Worked example

Determining if a transferred loss can be utilised – COT transfer case

Description

A head company of a consolidated group is subject to special rules in determining whether it can utilise a loss transferred to it because the continuity of ownership test (COT) was satisfied. The head company is considered to meet the COT if the 'test company' (generally, the company from which the loss was first transferred) satisfies the COT based on certain assumptions.

This example shows how the test company is identified and explains the application of the COT and same business test (SBT) to the head company.

Commentary

To determine whether a transferred loss can be utilised, the general loss recoupment tests for companies are modified by Subdivision 707-B.

Section 707-210 modifies the rules regarding satisfaction of the COT[1] for a loss transferred to the head company as a COT transfer. For this purpose, a COT transfer is defined[2] as a transfer of a loss from a company that occurs because:

- the COT is satisfied, and
- the control test conditions in section 165-15 do not exist.

In determining whether the head company is taken to have satisfied the COT in respect of a loss transferred to it as a COT transfer, ownership changes before and after the joining time are recognised.

If the loss has been transferred, as a COT transfer, for the first time to the head company from a joining company, the test company is that joining company. If the loss has been transferred to the head company in consecutive COT transfers, the test company is the first joining company in that series of loss transfers.

If the test company meets the COT based on the assumptions in subsection 707-210(4), the head company is taken to have satisfied the COT. If the test company fails the COT, the head company is taken to have failed the COT at the first time the test company does not meet the relevant conditions in section 165-12. The result of ownership testing of the test company is therefore attributed to the head company.

---

[1] Section 165-12.

[2] Subsection 707-210(1A).

The assumptions made for the purposes of applying the COT to the test company are that, effectively:

1 the test company is reinstated as the owner of the loss
2 the loss year is the income year in which the test company made the loss
3 the test company is a wholly-owned subsidiary of the head company at all times from the date of transfer
4 if the loss is transferred to another head company, the test company is a wholly-owned subsidiary of the new head company from the time of that later transfer.

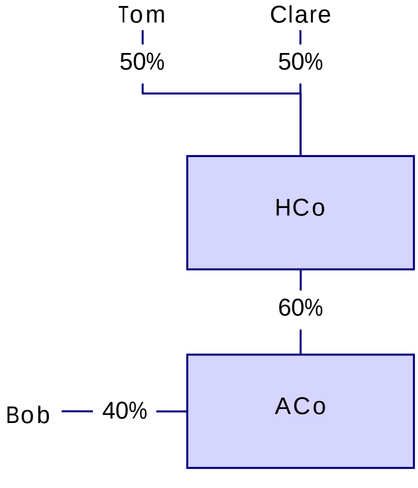
Assumptions 3 and 4 effectively 'freeze' the ownership structure below the applicable head company as at the date of transfer, so that only ownership changes above the applicable head company after that time are relevant. If the test company ceases to be a subsidiary member of the consolidated group after the date of transfer, this exit from the group is ignored for the purposes of determining whether it satisfies the COT.

Example

Facts

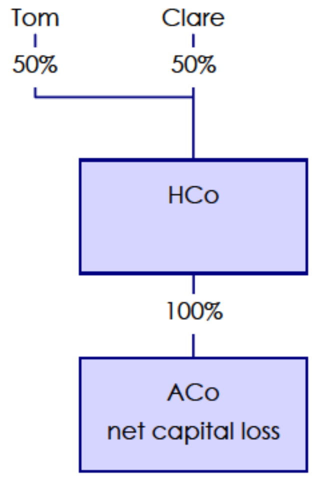
At 1 July 1999, ACo is owned 60% by HCo and 40% by Bob. The membership interests in HCo are owned 50% by Tom and 50% by Clare.

Figure 1: Ownership structure at 1 July 1999



ACo incurs a net capital loss for the year ended 30 June 2000. On 15 December 2001, ACo becomes a wholly-owned subsidiary of HCo when HCo acquires Bob's 40% membership interest.

