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 inherited history rule.

Commentary

The inherited 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 head company becomes entitled under section 701-5 of the *Income Tax Assessment Act 1997* (ITAA 1997) as a result of the joining entity becoming 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 head company because subsection 701-1(1) of the ITAA 1997 (the single entity rule) applies, or
- to which section 110-40 of the ITAA 1997 (expenditure on assets acquired before 7.30 pm on 13 May 1997) applies, or
- to the extent that the expenditure reduced the undistributed profits comprising the step 3 amount of the ACA.

→ subsection 705-115(2), ITAA 1997

'Owned deductions' are the sum of all deductions mentioned above that accrued to the joined group. → subsection 705-115(1)

'Acquired deductions' are deductions mentioned above for expenditure that are not owned 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.

Unclaimed Division 43 deductions

Unclaimed deductions for allowable capital expenditure on assessable income-producing buildings and other capital works under Division 43 of the ITAA 1997 that were previously available to a joining entity become available to the head company when the entity joins a consolidated group. These unclaimed Division 43 deductions do not reduce the entry ACA at step 7 when an entity joins a consolidated group, and unclaimed Division 43 deductions do not increase the exit ACA at step 2 when the entity leaves the group.

Where a consolidated group is not consistent in its treatment of unclaimed Division 43 deductions in the calculation of its entry and exit ACAs, the Tax Office will amend the head company's assessment to reduce the entry ACA at step 7 by any unclaimed Division 43 deductions.

→ See also 'Adjustment for certain inherited deductions (exit ACA step 2)', C2-5-240

Example 1

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 costs. ACo's financial position immediately before consolidation is as shown in table 2. The borrowing costs are expensed in the accounts.

Table 2: ACo – financial position at 30 June 2002 ($'000)

Asset (MV $400)	400	Equity	100
Cash	50	Liability	400
Deferred tax assets	15	Loss	(35)
	465		465

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.

On 1 July 2002, HCo acquires the remaining 40% of ACo's membership interests for $26,000, i.e. ($465k – $400k) x 40%, and forms a consolidated group with ACo.

By virtue of the inherited 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 was incurred, was 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. $86,000 ($60,000 + $26,000).

Steps 2

Add ACo's liabilities taken on by HCo ($400,000), giving a result after step 2 of $486,000.

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 $474,000 ($486,000 – $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 $471,600 ($474,000 – $2,400).

Step 7

Subtract $21,600, giving a result after step 7 of $450,000 ($471,600 – $21,600).

Step 8

The entry ACA is therefore $450,000.

Example 2

On 1 July 2006, HCo, the head company of a consolidated group, acquires all of the membership interests in ACo for $600,000. ACo's only asset is an income producing property acquired on 1 July 1996. On 1 July 1994, the owner of the property at that time incurred capital expenditure of $100,000 on it, giving rise to Division 43 deductions of $4,000 each year (4% per annum) for 25 years.

When ACo joins the consolidated group on 1 July 2006, HCo becomes entitled to Division 43 deductions of $52,000 (13 years @ $4,000 per year).

Table 3: ACo – financial position at 30 June 2006 ($'000)

Income producing property	600	Equity	600
Total	600	Total	600

Calculation of the ACA

Step 1

Start with the amount paid by HCo for membership interests in ACo, i.e. $600,000.

Steps 2 to 7

No amounts are added or deducted at these steps. The unclaimed Division 43 deductions do not reduce the ACA at step 7.

Step 8

The entry ACA is therefore $600,000.

Note

Proposed changes to consolidation rules

Proposed changes to the consolidation rules will ensure that inherited deductions relating to expenditure on certain assets acquired on, or constructed before, 13 May 1997 will not decrease the allocable cost amount of a joining entity or increase the allocable cost amount of a leaving entity – see Assistant Treasurer's media release no. 50 of 8 May 2007.

The tax cost setting rules will be modified to clarify both the valuation of liabilities, and that the accounting principles must be used consistently – see Assistant Treasurer's media release no. 50 of 8 May 2007.

References

Income Tax Assessment Act 1997, sections 701-1 and 701-5; 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 and 705-115; 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

Income Tax Assessment Act 1997, sections 705-60, 705-65

Revision history

Section C2-4-340 first published 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
2.10.03	Substantial revisions to commentary definitions and example calculation figures.	To take deferred tax assets into account.
15.11.06	New paragraphs on Division 43 unclaimed deductions in Commentary, p. 2.	For clarification.
	Additional example, showing treatment of unclaimed Division 43 deductions, p. 4.	For clarification.
26.6.07	Note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used, and proposed changes to the treatment of certain inherited deductions, p. 4.	Reflect announcement on 8 May 2007 by Assistant Treasurer in media release no. 50.

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).