High-level worked example

Consolidation loss provisions

Description

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 use of transferred losses is limited by their available fraction – that is, they may be offset against only a fraction of the head company's income and gains. Subject to certain conditions, the available fraction for a bundle of losses[1] transferred by a loss entity may be increased when the head company chooses to consolidate during the transitional period and the loss entity joins the consolidated group at the time that the consolidated group comes into existence.

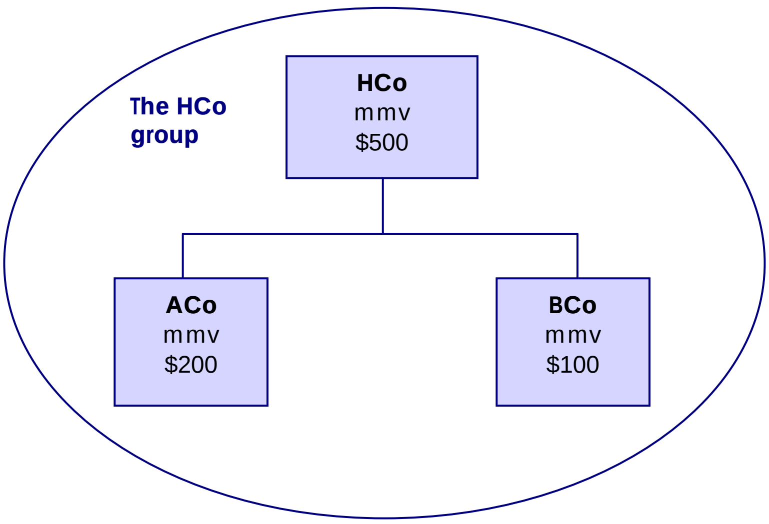
Commentary

Subdivision 707-A sets out the rules for determining whether the joining entity's losses can be transferred to the head company. Subdivision 707-C outlines how much of a transferred loss may be deducted or applied by the head company. The transitional concessions available in relation to losses transferred to a consolidated group are contained in Subdivision 707-C, *Income Tax (Transitional Provisions) Act 1997*.

Example – facts

Assume the following consolidated group structure as at the joining time (1 July 2002).

Figure 1: HCo group structure



ACo has been 90% owned by HCo since incorporation in 1995. The remaining 10% is acquired at the joining time.

BCo was purchased 100% in a takeover by HCo on 27 July 1998.

mmv = modified market value

[1] 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.

Example – calculation

Loss transfer

How do ACo and BCo determine the amount of any transferable losses?

HCo, ACo and BCo all need to establish their tax position at the joining time (1 July 2002). This enables each entity to determine what unutilised losses they may have available for potential transfer to the head company.

Generally, in order to be transferable, each unutilised loss must have been able to be utilised by the joining entity had it remained outside the consolidated group.

At the joining time, ACo and BCo had the following losses that were eligible for potential transfer to HCo.

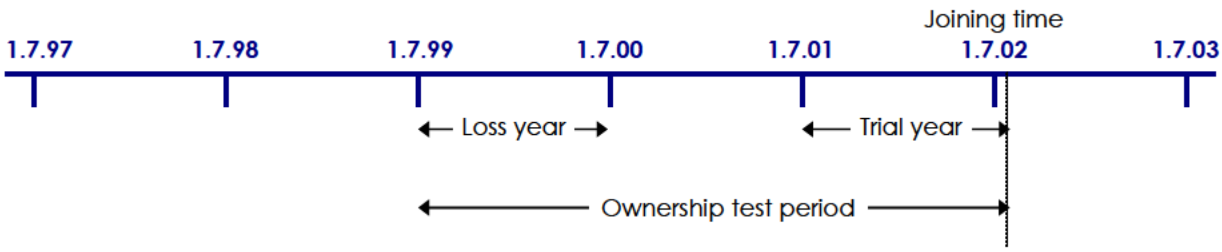
Table 1: Eligible losses of ACo and BCo at joining time

Subsidiary	Loss	Sort	Year incurred
ACo	$250	Net capital loss	2001
	$650	Tax loss	2000
BCo	$350	Net capital loss	1998
	$300	Tax loss	2000

Have the joining entities maintained substantially the same ownership or the same business for the period since the loss was incurred until just after the joining time?

A loss is transferred from ACo or BCo to HCo to the extent that the loss could have been utilised by either ACo or BCo for an income year consisting of the *trial year*.

