Treatment of losses

Note

The diagram on page 2 provides an overview of the consolidation loss provisions.

One of the principles recommended by *A tax system redesigned* is that a company or trust entering a consolidated group should be able to bring its losses into the group.

The consolidation provisions are not designed to facilitate the earlier or greater use of those losses. Rather, they ensure that the tax system does not stand in the way of commercial group restructures. The loss rules complement the consolidation regime.

Unrestricted transfer of losses to the head company of a consolidated group and subsequent unrestricted utilisation of these losses would be too costly to the revenue. Accordingly, the amount of losses that can be transferred to the head company of a consolidated group is restricted by ensuring that entities seeking to transfer losses pass, at the transfer time, modified versions of the general tests for utilising losses.

The rate at which transferred losses can be used by the head company of a consolidated group is generally restricted to approximate the rate of use that the joining entity would have experienced had it remained outside of the consolidated group. A concessional method for the use of transferred losses has been developed in respect of eligible company losses made in an income year ending on or before 21 September 1999 (the date of release of the Ralph Report) and transferred when the group first consolidates in the transitional period – that is, between 1 July 2002 and 30 June 2004.

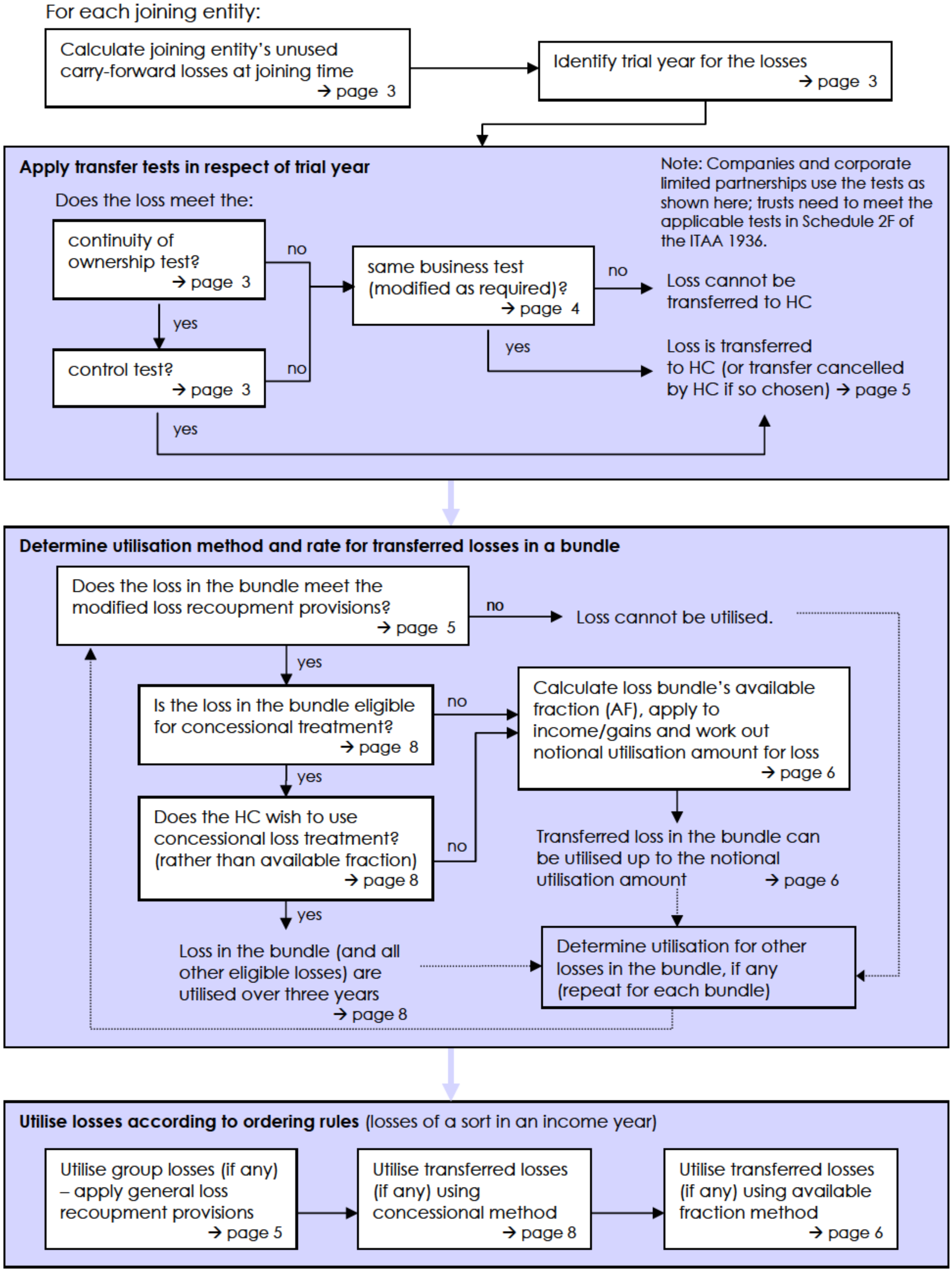
Transferring losses to the consolidated group

