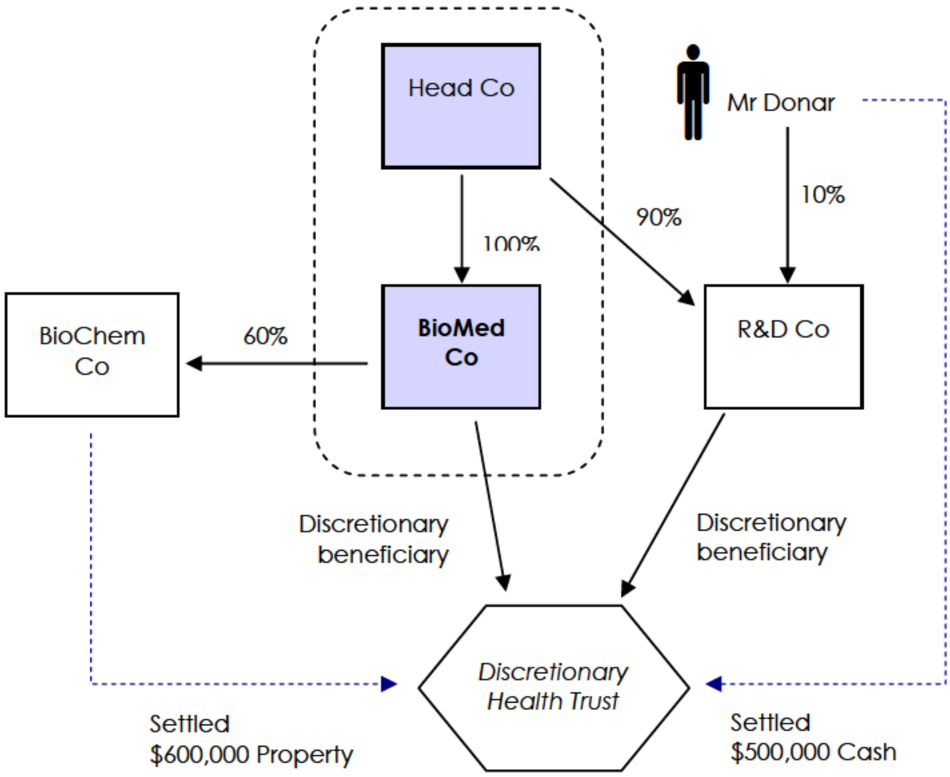
Example

Facts

Head Co is the head company of a consolidated group. BioMed Co is a member of that group. On 1 July 2004, Head Co acquires 90% of the membership interests in R&D Co for $450,000. The other 10% are held by an unrelated taxpayer, Mr Donar. In the same year BioMed Co acquires 60% of the interests in BioChem Co for $600,000.

On 1 July 2005 a discretionary trust known as the Discretionary Health Trust (DH Trust) is created by the settlement of $500,000 cash by Mr Donar and an item of property to the value of $600,000 by BioChem Co. The discretionary beneficiaries of this trust are BioMed Co and R&D Co. Neither company contributes any amount or property to the discretionary trust nor pays any consideration for its beneficial interest in the trust. The corporate structure after the settlement of the trust is shown in Figure 1.

Figure 1: Structure after settlement of Discretionary Health Trust



The trustee of DH Trust chooses to exercise its discretion and distribute all the income derived by the trust in the income year ending 30 June 2006. It distributes 60% of the income to BioMed Co and the remaining 40% to R&D Co. Following the income year ending 30 June 2007, the trustee does not exercise its discretion and so pays tax at the top marginal rate on the $93,458 of taxable income derived by the trust in that year. The trust's realised undistributed profits net of tax amount to $50,000.

R&D Co and DH Trust join the consolidated group

On 1 July 2007, Head Co acquires the remaining 10% of the membership interests in R&D Co for $96,000. As a result, both R&D Co and DH Trust are consolidated into the group, because Head Co now indirectly owns all the membership interests in DH Trust.

When linked entities are joining a consolidated group, the cost setting process is first applied to the top entity in the chain of linked entities (the top-down approach) → section 705-225, ITAA 1997. The tax cost setting amount allocated to the assets that are membership interests in the next entity is included at step 1 of the entry ACA for that entity. → 'Modifications to entry cost setting rules', C2-1-040, and worked example: 'Linked entities join a consolidated group', C2-2-130.

Consequently, the tax cost setting amounts for R&D Co's assets must be determined before DH Trust's ACA can be calculated.

Calculation – setting the tax costs of R&D Co's assets

R&D Co joined the group after it became a discretionary beneficiary of DH Trust. This means a tax cost setting amount will be allocated to the membership interest the company holds in the trust, as follows:

Calculate ACA

For the purpose of this example assume R&D Co has no liabilities, undistributed profits or losses at the joining time. The amount added at step 1 of the entry ACA calculation is $546,000, i.e. $450,000 + $96,000 (10% of $500,000 in assets and $460,000 in market value of discretionary beneficial interests). As no adjustments are made at steps 2 to 7 of the ACA calculation, the ACA for R&D Co is $546,000.