Figure 2: ACo's 2000 tax loss



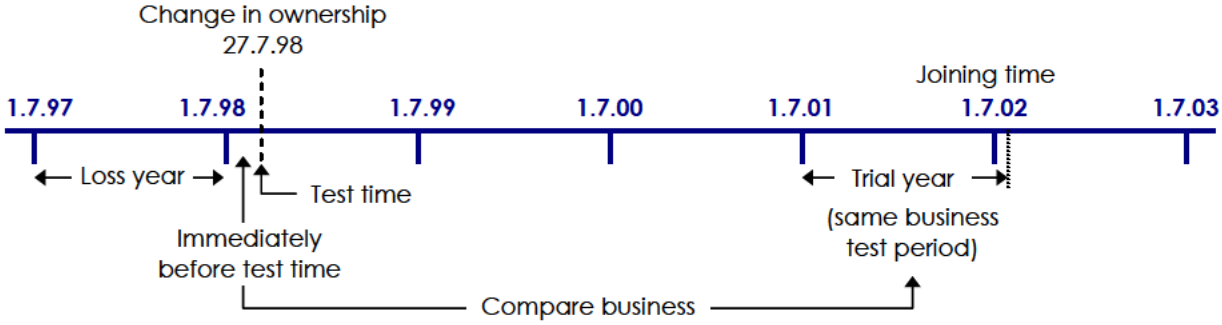
Assume ACo's 2000 tax loss satisfies the continuity of ownership test (COT) and the control test. It follows that ACo's 2001 net capital loss also satisfies these tests. Both losses can therefore be transferred to HCo.

BCo's 1998 net capital loss (pre-1999)

BCo experienced a change in its majority ownership on 27 July 1998. Therefore, the net capital loss that BCo made in the 1998 income year cannot satisfy the COT. BCo will only be able to transfer the loss to HCo if it satisfies a modified same business test (SBT).

As the capital loss was made in an income year beginning prior to 1 July 1999, BCo compares the business conducted immediately before the test time to the SBT period (or trial year[2]) to see if it satisfies the SBT for the loss, as shown in figure 3.

Figure 3: BCo change in ownership on 27.7.98 (test time)



Assume that BCo's 1998 net capital loss satisfies the SBT and can therefore be transferred to HCo.

BCo's 2000 tax loss

Assume that BCo's 2000 tax loss satisfies the COT (as well as the control test) and can therefore be transferred to HCo.

Calculating the available fractions

What are the available fractions for each bundle of losses transferred to HCo in the absence of the value donor concession?

In this example, the calculation of the available fraction is as follows:

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

[2] Although the trial year ends just after the joining time, the SBT period effectively ends immediately before the joining time. This is achieved by assuming 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.

The adjusted market value of the consolidated group as at the joining time, ignoring any losses and assuming a nil franking account balance, is $800. Thus the available fractions are as follows:

Bundle A: $\frac{200}{800} = 0.250$

Bundle B: $\frac{100}{800} = 0.125$

HCo chooses to apply the value donor concession

As the HCo group consolidates during the transitional period and BCo has a $300 tax loss that is transferable to HCo under the existing group loss transfer rules contained in Division 170 of the *Income Tax Assessment Act 1997*, a portion of HCo's modified market value can be added to BCo's modified market value for the purposes of working out the available fraction for bundle B. That portion is based on the amount of BCo's losses that are transferable to HCo as a proportion of BCo's total losses. (It should be noted that BCo's 1998 net capital loss of $350 is not transferable to HCo under the group loss transfer rules – it was incurred before BCo became a part of a wholly-owned group with HCo.) Thus the portion of HCo's modified market value that can be added to BCo's modified market value is:

$$\$500 \times 100\% \times \frac{300}{650} = \$231$$

(If losses were also transferred from HCo to the consolidated group, its modified market value would then have to be reduced by the above amount for the purposes of calculating the available fraction for the bundle of losses transferred from HCo.)

As a result of the increase in BCo's modified market value, the available fraction for bundle B is calculated as follows:

$$\frac{(100 + 231)}{800} = 0.414$$

Note

This example is designed to illustrate the operation of the rules. The choices made by HCo here are not purported to represent the best outcome for the group in every case where similar scenarios may exist.

Utilisation of transferred losses

The HCo group's loss bundles are shown in table 2.

Table 2: HCo group loss bundles

Bundle	Loss	Available fraction (AF)	Sort	Basis of transfer	Year incurred*
A	$250	0.250	Net capital loss	COT	2003
	$650	0.250	Tax loss	COT	2003
B†	$350	0.414	Net capital loss	SBT	2003
	$300	0.414	Tax loss	COT	2003

* Losses that have been transferred to HCo are deemed to be made by HCo in the income year in which the transfer occurs.
† BCo's available fraction has been calculated using the value donor concession.