When an entity becomes a member of a consolidated group (whether as head company or as a subsidiary), its unused carry-forward losses are transferred to the head company if the losses satisfy modified versions of the usual tests for deducting and applying them (referred to as the ‘general loss provisions’, which are outside the consolidation rules).

Broadly, the tests are applied as though the 12 months prior to the joining time were the loss claim year (known as the trial year).

The loss is transferred to the head company of the group if the joining entity could have utilised the loss in the trial year assuming it had sufficient income or gains of the relevant type.

Figure 1: Treatment of losses – overview



The trial year

The trial year is the notional loss claim year for transfer testing purposes. It serves two purposes. First, the trial year ensures that the ownership test period ends just after the joining time, which means that ownership changes that occur as part of either forming or joining a consolidated group are counted in determining whether the loss can be transferred. Second, if required to apply the same business test to the joining entity, the trial year ensures that its business is tested for a minimum 12-month period.

While generally the trial year encompasses a 12-month period, in certain circumstances it may actually be shorter. → 'Glossary', A2

Process for transferring losses to the head company

There are generally three steps to be followed by a joining entity seeking to transfer losses to the head company of a consolidated group:

Step 1: the entity works out its taxable income or loss for the period up to the time it joins the group → worked examples C3-3-110, C3-3-120

Step 2: the entity identifies the amount of its unused carry-forward losses as at the joining time → worked examples C3-3-110, C3-3-120

Step 3: the entity then determines whether those losses satisfy the modified tests for using them in the context of the trial year

→ worked examples C3-3-210, C3-3-220, C3-3-230, C3-3-240, C3-3-250

Thus, where the entity joins the group as a subsidiary member it is required to consider the general loss provisions in the course of establishing its income tax liability (if any) to the point of consolidation, and to then consider them again as transfer tests (modified as required) in the context of the trial year.

The tests generally require the joining entity:

- to have maintained a majority of the same ownership and control for the period between incurring the loss and just after the joining time (the continuity of ownership and control tests), or
- in certain cases, to have carried on the same business for at least the 12 months before the joining time (the same business test).

The continuity of ownership and control tests

→ worked examples C3-3-210, C3-3-220

For companies

The continuity of ownership test would be satisfied if the same majority ownership of the joining entity was maintained from the start of the income year in which the loss was made until just after consolidation. Thus, the trial year captures ownership changes resulting from the choice to consolidate joining entities. The continuity of ownership test requires that the same owners, owning the same shares, satisfy the test for the whole of the period.

The control test is failed if a person starts to control the entity's voting power, during the period in which the continuity of ownership test is applied, for the purposes of gaining a benefit or advantage in relation to the application of the Tax Act.

If the continuity of ownership and control tests are satisfied, the joining entity's losses are transferred to the head company. If either of the tests is not satisfied, the same business test would need to be satisfied before the joining entity's losses could be transferred at consolidation.

Corporate limited partnerships that are treated as companies because of section 94J of the ITAA 1936 also apply these tests, though they are not required to test maintenance of voting power.

For trusts

Where the joining entity is a fixed trust it needs to meet the 50% stake test. This applies in a broadly similar manner to the company continuity of ownership test, though trusts are not required to examine voting power. A non-fixed trust must pass a control test. A non-fixed trust may also be required to pass the 50% stake test or the pattern of distributions test, or both.

→ 'Glossary', A2

The same business test

→ worked examples C3-3-230, C3-3-240, C3-3-250

Where the ownership or control tests are failed but the joining entity meets the same business test, the loss is transferred to the head company.

The general company same business test compares the time just before the ownership (or control) test was failed with the income year in which the loss is claimed to determine if the same business was conducted in both periods. However, when applying the same business test as a loss transfer test, the periods examined for comparison may be different to those ordinarily used for recoupment purposes.

