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		
	$420,000		**$420,000**

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) = $120,000[1].

[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).

Note

Proposed changes to consolidation rules

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, 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

Revision history

Section C2-4-410 first published (excluding drafts) 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
26.6.07	Note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used, p. 2.	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).