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. → Subdivision 709-D; worked examples, C9-5-350 to C9-5-352; paragraphs 6.30 to 6.55 of the Explanatory Memorandum to the Tax Laws Amendment (2004 Measures No. 7) Bill 2004

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.

The Tax Office has issued the following taxation determinations related to the application of the entry history rule: TD 2004/43, TD 2004/80.

Situations where history is not inherited

For some purposes, specific provisions of the consolidation 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 covering the entitlement to the R&D tax offset → section 73BABA, ITAA 1936, and the R&D incremental concession → section 73BAC, ITAA 1936
- a rule requiring that the entry history rule be ignored when determining a debt test period for the purpose of applying the consolidation bad debt rules → subsection 709-205(3), ITAA 1997.

The entry history rule is also modified by rules that permit the head company of a consolidated group to remake certain normally irrevocable elections or choices made by entities before they join the group. → Subdivision 715-J, ITAA 1997. These fall into three categories:

1. Resettable elections

Where a joining entity was eligible to make a choice in this category (see list below) in relation to an income year starting before the joining time, or had, before the joining time, made such a choice which would have started to have effect for its first income year starting after the joining time if it had not joined the group, its choice (or absence of it) is ignored for the purposes of the head company's income tax affairs and the head company may make the choice, if it is eligible.

The head company has until the later of the time allowed under the choice provision and 90 days after it notifies the Tax Office that the entity has joined the group to make the choice. The Commissioner has discretion to extend this deadline.

Note that this rule came into effect on 21 March 2005. If the head company notified the Tax Office before 21 March 2005 that the entity had joined the group, the 90 day limit mentioned above is taken to be 90 days after 21 March 2005.

→ section 715-659, IT(TP)A 1997

The choice has effect from the joining time (or from the income year containing the joining time if the choice relates to a whole income year).

The choices in this category are:

- irrevocable declarations, elections, choices or selections provided for in Part X or XI of the ITAA 1936 (about attribution of income in respect of CFCs, FIFs and FLPs)
- the election to value all items of trading stock that are interests in a FIF at market value (rather than cost) under section 70-70 of the ITAA 1997
- the election to use a particular foreign currency to work out taxable income or a tax loss for an income year under item 1 of the table in subsection 960-60(1) of the ITAA 1997
- elections provided for under other provisions that may be prescribed by regulation under this category in the future.

→ section 715-660, ITAA 1997; paragraphs 1.183 – 1.196 of the Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004; 'Effect of exit history rule', C9-5-810

2. Limited resettable elections to overcome inconsistencies

Where a joining entity and another entity that was a member of the group at the joining time were both eligible to make a choice in this category (see list below) in relation to an income year starting before the joining time, and the choice was in effect just before the joining time for one entity but not the other, the choice (or absence of it) of the joining entity is ignored for the purposes of the head company's income tax affairs, and the head company may make the choice, if it is eligible.

The time limit for the head company to make the choice is the same as for resettable elections (see above). The choice has effect from the joining time (or from the income year containing the joining time if the choice relates to a whole income year).

The choices in this category are:

- the election under section 148 of the ITAA 1936 by a person carrying on a business of insurance in Australia who reinsures with a non-resident, in relation to reinsurance under contracts made at or after the joining time. (For contracts made before the joining time, the head company is taken to have made the same decision as the joining entity that was party to the contract to make or not make the election.)

- the election under section 775-80 of the ITAA 1997 that sections 775-70 and 775-75 of that Act (concerning the tax consequences of certain short-term foreign exchange gains and losses) not apply
- elections provided for under other provisions that may be prescribed by regulation under this category in the future.

→ section 715-665, ITAA 1997; paragraphs 1.200 – 1.213 of the Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004; 'Effect of exit history rule', C9-5-810

3. Choices with ongoing effect

If a joining entity was eligible to make a choice in this category in relation to something that was its asset, right, liability or obligation until it became that of the head company because of the single entity rule, and the head company is similarly eligible under that rule, the head company is taken to have made the choice or not made the choice depending on whether the joining entity did or did not have that choice in effect at the joining time.