Same business test: modifying the periods during which it applies

Modifying the existing same business test rules for transfer testing is required because of the possibility that some or all of the test periods overlap or coincide.

Table 1 shows how the same business test applies for companies joining a consolidated group. Consideration must be given to the different rules as they apply to listed public companies and their 100% subsidiaries.

Table 1: Same business transfer tests for companies

No	In these circumstances:	Test the joining entity's business at these points:
1	The loss was made by the joining entity for an income year starting after 30 June 1999	• just before the end of the income year in which the loss was made • the income year in which the joining entity first fails the ownership or control tests, and • the trial year
2	The loss was made by the joining entity for an income year starting before 1 July 1999	• just before the ownership or control tests were first failed, and • the trial year

In applying the same business test as a transfer test, it is assumed that the business carried on by the joining entity at and just after the joining time is the same as the business it carried on just before the joining time. This ensures that the test period effectively ends immediately before the joining time.

Where a loss is transferred as a result of satisfying the same business test, in order for it to be transferred again an additional test must be satisfied.

→ worked example C3-3-250

Joining entity losses become losses of the head company

A joining entity's eligible losses are transferred to the head company at the joining time. The head company is then treated as having made the loss itself in the income year of the transfer.

The head company is then the only entity capable of utilising the loss. Losses that have been transferred can be deducted, applied or taken into account (subject to limitations) for all income years of the head company following consolidation, until the losses are either exhausted or rendered non-utilisable.

If the joining entity ceases to be a member of the consolidated group, all losses remain with the head company of the consolidated group.

Using losses in the consolidated group

A head company is required to work out its taxable income under section 4-5 of the ITAA 1997 as if each of the other entities in the consolidated group were part of the head company. In the process of working out the head company's taxable income it is entitled to shelter its income through the utilisation of its carry-forward losses (subject to the limits imposed). Broadly speaking, these losses can either be:

- losses generated by the consolidated group (group losses), and/or
- transferred losses that were generated by an entity before it became a member of the group.

Before utilising a group loss or a transferred loss, the head company is required to apply the general loss recoupment provisions. This necessitates the head company passing the continuity of ownership and control tests or the same business test. For transferred losses, these recoupment tests are modified for the purposes of determining whether the company has maintained the same ownership. The two modifications are outlined in Subdivision 707-B.

First, the loss year is modified so that it starts from when the loss was transferred to the head company. This ensures that things that happened to the head company before the transfer time are not taken into account in applying the continuity of ownership test. However, this is subject to the second modification.

The second modification is that in determining whether the head company can use a loss transferred to it from a company as a result of passing the continuity of ownership and control tests, pre-consolidation changes in ownership of the loss company are recognised. → Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 7

When determining the amount of losses utilised in an income year, group losses are effectively utilised before transferred losses of the same sort. Similarly, any losses claimed on a concessional basis in an income year are effectively claimed prior to any utilisation of other transferred losses of the same sort. In certain limited circumstances, group tax losses and tax losses claimed on a concessional basis are deducted after other transferred tax losses are claimed in an income year.

Transferred losses are bundled. At first instance, a bundle of losses consists of all the losses that are transferred to the head company for the first time by the entity that actually made them. A bundle of losses may consist of only one loss. Losses within the bundle are categorised by sort (such as a film loss or a net capital loss). An available fraction is calculated for each bundle.

All losses in the bundle are treated as having been made by the head company in the same income year.

Determining the amount of a transferred loss that can be utilised for an income year

The amount of a transferred loss that can be utilised by the head company from a particular joining entity is calculated by reference to an available fraction. Generally, each bundle has an available fraction calculated on the basis of the loss entity's modified market value as a fraction of the adjusted market value of the consolidated group.

There is a limit on the amount of losses of each sort within a bundle of losses that can be utilised by the head company. Broadly, the limit is set by multiplying the head company's income or gains of that type by the available fraction for the bundle of transferred losses.

In situations where losses are transferred to the head company part-way through the head company's income year, a rule operates to apportion the limit to which losses can be deducted against income. The apportionment rule ensures that the head company does not obtain 'full-year access' to losses that it has owned for only part of its income year.

The apportionment rule also ensures that the head company's use of its own prior year losses (transferred to itself on consolidation) are unrestricted in respect of income broadly attributable to the pre-consolidation period.

