

Worked example

Tax cost setting amount for retained cost base assets – entitlement to pre-paid services

Description This example shows the calculation of a head company's cost setting amount for an asset created by a prepayment for services, based on the undeducted portion of the prepayment.

Commentary If a retained cost base asset is an entitlement to a pre-paid service or other entitlement arising from a pre-paid amount, a head company's tax cost for the asset is equal to its entitlement to deductions in relation to the pre-paid amount arising out of the head company's inheritance of the joining entity's entitlements.

Example

Facts ACo is wholly acquired by HeadCo (the head company of a consolidated group) on 1 July 2002 for \$420,000. The financial position of ACo on joining the group is shown in Table 1.

Table 1: ACo – financial position at 1 July 2002

Land & Buildings (MV \$120,000)	\$100,000	Capital	\$400,000
Pre-paid services	\$300,000	Mortgage on Land & Buildings	\$20,000
Cash at bank	\$20,000		
	<u>\$420,000</u>		<u>\$420,000</u>

Note: MV = market value

On 1 July 2000, ACo pre-pays \$500,000 for financial services, based on a five-year service agreement. The allowable deduction is spread over the eligible service period – that is, \$100,000 per year. (At the date of consolidation \$300,000 of the prepayment has not been claimed and allowed as a deduction.)

Calculation The tax cost setting amount for the retained cost base assets will be Cash \$20,000 and Pre-paid Services \$300,000, totalling \$320,000.

The remainder of ACo's allocable cost amount (ACA), after deducting the sum of the tax cost setting amounts for retained cost base assets, will be \$120,000. This will be allocated to the only reset cost base asset, Land & Buildings – i.e. ACA step 1 (\$420,000) + ACA step 2 (\$20,000) less retained cost base assets (\$320,000) = \$120,000¹.

¹ The \$300,00 of the prepayment that has been inherited by the head company at the time ACo joined the group is not an 'acquired deduction' for the purposes of step 7 of the ACA calculation. This is because the expenditure forms the cost base of the asset, being the entitlement to pre-paid services, and is excluded by subsection 705-115(2).

References

Income Tax Assessment Act 1997, subsection 705-25(4); as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Explanatory Memorandum accompanying the New Business Tax System (Consolidation) Bill (No 1) 2002, paragraph 5.26