Figure 2: Ownership structure at 15 December 2001

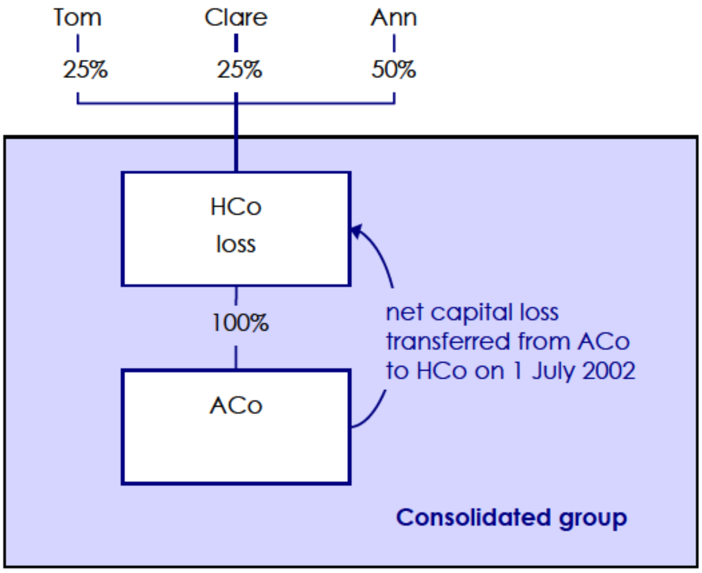


HCo chooses to form a consolidated group on 1 July 2002, with ACo as a subsidiary member. The net capital loss incurred by ACo for the 2000 income year is transferred to HCo as a COT transfer.

The consolidated group makes capital gains in both the 2003 and 2004 income years. These capital gains total less than the transferred net capital loss.

On 15 March 2004, Ann acquires one-half of each of Tom and Clare's membership interests in HCo.

Figure 3: Ownership structure at 15 March 2004



Can HCo apply the transferred net capital loss in determining its net capital gain for each of the 2003 and 2004 income years?

Calculation

To determine if HCo satisfies the COT for the loss transferred from ACo, the COT must be applied to the test company under the assumptions in subsection 707-210(4). The test company in this case is ACo, the joining company that actually incurred the net capital loss.[3]

The assumptions in determining if ACo satisfies the COT in the 2003 and 2004 income years are that:

1 ACo made the loss

2 the loss year is the 2000 income year and not the year of the transfer, and

3 ACo is a wholly-owned subsidiary of HCo from 1 July 2002.

2003 income year

ACo's ownership test period for COT purposes is from 1 July 1999 (the beginning of the loss year) to 30 June 2003 (the end of the recoupment income year). Throughout this period there are two continuing shareholders, Tom and Clare. For the entire ownership test period, Tom and Clare between them have continuously maintained the 60% interest in ACo, held indirectly through HCo, that existed at the beginning of the loss year.

The third assumption means that ACo is treated as being a subsidiary member of HCo's consolidated group from 1 July 2002. (In this case, ACo actually does continue to be wholly-owned by HCo.)

ACo satisfies the COT as continuing underlying majority ownership has been maintained.

As the test company, ACo, satisfies the COT, HCo is taken to have satisfied the COT. HCo is able to utilise an amount of the transferred net capital loss in accordance with the limit under the available fraction method in Subdivision 707-C.

2004 income year

ACo's ownership test period for COT purposes is from 1 July 1999 (the beginning of the loss year) to 30 June 2004 (the end of the recoupment income year). Throughout this period there are two continuing shareholders, Tom and Clare.

Ann's acquisition of 50% of the membership interests in HCo on 15 March 2004 means that Tom and Clare between them did not maintain a majority of the voting power and relevant rights in ACo at all times during the entire ownership test period[4]. As a result, ACo fails the COT.

---

[3] Subsection 707-210(3).

[4] Tom and Clare each had a maximum membership interest at all times during the ownership test period of 25% in HCo and HCo always had at least a 60% interest in ACo. Therefore Tom and Clare each had a maximum continuous indirect interest of 15% (25% × 60%) in ACo, applying the 'same share same interest rule' in section 165-165. Because Ann acquires a 50% interest in ACo on 15 March 2004, the 'savings rule' in subsection 165-12(7) is not

HCo is therefore taken to have failed the COT on 15 March 2004 and will only be able to utilise an amount of the transferred net capital loss if it meets the SBT.[5] In applying the SBT, the test time will be 15 March 2004 and the same business test period will be the 2004 income year.

References

Income Tax Assessment Act 1997:

- Subdivisions 707-A, 707-C
- sections 165-12, 165-13, 165-15, 165-165, 707-210

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 7

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 3

Revision history

Section C3-4-440 first published 3 December 2003.

applicable as there is not a continuity of majority underlying ownership by Tom and Clare, ignoring section 165-165.

[5] Section 165-13.