Calculating the available fraction

The available fraction is a representation of the market value of the loss entity as a proportion of the market value of the consolidated group (including the loss entity). The market values are determined as at the joining time.

The calculation of the available fraction is as follows:

$$\frac{\text{Modified market value of the loss entity}}{\text{Adjusted market value of the consolidated group}}$$

The modified market value of the loss entity is its market value assuming:

- the loss entity has no losses and the balance of its franking account is nil
- the subsidiary members of the group at the joining time are separate entities and not divisions or parts of the head company at the joining time
- the entity's market value does *not* include an amount attributable to a membership interest in a member of the group that is a corporate tax entity or an entity that transferred losses to the head company, and
- a trust (other than a corporate tax entity or a trust with losses) contributes to the joining entity's market value only to the extent attributable to fixed entitlements at the joining time to income or capital of the trust that is not attributable to a membership interest in another member of the group that is a corporate tax entity or a trust with losses.

→ worked example C3-4-110

The adjusted market value of the consolidated group at the joining time is its market value ignoring any losses it has and assuming that its franking account balance is nil.

An increase in the value of the loss entity is excluded from the entity's modified market value if the increase results from either of these events:

- an injection of capital into the loss entity, its associate or, if the loss entity is a trust, an associate of the trustee (→ worked example C3-4-120), or
- a non-arm's length transaction that involved the loss entity, its associate or, if the loss entity is a trust, an associate of the trustee.

These rules prevent a loss entity from inflating its market value before it joins a consolidated group in order to obtain a higher available fraction. They apply to those events described above that occur in the four years before the loss entity joins the group – however, they do not apply to events that occurred before 9 December 2000.

Note

Options during the transitional period (1 July 2002 to 30 June 2004)

- An available fraction calculation for a loss bundle may not be necessary if the head company chooses the concessional method for utilisation and all losses in the bundle can be utilised under this method.

  → 'Utilising transferred losses over three years', page 8
- Subject to certain conditions, the available fraction for a bundle of transferred losses may be increased by allowing the head company to add to the loss company's modified market value all or part of the modified market value of another group company.

  → 'Increasing the available fraction (value donor concession)', page 9
- An administrative provision applies during the transitional period under which, if certain conditions are met, market valuations may not be required where the available fraction can be assumed to be 1.000.

  → 'Market valuation transitional option', page 10

Adjustments to available fractions

The available fraction for a bundle of losses must be adjusted if certain events occur. For example, if a new loss member joins the group (and hence a new bundle of losses is transferred), each pre-existing available fraction needs to be recalculated to reflect the new consolidated group structure → worked example C3-4-330. The head company may choose to cancel all the loss transfers in respect of the incoming bundle, thereby avoiding the requirement to adjust each pre-existing available fraction in the group.

The available fraction for each bundle needs to be adjusted if there is an injection of capital or a non-arm's length transaction that results in an increase in the market value of the group.

There will also be a requirement to adjust the available fraction when a bundle is transferred for a second or subsequent time. This occurs when another consolidated group acquires the head company of an existing group, and the existing group has transferred losses. → worked example C3-4-310

If the sum of the available fractions in the group exceeds 1, the available fractions need to be adjusted so that their sum is capped at 1.

→ worked example C3-4-350

Concessional treatment in deducting transferred losses

There are concessional measures that may apply to a head company in deducting or utilising transferred losses.

Utilising transferred losses over three years

A head company can choose that certain transferred losses be utilised over three years. These are losses that are transferred from a company, as a result of passing the continuity of ownership and control tests, and were actually incurred in an income year ending on or before 21 September 1999. The loss company must join the group during the transitional period – that is, between 1 July 2002 and 30 June 2004 – at the time the group consolidates. This choice is irrevocable and must be made for all eligible losses in a particular bundle.

→ worked examples C3-4-520, C3-4-530

Example

Comparing concessional method and available fraction method

A head company has a bundle consisting of a net capital loss of $600, which it can choose to claim on a concessional basis of one-third per annum. The bundle has an available fraction of 0.250 and the head company derived a capital gain of $1,000 for the year. The head company could claim:

under the concessional method:

Capital gain	$1,000
Less: $600 x 1/3 =	<u>$200</u>
Net capital gain	$800

under the available fraction method:

Capital gain	$1,000
Less: $1000 x .250	<u>$250</u>
Net capital gain	$750

In this case, the head company would be able to utilise more of the loss using the available fraction method.

