

Worked example

Aligning income/deductions with services – arrangements between prospective fellow members

Description

This example shows the process for aligning, at the joining time:

- the income and deductions arising from an ongoing arrangement between two entities that subsequently become members of the same consolidated group, with
- the services actually provided or received up to that time.

Commentary

Ongoing arrangements of various kinds involving income and expenditure can exist between two entities before they become members of a consolidated group (or, alternatively, between a consolidated group and another entity before that entity joins the group). Examples of such arrangements include loans subject to interest, provision of property under a lease, or prepayment for the future provision of goods or services including insurance.

After entities in an ongoing arrangement become members of the same consolidated group, payments between them will not be recognised for income tax purposes – each subsidiary member is treated under the single entity principle as a part of the head company. This means that any difference between the proportion of services actually provided and the assessable income the providing entity has derived – when compared to the whole arrangement – will become frozen once the entities become members of the same consolidated group. Similarly, for the recipient of the services, any difference between the proportion of services received and its allowable deductions will likewise become frozen. → section 701-70, *Income Tax Assessment Act 1997*.

The purpose of section 701-70 is to align each entity's tax position at the joining time with the proportion of services it has actually provided or received. The provision ensures that assessable income and deductions are brought to account in respect of the amount of service provided under such arrangements before the entities become members of the same consolidated group.

Note that section 701-75 operates in similar fashion to section 701-70 where an ongoing arrangement exists between two members of the same consolidated group and one (or both) *ceases* to be a member of the group.

Example

Facts Entity A becomes a wholly-owned subsidiary of holding company HC on 1 July 2002. Before that date Entity A was totally unrelated to HC.

Entity A executed a car lease with HC, effective 1 July 1998, under which Entity A is obliged to pay HC \$100 monthly for 5 years in return for the lease of a car.

At 30 June 2002, Entity A is two months in arrears on the car lease payments. At that time Entity A accounts for its tax affairs on a cash basis. HC has at all times been an accruals taxpayer.

HC chooses to consolidate with all its wholly-owned subsidiaries with effect from 1 July 2002.

Calculation As there is an arrangement in place that satisfies section 701-70(1), HC and Entity A must each apply the provision to their own tax positions at the consolidated group's formation time (1 July 2002).

Adjustment for disproportionate deductibility – Entity A

Subsection 701-70(3) requires Entity A to compare its total allowable deductions on the lease up to the time of consolidation with the proportion of allowable deductions for the whole of the lease arrangement that are attributable to this period. If there is any difference, Entity A is entitled to deduct the amount or must include it in its assessable income.

The adjustment is calculated in the following steps:

Step 1

The 'pre-joining time proportion of total arrangement deductions' is worked out as follows → subsection 701-70(4):

$$\begin{array}{ccc} \text{(A)} & & \text{(B)} \\ \text{Pre-joining time} & \times & \text{Total arrangement} \\ \text{services proportion} & & \text{deductions} \end{array}$$

In this example:

$$\text{A is } \frac{\text{lease period before the joining time}}{\text{total period of lease}} = \frac{4 \text{ years}}{5 \text{ years}} = 0.8$$

$$\text{B is } \$1200 \times 5 \text{ years} = \$6000$$

Therefore, the step 1 outcome is $0.8 \times \$6000 = \4800

Step 2

Calculate the sum of:

- lease payments deductible to Entity A for the year ending 30 June 2002 (the amount incurred by Entity A in the income year ending at the joining time) → paragraph 701-70(3)(a): that is, \$1000 (10 months' payments made by Entity A before falling into arrears)

and

- total lease payments deductible to Entity A for all earlier years of income → paragraph 701-70(3)(b): that is,

1998-99	\$1200
1999-2000	\$1200
2000-01	<u>\$1200</u>
Total to 30 June 2001	\$3600

The step 2 outcome is **\$4600**.

Step 3

Compare the amount calculated under step 1 with the amount calculated under step 2:

- If step 1 outcome > step 2 outcome, deduct the difference in these figures from assessable income in Entity A's return for 2001-02.
→ paragraph 701-70(3)(c)
- If step 1 outcome < step 2 outcome, include the difference in these figures in assessable income in Entity A's return for 2001-02.
→ paragraph 701-70(3)(d)

The step 3 outcome is that the step 1 outcome > step 2 outcome by \$200 – therefore Entity A is entitled to deduct an amount of \$200 in its 2001-02 income tax return. → paragraph 701-70(3)(c)

Adjustment for disproportionate assessability – HC

As lessor, HC must include in its assessable income any income it derives on the car lease.

Subsection 701-70(5) requires HC to compare the total assessable income it has derived on the car lease up to the time of consolidation with the proportion of assessable income it will derive over the whole of the lease arrangement that is attributable to this period. If there is any difference, HC is entitled to deduct the amount or must include it in its assessable income.

The adjustment is calculated in the following steps:

Step 1

Work out the pre-joining time proportion of total arrangement assessable income → subsection 701-70(6):

$$\begin{array}{ccc} \text{(A)} & & \text{(B)} \\ \text{Pre-joining time} & \times & \text{Total arrangement} \\ \text{services proportion} & & \text{assessable income} \end{array}$$

In this example:

$$\text{A is } \frac{\text{lease period before the joining time}}{\text{total period of lease}} = 0.8$$

4 years
5 years

B is \$1200 x 5 = \$6000

Therefore the step 1 outcome is $0.8 \times \$6000 = \mathbf{\$4800}$

Step 2

Calculate the sum of:

- lease payments included in HC's assessable income for the year ended 30 June 2002 (i.e. the amount derived by HC in the income year ending at the joining time): that is, \$1200 (because HC accounts for income on an accruals basis)

and

- total lease payments included in HC's assessable income for all earlier years of income: that is,

1998-99	\$1200
1999-2000	\$1200
2000-01	<u>\$1200</u>
Total to 30 June 2001	\$3600

→ subsection 701-70(5)

Step 2 outcome is **\$4800**.

Step 3

Compare the amount calculated under step 1 with the amount calculated under step 2:

- If step 1 outcome > step 2 outcome, include the difference in these figures in HC's assessable income in its return for 2001-02.

→ paragraph 701-70(5)(a)

- If step 1 outcome < step 2 outcome, deduct the difference in these figures from HC's assessable income in its return for 2001-02.
→ paragraph 701-70(5)(b)

The step 3 outcome is that the step 1 outcome = step 2 outcome – that is, the two amounts are both \$4800. Therefore, there is no adjustment to the taxable income of HC.

References

Income Tax Assessment Act 1997, section 701-70; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2

Income Tax Assessment Act 1997, section 701-75; 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 2.69-74

Explanatory Memorandum to the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, paragraphs 1.22-24

Revision history

Section C9-5-210 first published 2 December 2002.

Further revisions are described below.

Date	Amendment	Reason
30.6.09	Changes to the Example to reflect the replacement of the simplified tax system by the small business entity provisions.	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).



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