Worked example

Limiting the tax cost setting amounts of revenue-like assets (step E)

Description

This example shows how the tax cost setting amount for a revenue-like asset is reduced at step E of the entry cost setting process where there has been an earlier resetting of the cost bases and reduced cost bases of pre-CGT membership interests in a joining entity because of a change in the underlying ownership of those interests. (Note that trading stock, depreciating assets and revenue assets are referred to in the consolidation legislation as 'assets held on revenue account' and 'revenue etc. assets'. In the reference manual, they are generally referred to as 'revenue-like' assets.)

Commentary

The tax cost setting amounts for revenue-like assets (i.e. trading stock, depreciating assets, and revenue assets) are limited to the greater of their terminating values or market values under section 705-40 of the ITAA 1997. The tax cost setting amounts for depreciating assets may also be reduced for over-depreciation under section 705-50. A further reduction may also apply to revenue-like assets if:

- the tax cost setting amount worked out for the asset exceeds its terminating value, and
- before consolidation, Division 149 of the ITAA 1997 or its predecessor reset the cost bases of pre-CGT membership interests in the joining entity at a higher value (because there was a change in majority ownership of the entity).

The entry ACA will need to be recalculated and reallocated. The first calculation and allocation of the ACA sets the tax cost setting amounts for all assets other than revenue-like assets. The second calculation and allocation of the ACA sets the tax cost setting amounts for revenue-like assets.

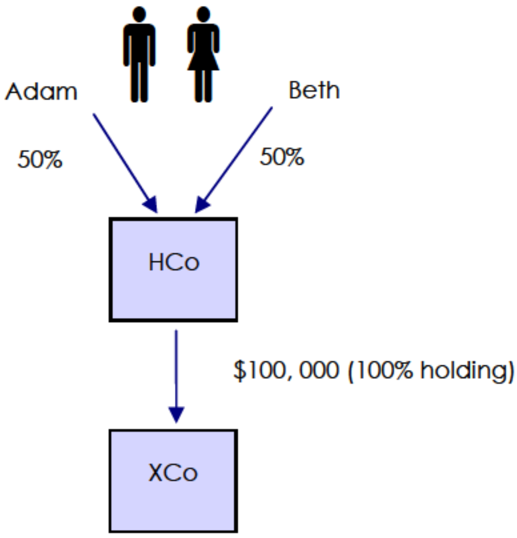
Those revenue-like assets will be given reduced tax cost setting amounts that remove the effect of the change in majority ownership on the cost bases of membership interests. The reduction amount gives rise to a capital loss for the head company and can be offset against capital gains over a minimum period of 5 income years. → section 104-500, ITAA 1997

Example

Facts

Adam and Beth incorporate HCo on 1 July 1985 with $100,000, each holding 50% of the shares. HCo then incorporates XCo with $100,000 (1,000 ordinary shares).

Figure 1



On 1 July 1985, XCo acquires Asset 1 for investment purposes. XCo's financial position at that time is as follows:

Table 1: XCo – financial position at 1 July 1985

Asset 1 (MV $30,000)	$30,000	Equity	$100,000
Cash	$70,000		
	$100,000		$100,000

MV = market value

XCo made profits every year to 30 June 2001. All profits were taxed but not distributed. Taxed profits total $200,000. Asset 1 was a pre-CGT asset. Assets 2 to 5 were acquired after 20 September 1985. Asset 2 was acquired for long-term investment. Assets 3 to 5 are held on revenue account.

On 30 June 2001 Adam and Beth decide to retire and sell their shares in HCo to an unrelated couple Ted and Alice for $370,000. XCo's financial position was as follows:

Table 2: XCo – financial position at 30 June 2001

Asset 1 (MV $70,000)	$30,000	Equity	$100,000
Asset 2 (MV $60,000)	$30,000	After tax profits	$200,000
Asset 3 (MV $40,000)	$50,000		
Asset 4 (MV $70,000)	$60,000		
Asset 5 (MV $70,000)	$70,000		
Cash	$60,000		
	$300,000		$300,000

MV = market value

As the majority underlying interests in XCo (and its assets) are not the same as they were before 20 September 1985, Division 149 applies at this time. The shares in XCo and Asset 1 cease to be pre-CGT assets. The first element in their cost base and reduced cost base is reset to their respective market values at that time. The market value of the shares was $370.00 each.

