Worked example

CGT event L7 and reconstruction of the ACA

Description

This example shows how the allocable cost amount (ACA) may need to be recalculated for the purposes of determining the CGT event L7 amount when a liability of a joining entity is discharged for a different amount to that taken into account in the original ACA calculation.

Commentary

Each of the following conditions must be met in order for CGT event L7 to apply:

- the liability of the joining entity must have been taken into account in working out the group's ACA for the entity
- the liability must be discharged for an amount that is different from that used to work out the ACA at the joining time, and
- the ACA as originally calculated is different to what it would have been (referred to as the 'true ACA') had the discharged amount been taken into account in working out the ACA.

→subsection 104-530(3), *Income Tax Assessment Act 1997*

In working out the true ACA the liability amount used at step 2 of the original ACA calculation is substituted with the discharged amount of the liability, and the ACA is recalculated accordingly. A change at step 2 could affect subsequent ACA steps such as steps 3, 5 or 6, requiring a full reconstruction of the ACA, including a notional recasting of the statement of financial position as at the joining time. → Tax Determination TD 2004/67

During the notional recasting process the discharged amount is filtered through the profit and loss and financial position statements as if the amount accrued during the same period as it was recognised for accounting purposes. From this the head company can work out what the retained earnings or accumulated losses would have been for the entity at the joining time had the discharged amount been used. These amounts are then used to work out whether the third condition, required to trigger CGT event L7, is met.

Note

Where the amount of a liability that was recognised at the joining time is later not recognised because of the adoption of a new accounting standard or change in accounting policy by the joined group, the liability now has a nil value and is considered to have been discharged within the meaning of CGT event L7.
→ 'Dealing with changes in liabilities when a new accounting standard or change in accounting policy is adopted by the joined group' in C2-1

Example

Facts

HCo (the head company of a consolidated group) elected to consolidate at 1 July 2004 and at the time had one wholly-owned subsidiary, Subco. HCo had acquired all the shares in Subco on 1 July 2002 for $1,000.

At formation time Subco's audited accounts were as follows:

Table 1: Subco – financial position at 30 June 2004

Trade debtors	100	Equity	50
Plant	150	Retained earnings	100
Land and buildings	200	Bank overdraft	200
		Provision for penalty	100
	450		450

Note: $10 of the $100 retained earnings accrued post 1 July 2002.

The provision for penalty relates to a liability for a potential Trade Practices Act penalty of $100 relating to an unresolved dispute. This liability accrued in a period before HCo acquired any interests in Subco. A deduction was not and cannot be claimed for this penalty.

The ACA for Subco at the joining time is $1,310, worked out as follows:

Step 1

Cost base of membership interests is $1,000.

Step 2

Add liabilities of $300.

Step 3

Add undistributed taxed profits that accrued to the joined group of $10.

In the year ending 30 June 2005 the trade practices matter was resolved and a penalty of $20 was paid by Subco.

In determining whether CGT event L7 is triggered, the notional reconstructed financial position and ACA are as follows:

Notional reconstruction

Table 2: Subco – notional reconstructed financial position at 30 June 2004

Trade debtors	100	Equity	50
Plant	150	Retained earnings	180
Land and buildings	200	Bank overdraft	200
		Provision for penalty	20
	450		450

Note: As the liability for penalty accrued in a period before HCo acquired any interests in Subco, the amount of the notionally reconstructed retained earnings that accrued post 1 July 2002 remains at $10.

The notional reconstructed ACA would be $1,230, worked out as follows:

Step 1

Cost base of membership interests is $1,000.

Step 2

Add liabilities of $220.

Step 3

Add undistributed taxed profits that accrued to the joined group of $10.

As the ACA would have been smaller had the discharged amount been used, CGT event L7 is triggered. Consequently the head company is deemed to make a capital gain equal to the difference between the original ACA and the true ACA, being $80 in this case.

References

Income Tax Assessment Act 1997, subsection 104-530(3)

Taxation Determination TD 2004/67 – Income tax: consolidation: capital gains: does the determination of a capital gain or loss under section 104-530 (CGT event L7) of the *Income Tax Assessment Act 1997* require a full reconstruction of the allocable cost amount in relation to the relevant liability?

Revision history

Section C2-4-350 first published 26 October 2005.

Further revisions are described below.

Date	Amendment	Reason
15.11.06	Note on application of CGT event L7 to changes in liabilities resulting from the adoption of a new accounting standard or change in accounting policy, p 1.	For clarification.

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).