The only choice currently available in this category is the choice provided under section 775-150 of the ITAA 1997 regarding whether to apply rules about disregarding certain forex realisation gains and forex realisation losses.

Choices of this type are not affected by the fact of consolidation: that is, such a choice (or absence of a choice) continues to apply with respect to an asset, right, liability or obligation that, before consolidation, was held by an entity that had made the choice (or not made the choice).

→ section 715-670, ITAA 1997; paragraphs 1.220-1.224 of the Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004

However, if an entity has a particular choice in this category in effect at the time it joins a consolidated group and it is the first time that any entity with that choice in effect has joined the group, the head company may make an irrevocable choice that all assets, rights, liabilities or obligations it holds at that time, or subsequently when other entities later join the group, are covered by the choice. The head company must make the choice within 90 days of notifying the Tax Office that the entity has joined the group. The Commissioner has discretion to extend this time limit.

Note that this rule came into effect on 21 March 2005. If the head company notified the Tax Office before 21 March 2005 that the entity had joined the group, the 90 day limit mentioned above is taken to be 90 days after 21 March 2005.

→ section 715-659, IT(TP)A 1997

If the head company later becomes a subsidiary member of another consolidated group, this choice will itself be treated as a choice with ongoing effect in relation to that other consolidated group.

→ section 715-675, ITAA 1997; paragraphs 1.225-1.226 of the Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004'; 'Effect of exit history rule', C9-5-810

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

Taking into account the entry history rule, HCo's 2002-03 and 2003-04 taxable income is calculated as follows:

	2002–03	**2003–04**
Taxable income before applying entry history rule:	$120,000	$100,000
add further assessable amounts:		
income received in advance	$2,000	
less 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* (No. 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 to 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 25-35

Income Tax Assessment Act 1936, section 73BABA; as amended by the *Taxation Laws Amendment (No. 2) Act 2004* (No. 20 of 2004), Schedule 8 item 10

Income Tax Assessment Act 1936, section 73BAC; as amended by the *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 11 item 7

Income Tax Assessment Act 1997, Subdivision 715-J; as inserted by *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1, Part 10

Income Tax Assessment Act 1997, Subdivision 709-D; as inserted by *Tax Laws Amendment (2004 Measures No. 7) Act 2005* (No. 41 of 2005), Schedule 6, Part 4

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004, paragraphs 1.183 – 1.196, 1.200 – 1.213 & 1.220 – 1.226

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 7) Bill 2004, paragraphs 6.30 – 6.55

Taxation determinations

TD 2005/23 – Income tax: consolidation: can the head company of a consolidated group satisfy subsection 25-35(1) of the *Income Tax Assessment Act 1997* in relation to a debt that is written off as bad by a subsidiary member, where the debt is in respect of money lent by the subsidiary in the ordinary course of its business of lending money before it became a member of the consolidated group?

TD 2004/43 – Income tax: consolidation: capital gains: for the purposes of the capital gains tax provisions in Parts 3-1 and 3-3 of the *Income Tax Assessment Act 1997*, is the head company of a consolidated group taken to have acquired an asset, which a subsidiary member brings to the group, at the same time that the subsidiary member acquired it?

TD 2004/80 Income tax: consolidation: capital gains: does an entity permanently lose its status as an 'originating company', in respect of a deferral event in subsection 170-255(1) of the *Income Tax Assessment Act 1997*, when the entity becomes a subsidiary member of a consolidated group?

Revision history

Section C9-5-150 first published 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
27.10.03	Minor change to description of calculation.	To clarify.
14.7.04	Note on proposed changes to consolidation rules.	Proposed legislative amendments.
	Reference to rules relating to R&D tax offset and R&D incremental concession as modifying the application of the entry history rule, p. 2.	Legislative amendments.
26.10.05	Changes and new material in 'Commentary' on rules that modify the entry history rule.	Legislative amendments.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).