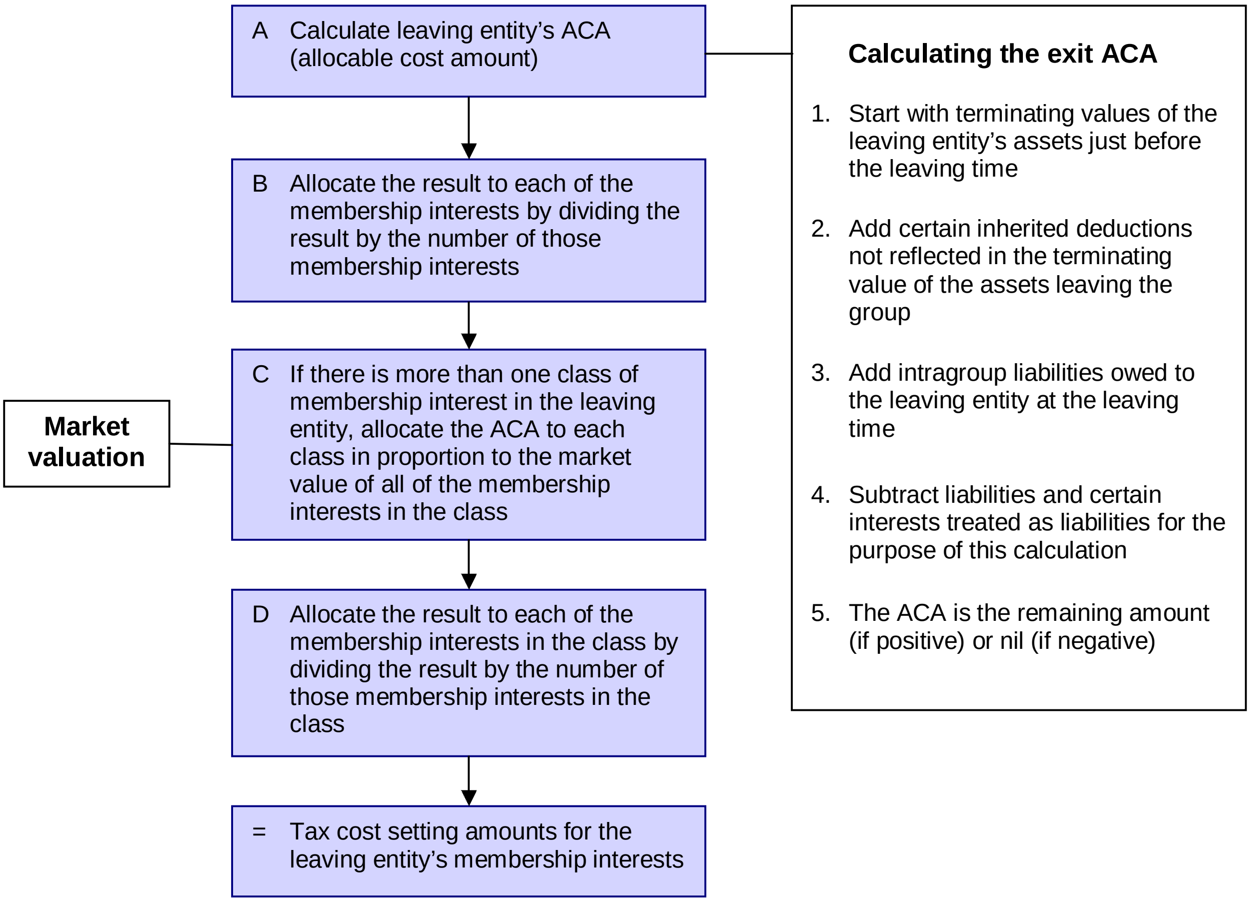
High-level worked example

The cost setting process on exit

Description

This high-level example shows how the cost setting rules apply when a subsidiary member of a consolidated group leaves the group. The process is shown in the figure below. Some steps in the process are expanded on in worked examples included in this section of the Reference Manual.

Figure 1: Cost setting process on exit



Commentary

When a subsidiary member (the leaving entity) leaves a consolidated group, the head company recognises for tax purposes, just before the leaving time, the membership interests in the leaving entity. These membership interests are not recognised while the entity is a member of the group. The cost for the membership interests equals the head company's cost for the net assets in the leaving entity just before the leaving time. This preserves the alignment between the costs for membership interests in the entity and its assets.

