Worked example

Adjustment for certain inherited deductions (ACA step 7)

Description

This example shows how, at step 7 of the allocable cost amount (ACA) calculation, an amount is subtracted for certain unclaimed deductions of the joining entity that become available to the head company because of the retained history rule.

Commentary

The retained history rule provides that for most purposes a consolidated group inherits the tax history of its joining subsidiaries. This means that the head company may be entitled to certain unclaimed deductions of the joining entity.

At step 7, adjustments are made to preclude the joined group from getting benefits from both higher tax cost setting amounts for the joining entity's assets *and* the deductions inherited by the head company.

This adjustment involves subtracting the full amount of any relevant 'owned' deductions and an amount equal to the future tax benefit embedded in any relevant 'acquired' deductions.

The deductions covered in this step of working out the entry ACA are any deductions (both owned and acquired) to which the leaving entity becomes entitled under section 701-40 of the *Income Tax Assessment Act 1997* (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) of the ITAA 1997 (the single entity rule) ceases to apply, or
- 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), ITAA 1997

'Acquired deductions' are deductions mentioned above for expenditure that constitutes an acquired deduction of the head company under subsection 705-115(1) of the ITAA 1997 when an entity (whether or not the leaving entity) joins the group.

'Owned deductions' are the sum of all deductions mentioned above that are not acquired deductions.

An unclaimed deduction for expenditure that would be included in the cost of an asset of the joining entity, or would reduce it, is not included at step 7.

Example

Facts

On 1 July 2000, HCo subscribes $60,000 for 60% of the membership interests in a new company, ACo, with the other 40% being subscribed for $40,000 by BCo.

Table 1: ACo – financial position at 1 July 2000 ('000)

Cash	$100	Equity	$100
	$100		$100

ACo then borrows $400,000 for which it incurs $50,000 of borrowing expenses. ACo's financial position immediately following this transaction is as shown in table 2.

Table 2: ACo – financial position post-borrowing ('000)

Asset (MV $400)	$400	Equity	$100
Cash	$50	Liability	$400
		Loss	($50)
	$450		$450

Note: MV = market value

The expenditure incurred is allowable as an income tax deduction apportioned over five years, that is, $10,000 per year. As ACo derives no assessable income in the income tax years ending 30 June 2001 and 2002, it incurs a tax loss of $10,000 in each of those years. However, ACo's financial position remains unchanged in those two years.

On 1 July 2002, HCo acquires the remaining 40% of ACo's membership interests for $20,000, i.e. ($450k – $400k) x 40%, and consolidates ACo into its group.

By virtue of the retained history rule, the remaining $30,000 of borrowing expenses as yet unclaimed by ACo become available to HCo on consolidation (as head company) to be claimed as a tax deduction over the remaining three income years.

The $20,000 of carry-forward tax losses of ACo are transferred to the head company on consolidation. None of the losses are recouped by undistributed profits nor does the head company cancel the transfer of any of the losses.

Calculation of the step 7 amount

HCo becomes entitled to deductions totalling $30,000 for the borrowing expenses as yet unclaimed by ACo. Of the deductions, $18,000 (60%) are owned deductions, being expenditure incurred by ACo that, at the time it is incurred, is in respect of membership interests continuously held by HCo until the joining time. The remaining $12,000 are acquired deductions. So the amount that must be subtracted at step 7 is $21,600, i.e. $18,000 + ($12,000 x 30%).

Calculation of the ACA

Step 1

Add the total amount paid by HCo for all the membership interests in ACo, i.e. $80,000 ($60,000 + $20,000).

Steps 2

Add ACo's liabilities taken on by HCo ($400,000), giving a result after step 2 of $480,000.

Steps 3, 3A and 4

There are no distributed or distributable profits, or rollovers, so no adjustments need to be made for ACA steps 3, 3A and 4.

Step 5

An adjustment must be made for the $20,000 loss that accrued while HCo continuously held 60% of the membership interest in ACo. An amount of $12,000 ($20,000 x 60%) for owned losses is subtracted, giving a result after step 5 of $468,000 ($480,000 – $12,000).

Step 6

The remaining $8,000 of the $20,000 carry-forward loss transferred did not accrue to membership interests continuously held by HCo in ACo until the joining time. Therefore $2,400 ($8,000 x 30%) must be subtracted, giving a result after step 6 of $465,600 ($468,000 – $2,400)

Step 7

Subtract $21,600, giving a result after step 7 of $444,000 ($465,600 – $21,600).

Step 8

The entry ACA is therefore $444,000.

References

Income Tax Assessment Act 1997, sections 701-1 and 701-40; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Income Tax Assessment Act 1997, sections 705-90, 705-100, 705-105, 705-110, 705-115 and 711-35; 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

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No 1) 2002, paragraphs 5.88–105

Income Tax Assessment Act 1997, section 110-40