

Worked example

Effect of entry history rule

Description This example shows how the entry history rule may affect the future tax liabilities of a consolidated group when an entity joins the group.

Commentary The entry history rule identifies the history that an entity takes with it into a consolidated group. This history can affect the future tax liabilities of the group.

For most purposes, a consolidated group inherits the tax history of its joining subsidiaries. Specifically, the entry history rule ensures that everything that happened in relation to an entity before joining a consolidated group is taken to have happened in relation to the head company for the purposes of calculating the head company's future income tax liability or tax losses. The entry history rule does not affect the joining entity's responsibility for taxation liabilities relating to pre-consolidation periods. → section 701-5, *Income Tax*

Assessment Act 1997 (ITAA 1997)

The entry history rule provides that a head company may be entitled to certain deductions for expenditure incurred by a joining entity before it joins, such as borrowing expenses, gift deductions (where the entitlement to the deduction is spread), the cost of connecting water, power and telephone lines, certain business-related costs and expenditure allocated to a project pool. A head company may also be entitled to a deduction for a debt brought into a consolidated group that subsequently goes bad.

Income is derived and therefore assessed when the services to which the payments relate are provided → *Arthur Murray (NSW) Pty Ltd v FC of T (1965) 114 CLR 314*. If such a period spans an entity joining, or the formation of, a consolidated group, the entry history rule requires a head company to include the relevant amounts as assessable income over the period in which the services are provided.

Where a specific provision of the Act requires that either income or deductions are spread over two or more periods, Division 716 of the ITTA 1997 operates to give effect to the spreading. The income tax history of the assessable income, or allowable deduction to be spread, is inherited under the entry history rule.

Other effects of the entry history rule include:

- The pre-CGT status of assets brought into a consolidated group by an entity that becomes a subsidiary member is inherited. (However, the pre-CGT status of interests in the asset would be lost if any acquisition of membership interests in the entity resulted in the ultimate owners not continuing to hold majority underlying interests in the asset).

- Private binding income tax rulings issued to an entity before it joins a consolidated group may apply to the head company insofar as the relevant facts or arrangement associated with the ruling have not changed either by reason of consolidation (e.g. because they relate to intragroup transactions, which are ignored) or otherwise.

Situations where history is not inherited

For some purposes, specific provisions of the consolidations regime override the entry history rule, with the effect that an asset's history is *not* brought into the group (such as where new costs for a joining entity's assets are set under the cost setting rules).

Other provisions that modify the application of the entry history rule include:

- rules covering the treatment of franking credits and losses → 'Introduction to consolidation', B0-2; section 701-85, ITAA 1997
- rules for certain elections made by controlled foreign corporations (CFCs), foreign investment funds (FIFs) and foreign life assurance policies (FLPs) → subdivision 717-F

Example

Facts

- HCo has beneficially owned 100% of ACo since the companies were incorporated in 1996 and there has been no change in the group's ultimate owners.
- HCo chose to form a consolidated group with effect from 1 July 2002. ACo is the only subsidiary member of the group.
- ACo incurred \$5,000 in borrowing expenses on 1 July 1999. The borrowing expenses have been deductible to ACo under section 25-25 of the ITAA 1997 at the rate of \$1,000 per year (i.e. 1/5 of \$5,000). The borrowed moneys continue to be used by ACo solely for income producing purposes.
- In 2000-01, ACo included in its assessable income \$3,000 relating to an item of trading stock sold by it on a credit basis. In 2002-03 this debt was written off as bad by ACo.
- On 1 July 2001, ACo received an up-front payment of \$4,000 under a contract to provide services to a customer for the period 1 July 2001 to 30 June 2003. ACo included \$2,000 as assessable income in 2001-02 as the remaining \$2,000 would not be earned until 2002-03.
- If the events in relation to ACo that occurred before consolidation are ignored, HCo's taxable income for the group would be \$120,000 for 2002-03 and \$100,000 for 2003-04.

Calculation of
HCo's taxable
income for
2002-03

The head company's 2002-03 taxable income is calculated as follows, taking into account the entry history rule:

	2002-03	2003-04
Taxable income before applying entry history rule:	\$120,000	\$100,000
<i>add</i> further assessable amounts:		
income received in advance	\$2,000	
<i>less</i> further deductions:		
borrowing expenses	(\$1,000)	(\$1,000)
bad debt	(\$3,000)	
Taxable income after applying entry history rule:	\$118,000	\$99,000

References

Income Tax Assessment Act 1997, sections 701-5 and 701-85; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (68 of 2002), Schedule 1

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 2.7, 2.8, 2.13, 2.30 - 2.37, 2.47 and 2.81

Income Tax Assessment Act 1997, Subdivision 717-F; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 8

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No 2) 2002, paragraphs 7.65 to 7.69

Income Tax Assessment Act 1997, Division 716; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 1

Income Tax Assessment Act 1997, section 25-25