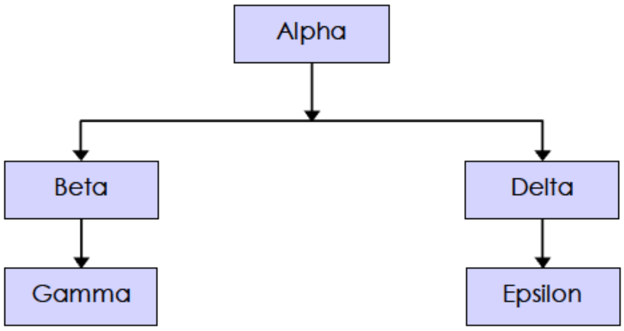
→ 'Treatment of assets', C2-1

Example

Facts

Alpha consolidated group, consisting of Alpha as the head company and Beta and Gamma as subsidiary members, is formed on 1 July 2002. On 30 June 2009, Alpha acquires 100% of Delta (and its wholly-owned subsidiary Epsilon) by paying $10,000 for 1,000 shares, and the consolidated group is structured as follows:

Figure 2: Alpha consolidated group



The financial position of Delta and Epsilon on joining the group is shown in tables 1 and 2.

Table 1: Delta – financial position at 30 June 2009

	Book value	Market value	Cost base	Terminating value
Assets				
Cash	$1,000	$1,000	$1,000	$1,000
Trading stock	$2,000	$2,000	$2,000	$2,000
Land 1	$3,000	$3,000	$3,000	$3,000
Shares in Epsilon	$4,000	$4,000	$4,000	$4,000
Liabilities	$0	$0		
Equity				
500 class A shares	$5,000	$5,000	$5,000	
500 class B shares	$5,000	$5,000	$5,000	

Table 2: Epsilon – financial position at 30 June 2009

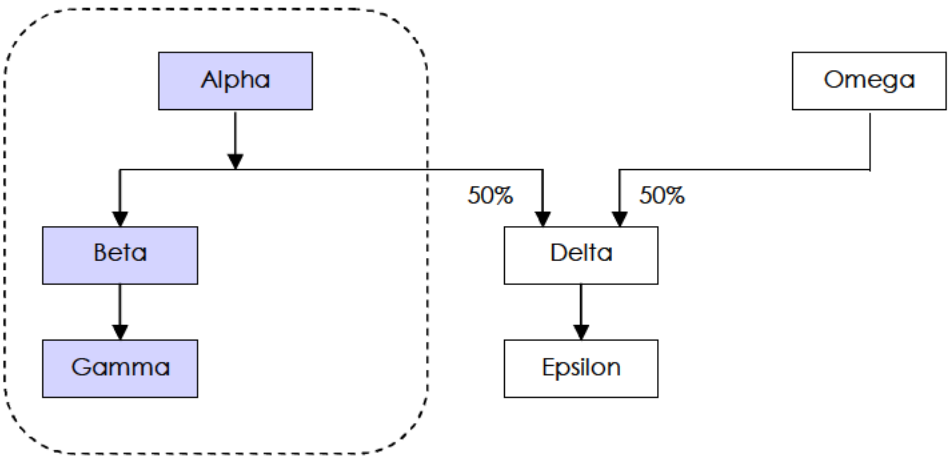
	Book value	Market value	Cost base	Terminating value
Assets				
Cash	$1,000	$1,000	$1,000	$1,000
Land 2	$2,000	$2,000	$2,000	$2,000
Land 3	$1,000	$1,000	$1,000	$1,000
Liabilities	$0	$0		
Equity				
100 shares	$4,000	$4,000	$4,000	

During the 2009–10 income year:

- Delta and Epsilon do not trade
- Delta loans $1,000 to Beta
- Delta borrows $2,000 from Omega on 1 July 2009 (immediately after joining Alpha's consolidated group) and incurs $200 borrowing expenses, and
- Gamma transfers an asset (Land 4) to Delta on 20 August 2009.

On 30 June 2010, Alpha sells 50% of its investment in Delta to Omega, which pays $14.80 for each of 250 Class A shares and $12.80 for each of 250 Class B shares. After the sale, Delta is 50% owned by Alpha and 50% by Omega. As Delta is no longer a wholly-owned subsidiary of Alpha it does not meet the criteria to be a member of the consolidated group. Therefore, Delta leaves the consolidated group on 30 June 2010, along with its wholly-owned subsidiary Epsilon, which (because of the part sale of its sole parent) is no longer wholly owned by the group.