Allocate ACA

R&D Co's assets consist of its interest in the trust and another reset cost base asset with a market value of $500,000. For the purposes of this example assume the market value of R&D Co's membership interest in DH Trust at the joining time is $460,000 – i.e. 40% of the trust's value of $1,150,000 ($500,000 cash + $600,000 property item + $50,000 undistributed after tax profits). The total market value of R&D Co's reset cost base assets is therefore $960,000.

The tax cost setting amount of R&D Co's discretionary membership interest is therefore $261,625 ($460,000/$960,000 x $546,000). The tax cost setting amount for the other reset cost base asset is $284,375 ($500,000/$960,000 x $546,000).

Allocating a tax cost setting amount to R&D Co's membership interest in DH Trust effectively gives the membership interest a cost base. Consequently, the modification to step 1 for trusts does not apply. Instead the amount of $261,625 is added to the DH Trust's ACA step 1 amount under section 705-65 (step 1 of the entry ACA calculation for the basic case).

Calculation – setting the tax costs of DH Trust's assets

Calculate ACA

Step 1 amount

BioMed Co is already a member of the consolidated group when it becomes a discretionary beneficiary of DH Trust. It did not contribute any amount or property to the discretionary trust nor pay any consideration for its beneficial interest. Therefore, the group's membership interest in the trust through BioMed has a nil cost base. Also, BioMed Co acquired the membership interest in the trust because cash and property were settled on the trust. Consequently, the step 1 modification for trusts applies in relation to this membership interest.

The adjustment at step 1 of DH Trust's ACA calculation is determined using the discretionary trust method statement in section 713-20 of the ITAA 1997.

1. Determine the amounts and property settled on the trust at or before the joining time. Exclude those settled amounts and property forming part of the cost base of a membership interest in the trust that have already been added at step 1 under section 705-65 of the ITAA 1997.

   This amount is $838,375 ($500,000 cash + $600,000 property item – $261,625 cost base of R&D Co's membership interest).

2. Determine how much of the amount calculated at 1 would be distributed to BioMed Co if the entire capital and income of the trust had been realised and the trust ended.

   Given the trustee's sole prior pattern of distribution, it is assumed BioMed Co would receive 60% of the cash and property item settled on the trust. This amounts to $660,000 ($1,100,000 x 60%).

3. Reduce the amount from 2 by any amount that would have been included in the assessable income or has been taken into account in working out a capital gain or capital loss of Head Co because BioMed Co was a beneficiary in the discretionary trust.

   The distribution of the capital would not trigger CGT event E4 and the income has already been taxed to the trustee. Accordingly, there is no reduction and the amount remains $660,000.

4. Determine the amounts and market value (as at settlement time) of property settled on DH Trust by the head company and by parties independent of and unconnected to the group.

   – Nothing was settled by the head company.

   – BioMed Co owned 60% of BioChem Co at the time of settlement so could control the company for value shifting purposes → section 727-355, ITAA 1997. Section 713-20(3) therefore requires the property settled by BioChem Co to be excluded when making this calculation.

   – The amount settled by independent parties was $500,000 in cash settled by Mr Donar.

   The amount counted at step 4 of the discretionary trust method statement is therefore $500,000.

5. The amount by which step 1 of DH Trust can be increased is the lesser of the amounts determined at 3. or 4. which is $500,000.

The amount that is added at step 1 of DH Trust's ACA calculation is therefore $761,625 ($261,625 + $500,000).

Step 3 amount

The trust also has $50,000 of realised, taxed, undistributed profits at the joining time. If these profits had been distributed by the trust at the time at which they arose, and assuming the previous pattern of distribution had been maintained, $30,000 would have been distributed to BioMed Co, which was wholly-owned by the group for the whole time in which the profits accrued. R&D Co, however, was only 90% owned by the group during that period. So of the $20,000 that would have been distributed to R&D Co, only $18,000 accrued to the group. The amount added at step 3 is therefore $48,000.

For the purpose of this example assume DH Trust has no liabilities or losses at the joining time. The ACA that can be allocated to DH Trust's assets is therefore:

Step 1	$761,625
Step 2	0
Step 3	$48,000
Step 3A	0
Step 4	0
Step 5	0
Step 6	0
Step 7	0
ACA	$809,625

Assets held by Head Co as a consequence of R&D Co and DH Trust joining the consolidated group are shown in table 1:

Table 1: Assets held by Head Co at 2 July 2007

Asset	Tax value	Market value
Shares in BioChem Co	$600,000	$240,000*
Assets from R&D Co	$284,375	$500,000
Cash from DH Trust	$550,000	$550,000
Other Assets DH Trust	$259,625	$600,000

* 60% of ($1,000,000 capital less $600,000 settled on trust)

References

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, section 705-225; 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, section 705-65; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2
- *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedules 3 and 5

Income Tax Assessment Act 1997, section 727-355; as amended by *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 15

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No 1) 2002, Chapter 1, paragraphs 1.47 to 1.86

Revision history

Section C2-2-140 first published 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on proposed changes to consolidation rules, p. 1.	Proposed legislative amendments.
28.2.08	Minor corrections to calculations.	Amend calculation errors.

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).