The HCo group has then traded for an income year. Prior to taking into account transferred losses, it determines that it has a capital gain of $500 and other assessable income, net of deductions (assuming no capital gains or assessable foreign or film income) of $1,800 for the 2003 income year. No other losses were incurred by the group during this period.

What is the taxable income position of the HCo group for the 2003 income year?

Assume that HCo has satisfied the COT (as well as the control test) to enable it to utilise its transferred losses for this income year.

Determine limits for utilisation of transferred losses

Step 1: Work out the categories of group income or gains – section 707-310(3)

Table 3: Categories of group income or gains (step 1)

Column 1 income or gains	Gross amount	*Less:* allowable deductions/ reductions	*Less:* group/ concessional losses of that kind	Column 2 income/gains available for bundle
Capital gains	$500	–	–	$500
Other assessable income	$1,800	–	–	$1,800

Step 2: Calculate the fraction of the income/gain that is attributable to each bundle – subsection 707-310(3)

Table 4: Fraction of income/gains attributable to each bundle (step 2)

Column 1 income or gains	Loss bundle	Column 2 income/gains for bundle	*Multiplied by:* AF	AF amount for the bundle
Capital gains	Bundle A	$500	0.250	$125
	Bundle B	$500	0.414	$207
Other assessable income	Bundle A	$1,800	0.250	$450
	Bundle B	$1,800	0.414	$745

Step 3(a) – Work out a notional taxable income for bundle A – subsection 707-310(2)

Table 5: Net capital gain (step 3a)

Capital gains	$	Losses applied	$
Capital gain	125	Transferred net capital loss	125
Total	**125**	**Total**	**125**

The (notional) net capital gain is $0 ($125 – $125).

Table 6: Taxable income (step 3a)

Assessable income	$	Deductions	$
Net capital gain	0	Transferred tax loss	450
Other assessable income	450		
Total	**450**	**Total**	**450**

Transferred losses 'used' in working out notional taxable income for bundle A are:

- transferred net capital loss $125
- transferred tax loss $450

These are the limits for utilisation of these transferred losses when determining the actual taxable income for the group.

Step 3(b) – Work out a notional taxable income for bundle B – subsection 707-310(2)

Table 7: Net capital gain (step 3b)

Capital gains	$	Losses applied	$
Capital gain	207	Transferred net capital loss	207
Total	**207**	**Total**	**207**

The (notional) net capital gain is $0 ($207 – $207).

Table 8: Taxable income (step 3b)

Assessable income	$	Deductions	$
Net capital gain	0	Transferred tax loss	300
Other assessable income	745		
Total	**745**	**Total**	**300**

The (notional) taxable income is $445 ($745 – $300).

Transferred losses ‘used’ in working out notional taxable income for bundle B are:

- transferred net capital loss $207
- transferred tax loss $300

These are the limits for utilisation of these transferred losses when determining the actual taxable income for the group.

Determine group’s actual taxable income

Table 9: Net capital gain

Capital gains	$	Losses applied	$
Capital gain	500	Transferred net capital loss (bundle A)	125
		Transferred net capital loss (bundle B)	207
Total	**500**	**Total**	**332**

The group’s net capital gain is $168 ($500 – $332).

Table 10: Taxable income

Assessable income	$	Deductions	$
Net capital gain	168	Transferred tax loss (bundle A)	450
Other assessable income	1,800	Transferred tax loss (bundle B)	300
Total	**1,968**	**Total**	**750**

The group’s taxable income is $1,218 ($1,968 – $750).

The loss bundles as at the end of the 2003 income year contain the losses shown in table 11.

Table 11: Losses in loss bundles

Bundle	Loss	Available fraction	Sort	Basis of transfer	Year incurred
A	$125 (i.e. $250 – $125)	0.250	Net capital loss	COT	2003
	$200 (i.e. $650 – $450)	0.250	Tax loss	COT	2003
B	$143 (i.e. $350 – $207)	0.414	Net capital loss	SBT	2003

Note: the whole amount of tax loss of $300 for bundle B is fully utilised.

References

Income Tax Assessment Act 1997, Subdivisions 707-A, 707-C; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

Income Tax (Transitional Provisions) Act 1997, Subdivision 707-C; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 2

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapters 6, 8 and 9