Figure 3: Alpha's consolidated group after part sale of Delta



The financial position of Delta and Epsilon at the time of Delta's part sale is shown in tables 3 and 4.

Table 3: Delta – financial position at 30 June 2010

	Book value	Market value	Cost base	Terminating value
Assets				
Cash	$1,800	$1,800	$1,800	$1,800
Receivables	$1,000	$1,000	–	–
Trading stock	$2,000	$2,000	$2,000	$2,000
Land 1	$3,000	$5,000	$3,000	$3,000
Land 4	$2,000	$2,000	$2,000	$2,000
Shares in Epsilon	$4,000	$4,000	$4,000	$4,000
Liabilities	$2,000	$2,000		
Equity				
500 class A shares	$5,900	$7,400	$5,000	
500 class B shares	$5,900	$6,400	$5,000	

Table 4: Epsilon – financial position at 30 June 2010

	Book value	Market value	Cost base	Terminating value
Assets				
Cash	$1,000	$1,000	$1,000	$1,000
Land 2	$2,000	$2,000	$2,000	$2,000
Land 3	$1,000	$1,000	$1,000	$1,000
Liabilities	$0	$0	$0	
Equity				
100 shares	$4,000	$4,000	$4,000	

Order of application of cost setting

The cost of the membership interests in each of the leaving subsidiaries must be worked out on a 'bottom up' basis, as the membership interests in the lower level entity (which represent an asset of the higher level entity) must be given a cost which is used in turn to calculate the cost of membership interests in the higher level entity → section 711-55, *Income Tax Assessment Act 1997* (ITAA 1997) and Explanatory Memorandum to New Business Tax System (Consolidation) Bill No. 1, paragraph 5.142. Therefore, Alpha must first apply the cost setting rules to Epsilon, before applying them to Delta.

Setting the tax costs of membership interests in Epsilon

A: Calculate exit ACA for Epsilon

ACA step 1: Add up the terminating values of assets in Epsilon just before the leaving time.

Epsilon has three assets just before the leaving time (table 5).

Table 5: Epsilon assets just before the leaving time

	Terminating value
Cash	$1,000
Land 2	$2,000
Land 3	$1,000
	$4,000

ACA step 2: Add certain inherited deductions

As Epsilon does not inherit any deduction from Alpha, no amount is added.

ACA step 3: Add intragroup liabilities owed to Epsilon

As members do not owe any liability to Epsilon, no amount is added.

ACA step 4: Subtract liabilities of Epsilon

As Epsilon has no liability, no amount is subtracted.

Exit ACA Step 5

The ACA is $4,000.

B: Apportion ACA to each class of membership interest

There is only one class of membership interests in Epsilon.

C: Divide ACA by number of membership interests in each class

The tax cost for each share in Epsilon is calculated as:

$$\frac{\$4{,}000}{100 \text{ shares}} = \$40 \text{ per share}$$

Setting tax costs of membership interests in Delta

A: Calculate Delta's exit ACA

ACA step 1: Add up the terminating values of assets in Delta just before the leaving time.

Delta has five assets just before the leaving time (table 6).

Table 6: Delta assets just before the leaving time

	Terminating value
Cash	$1,800
Trading stock	$2,000
Land 1	$3,000
Land 4	$2,000
Shares in Epsilon	$4,000
	$12,800

Note: the receivables of $1,000 is an intragroup debt and is not recognised within a consolidated group.

ACA step 2: Add certain inherited deductions

The borrowing expenditure of $200 incurred by Delta before the leaving time is allowable to the head company Alpha as an income tax deduction apportioned over five years; that is, $40 per year. Alpha claims $40 for the income year ended 30 June 2010, and the remaining $160 of borrowing expenses as yet unclaimed by Alpha becomes available to Delta on leaving the group to be claimed as a tax deduction over the remaining four years.