However, if the capital gain for the year were $500 instead of $1,000, the head company would be able to utilise more of the loss using the concessional method: $200 as opposed to $125 ($500 x 0.250). If the concessional method is chosen, the head company must utilise all of the eligible losses in the bundle on this basis in subsequent income years.

Increasing the available fraction (value donor concession)

The available fraction for a bundle of losses transferred by a loss entity may be increased when a head company chooses to consolidate during the transitional period – that is, between 1 July 2002 and 30 June 2004 – and the loss entity joins the consolidated group at the time that consolidated group comes into existence. Subject to certain conditions, if the loss entity had losses that could have been grouped under the loss transfer provisions available prior to 1 July 2003 (that is, in Division 170 of the ITAA 1997), the bundle of losses transferred by that loss entity will be eligible for a higher available fraction. This concession only applies where the relevant loss entities are companies.

Broadly, this is achieved by allowing the head company to add to the loss company's modified market value all or part of the modified market value of another group company (referred to as the value donor) to which the loss company could have transferred losses under the group loss transfer rules available prior to 1 July 2003. The value donor must also join the consolidated group when it first comes into existence.

The head company may also treat one or more of the value donor's losses as if it was included in the real loss-maker's bundle for the purpose of determining the amount of the losses that can be utilised by the group in any given income year. Broadly, losses can be treated in this way only if they could be transferred from the value donor to the real loss-maker, and to any of the real loss-maker's other value donors, under the group loss transfer rules.

→ worked examples C3-4-210, C3-4-220, C3-4-230, C3-4-240

Market valuation transitional option

Generally, market valuations of the loss entity (joining subsidiary) and the consolidated group are required to determine the available fraction for losses transferred to the head company. → 'Market valuation guidelines', C4-1

However, a transitional option provides that market valuations are not required for this purpose during the transitional period (1 July 2002 to 30 June 2004) where the available fraction can be assumed to be 1.000 irrespective of the actual market values of the group member entities. This will be the case where:

- 100% of the value of all value donors is included in the modified market value of a particular real loss-maker, and
- the value donors plus the real loss-maker consist of the entire consolidated group, whose values are taken into account in determining the adjusted market value of the consolidated group.

This option is provided by the Commissioner of Taxation under the general administrative provision (section 8) of the ITAA 1936. It applies only if all of the following conditions are met:

- All members of the consolidated group are companies.
- At least one company has a modified market value greater than nil at the time the group is formed (calculation of the actual amount is not required under the concession).
- The conditions in Subdivision 707-C of the *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A) must be satisfied such that *all* of the companies in the consolidated group are value donors to the particular real loss-maker.
- All value donors and the real loss-maker (all group members) became a consolidated group at the same time and before 1 July 2004.
- The choice is able to be made and is made to add 100% of the modified market value of all the value donors to the real loss-maker.
- There must be no overall foreign loss transferred to the head company of the group at the time the group is formed.
- The losses in the bundle of the real loss-maker are tax losses or net capital losses whose utilisation is *not* affected by section 707-350 of the IT(TP)A. This section provides a choice to utilise certain losses over three years.
- Each value donor would have been able to transfer all of its losses whose utilisation is *not* affected by section 707-350 of the IT(TP)A to the head company at the initial transfer time, pursuant to the consolidation provisions, assuming that each value donor made the loss for the same income year as the real loss-maker did and had not utilised it.
- The real loss-maker would have been able to transfer the loss to each value donor under the existing grouping provisions (Division 170 of the ITAA 1997) for the income year which is generally the trial year as prescribed by section 707-328 of the IT(TP)A.

- All of the losses of each value donor must be able to be transferred to the real loss-maker and to all of the other value donors under the conditions outlined in section 707-327 of the IT(TP)A.
- No injection of capital, as described in subsection 707-325(4) of the ITAA 1997, has taken place that would lead to a reduction in the modified market value of any member of the group.
- No non-arm's length transaction, as described in subsection 707-325(4) of the ITAA 1997, has taken place that would lead to a reduction in the modified market value of any member of the group.

A group may be able to bring itself within these conditions by cancelling the transfer of certain losses under section 707-145 of the ITAA 1997.

The above concession will no longer apply if, after formation, there is an adjustment event as described in subsection 707-320(2) of the ITAA 1997 and as a consequence a market valuation is required.

Revision history

Section C3-1 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
27.10.03	Additional condition to satisfy use of the market valuation transitional option.	Clarify that in a situation where the modified market values of all the members of the group are nil at the joining time, the transitional option is not available.