HCo elects to form a consolidated group on 1 July 2002. XCo's financial position at that time is as follows:

Table 3: XCo – financial position at 30 June 2002

Asset 1 (MV $70,000)	$30,000	Equity	$100,000
Asset 2 (MV $60,000)	$30,000	After tax profits	$220,000
Asset 4 (MV $70,000)	$60,000		
Asset 5 (MV $80,000)	$70,000		
Asset 6 (MV $80,000)	$80,000		
Cash	$50,000		
	$320,000		**$320,000**

MV = market value

Table 4: Working out tax cost setting amounts

	ACA 1	ACA 2
ACA calculation		
Step 1	370,000	100,000
For ACA 1 compare cost base (CB) $370 with reduced cost base (RCB) $370 and market value (MV) $410. As MV exceeds CB, use CB ($370 x 1,000 shares)		
For ACA 2 reduce CB and RCB by the loss of pre-CGT adjustment amount (both $270) before comparison. As MV exceeds the adjusted CB, use the adjusted CB of $100 ($100 x 1,000 shares)(see explanation below)		
Step 2		
Does not apply as there are no liabilities		
Step 3		
Add undistributed profits accrued to group only from the Division 149 change time	20,000	20,000
Steps 3A – 4		
Do not apply		
Steps 5 - 7		
Do not apply as there are no losses or inherited deductions		
Entry ACA is	390,000	120,000
Subtract: Tax cost setting amount of retained cost base assets (i.e. cash)	50,000	50,000
Remainder of ACA (to be allocated to reset cost base assets)	340,000	70,000

Table 5: Allocation of remainder of ACA 1 to reset cost base assets

Asset	Cost	Terminating value	Market value	Apportionment of remainder	Tax cost setting amount
Asset 1	30,000	70,000	70,000	70,000/360,000 x 340,000	66,111
Asset 2	30,000	30,000	60,000	60,000/360,000 x 340,000	56,666
Asset 4	60,000	60,000	70,000	70,000/360,000 x 340,000	66,111
Asset 5	70,000	70,000	80,000	80,000/360,000 x 340,000	75,556
Asset 6	80,000	80,000	80,000	80,000/360,000 x 340,000	75,556
Totals			**360,000**		**340,000**

Assets 4, 5 and 6 are revenue assets under section 977-50. There is no reduction to their tax cost setting amounts under section 705-40 of the ITAA 1997 as the tax cost setting amount worked out above does not in any case exceed the greater of the asset's terminating value or market value. However, these revenue assets are also 'revenue etc. assets' under paragraph 705-57(2)(c) of the ITAA 1997. As the tax cost setting amounts of Assets 4 and 5 worked out above exceed their respective terminating values, and the cost base and reduced cost base of membership interests in XCo were increased as a result of the operation of Division 149, the ACA must be recalculated.

In the second calculation (ACA 2 column in the ACA calculation above), the cost base and reduced cost base used in step 1 must be reduced by their respective loss of pre-CGT status adjustment amounts. For the cost base, the cost base of membership interests immediately before the Division 149 change time is compared with the cost base of those interests immediately after the change. The difference is the adjustment amount. The cost base before the change was $100 per share, and $370 after the change. The adjustment amount is $270. The same exercise is used to work out the adjustment for the reduced cost base ($370 less $100 is $270).

After subtracting for retained cost base assets (see above), the remainder of the second ACA is allocated to the reset cost base assets as follows:

Table 6: Allocation of remainder of ACA 2 to reset cost base assets

Asset	Cost	Terminating value	Market value	Apportionment of remainder	Tax cost setting amount
Asset 1	30,000	70,000	70,000	70,000/360,000 x 70,000	13,611
Asset 2	30,000	30,000	60,000	60,000/360,000 x 70,000	11,666
Asset 4	60,000	60,000	70,000	70,000/360,000 x 70,000	13,611
Asset 5	70,000	70,000	80,000	80,000/360,000 x 70,000	15,556
Asset 6	80,000	80,000	80,000	80,000/360,000 x 70,000	15,556
Totals			**360,000**		**70,000**

For assets that are not ‘revenue etc.’ assets under paragraph 705-57(2)(c), the tax cost setting amount worked out using ACA 1 is used. For ‘revenue etc.’ assets the tax cost setting amount worked out using ACA 2 is used, but not so as to reduce the tax cost setting amount for those assets below their terminating values.

Table 7: Application of section 705-57:

Asset	Cost	Terminating value	TCSA from ACA 1	TCSA from ACA 2	TCSA after s. 705-57	CGT event L1 amount
Asset 1	30,000	70,000	66,111	13,611	66,111	
Asset 2	30,000	30,000	56,666	11,666	56,666	
Asset 4	60,000	60,000	66,111	13,611	60,000	6,111
Asset 5	70,000	70,000	75,556	15,556	70,000	5,556
Asset 6	80,000	80,000	75,556	15,556	75,556	0
Totals			**340,000**	**70,000**	**328,333**	**11,667**

The tax cost setting amounts to be used are the figures in the second last column. The sum of these and the CGT event L1 amounts (the last column) is $340,000. This is equal to the remainder of the ACA 1 step 1 amount after subtracting for retained cost base assets.

The reduction of $11,667 is converted into a capital loss (CGT event L1) available to be deducted over a minimum period of 5 income years starting with the income year in which formation occurs. → section 104-500, ITAA 1997

References

Income Tax Assessment Act 1997, sections 705-40 and 705-50; 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

Income Tax Assessment Act 1997, paragraph 705-57(2)(c); as amended by: *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 3

Income Tax Assessment Act 1997, section 104-500; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 3

Income Tax Assessment Act 1997, Division 149

Income Tax Assessment Act 1997, section 977-50