The step 2 amount is worked out by multiplying all the deductions covered by subsection 711-35(2) by the corporate tax rate.[1] → subsection 711-35(1), ITAA 1997

The deductions included in this step are deductions to which the leaving entity becomes entitled under section 701-40 of the ITAA 1997 as a result of it ceasing to be a subsidiary member of the group, other than a deduction for expenditure:

- that is, forms part of or reduces, the cost of an asset that becomes an asset of the leaving entity because subsection 701-1(1) (the single entity rule) ceases to apply, or

[1] For exits that occurred before 10 February 2010, the step 2 amount is worked out using the formula: Owned deductions + (Acquired deductions x Corporate tax rate). Acquired deductions are those that were acquired deductions at step 7 of the entry ACA when an entity became a subsidiary member of a consolidated group → Adjustment for certain inherited deductions (ACA step 7), C2-4-340. Owned deductions are deductions that are not acquired deductions.

- to which section 110-40 of the ITAA 1997 (expenditure on assets acquired before 7.30 pm on 13 May 1997) applies.

→ subsection 711-35(2)

Therefore, the step 2 amount calculation is:

$160 x 30% = $48

This is then added to the step 1 amount of $12,800 to give a result of $12,848 after the application of step 2.

ACA step 3: Add intragroup liabilities owed to Delta

The intragroup liability of $1,000 owed to Delta is not recognised for income tax purposes while Delta is a member of the group. In this step, the liability is identified and its market value of $1,000 is added to the result of step 2:

$12,848 + $1,000 = $13,848

ACA step 4: Subtract liabilities of Delta

Delta has a $2,000 liability owed to an external party. The amount of the liability is subtracted from the result of step 3:

$13,848 – $2,000 = $11,848

Exit ACA Step 5

The ACA is $11,848.

B: Apportion ACA to each class of membership interest

Table 7: Apportion ACA to each class of membership interest

	Market value	Proportion to the market values	ACA	Apportionment
Class A	$7,400	$7,400 / ($7,400 + $6,400)	x $11,848	= $6,353.28
Class B	$6,400	$6,400 / ($7,400 + $6,400)	x $11,848	= $5,494.72

C: Divide ACA by number of membership interests in each class

The tax cost for class A shares is calculated as:

$$\frac{\$6{,}353.28}{500 \text{ shares}} = \$12.71 \text{ per share}$$

The tax cost for class B shares is calculated as:

$$\frac{\$5{,}494.72}{500 \text{ shares}} = \$10.99 \text{ per share}$$

The head company Alpha's capital gains from the sale of Delta shares are shown in table 8.

Table 8: Alpha capital gains from sale of Delta shares

	Proceeds – cost base		Number of shares sold	Total capital gains from the sale
Class A shares	$14.80 – $12.71	= $2.09	x 250 shares	= $522.50
Class B shares	$12.80 – $10.99	= $1.81	x 250 shares	= $452.50
				$975.00

References

Income Tax Assessment Act 1997, section 701-1; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *Tax Laws Amendment (2007 Measures No. 4) Act 2007* (No. 143 of 2007), Schedule 1

Income Tax Assessment Act 1997, section 701-40; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 11

Income Tax Assessment Act 1997, section 711-20; 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 2003* (No. 16 of 2003), Schedule 21
- *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 7- Division 1

Income Tax Assessment Act 1997, section 711-25; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (No. 83 of 2004), Schedule 2
- *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 7- Division 1

Income Tax Assessment Act 1997, section 711-35; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 7, Division 1 and Part 9

Income Tax Assessment Act 1997, section 711-45; 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
- *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1

- *Tax Laws Amendment (2004 Measures No. 7) Act 2005* (No. 41 of 2005), Schedule 6
- *Financial Sector Legislation Amendment (Restructures) Act 2007* (No. 117 of 2007), Schedule 3
- *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Parts 7, 8, 9, and 20.

Income Tax Assessment Act 1997, sections 711-40 and 711-55; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Income Tax (Transitional Provisions) Act 1997, sections 701-1 and 701-40; as amended by *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 7

Income Tax Assessment Act 1997, section 110-40

Explanatory Memorandum to New Business Tax System (Consolidation) Bill No. 1, paragraph 5.142

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5

Revision history

Section C2-2-210 first published (excluding drafts) 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on proposed changes to consolidation rules.	Proposed legislative amendments.
26.10.05	Removal of note on proposed change to rules.	Legislative amendment.
26.6.07	Note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used, p. 9.	Reflect announcement on 8 May 2007 by Assistant Treasurer in media release no. 50.
6.5.11	‘certain membership interests’ changed to ‘certain interests’, at step 4 in calculating the exit ACA in figure 1. Changes to the example to reflect modifications to the calculation of the step 2 amount and to clarify the facts. Removal of note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used.	Legislative amendments.