Worked example

Prepayment transitional rules – group consolidates 1 July 2002

Description

This example shows how the prepayment transitional rules interact with the single entity rule and entry history rule.

It applies to a situation where a head company and all of its relevant subsidiaries share the same balance date for income tax and consolidate on the first day of their income year that includes 21 September 2002 (in most cases, a consolidation date of 1 July 2002). Post-consolidation prepayments subject to the transitional rules are made by members of the consolidated group.

Note

Part-year membership

This example does not examine the Subdivision 716-A rules applying to deductions spread over two or more income years where an entity is a subsidiary member of a consolidated group for only some of the income year.

Commentary

When the '13-month rule' allowing full deductibility of certain prepaid expenditure was withdrawn, transitional rules were introduced to phase out its benefits.

The transitional rules allow a taxpayer to deduct, in the expenditure year, some of the expenditure that relates to services not provided until the following income year. Such expenditure is called the 'later year amount'.

Under the transitional rules, 80% of the later year amount is deductible for an expenditure year including 21 September 1999 (for most taxpayers, the 1999–2000 income year). Similar transitional deductions are available in each of the next three income years, but with different percentages of the later year amounts deductible in the expenditure year. For the income year including 21 September 2002 (for most taxpayers, the 2002–03 income year) the percentage is 20%. → subsection 82KZMB(5), ITAA 1936

There is a limit on the amount eligible for transitional treatment in each of the income years subsequent to the income year that includes 21 September 1999. This limit is referred to as the 'cap'. The cap is the total of all later year amounts subject to the transitional rules in the income year including 21 September 1999. → section 82KZMC, ITAA 1936

If the later year amount for one of the subsequent income years exceeds the cap, the later year amount subject to the transitional rules in that year is limited to the amount of the cap. The amount by which a later year amount exceeds the cap is allowed as a deduction proportionately over the eligible service period that occurs after the expenditure year. → subsection 82KZMB(6), section 82KZMC, ITAA 1936

When the head company of a consolidated group works out the sum of its later year amounts for the 2002–03 income year, it applies the single entity rule and the entry history rule:

- The effect of the single entity rule is that eligible prepaid expenditure incurred by subsidiary members of the group is taken to have been incurred by the head company. The later year amounts attributable to this expenditure are therefore the later year amounts of the head company for the purpose of working out its deductions under the transitional prepayment rules. → section 701-1, ITAA 1997
- The effect of the entry history rule is that the head company's prepayment cap is the sum of the prepayment caps of all members of the consolidated group. → section 701-5, ITAA 1997

Example

Facts

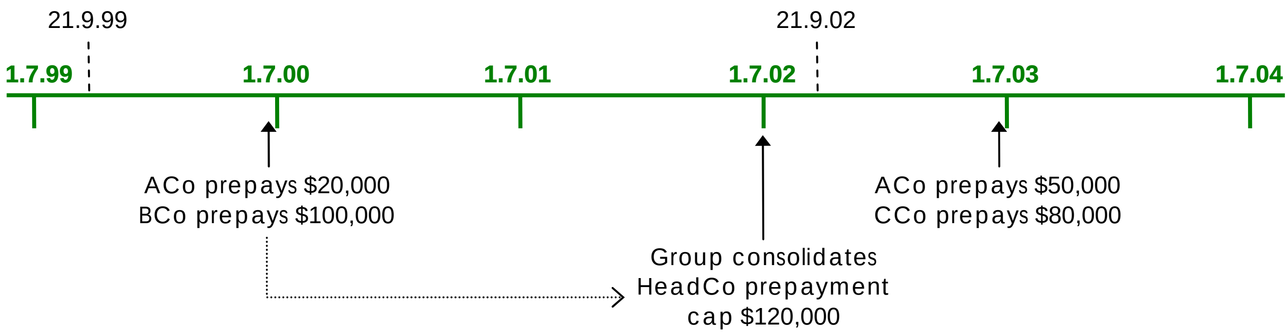
ACo, BCo and CCo are wholly-owned subsidiaries of HeadCo. All companies are 30 June balancers.

On 30 June 2000, ACo incurs prepaid expenditure of $20,000 and BCo incurs prepaid expenditure of $100,000 for services to be provided from 1 July 2000 to 30 June 2001. Neither CCo nor HeadCo incurs any prepaid expenditure for this period.

HeadCo chooses to consolidate with effect from 1 July 2002.

On 30 June 2003, ACo incurs expenditure of $50,000 and CCo incurs expenditure of $80,000 for services to be provided from 1 July 2003 to 30 June 2004. Neither BCo nor HeadCo incurs any prepaid expenditure for this period.

Figure 1: HeadCo group prepayments timeline



Calculation

Establishing the prepayment cap for HeadCo

To work out the sum of its later year amounts for the 1999–2000 income year, HeadCo applies the entry history rule. The effect is that, for the head company core purposes, everything that happened to ACo, BCo and CCo before they became subsidiary members of the consolidated group is taken to have happened to HeadCo. HeadCo is taken to have made the prepayments actually made by ACo and BCo on 30 June 2000 and to have had their later year amounts for the 1999–2000 income year. → section 701-5, ITAA 1997

The later year amounts of ACo and BCo for the 1999–2000 income year were $20,000 and $100,000 respectively. The sum of these amounts establishes a cap of $120,000, which is used to calculate HeadCo's deduction for the remaining income years of the transitional period. → subsections 82KZMB(6) and 82KZMC(3), ITAA 1936

Applying the provisions to expenditure prepaid in the 2002–03 year

Since the group consolidates with effect from 1 July 2002, the single entity rule applies for the core purposes.

For the purposes of working out HeadCo's income tax liability, ACo, BCo and CCo are taken to be parts of HeadCo and not separate entities. HeadCo is taken to have incurred the prepaid expenditure actually incurred by ACo and CCo under their service agreements.

The later year amount under ACo's service agreement is $50,000, because no part of the eligible service period falls within the 2002–03 income year. Similarly, the later year amount under CCo's service agreement is $80,000. For HeadCo, the sum of its later year amounts is therefore $130,000.

The amount that HeadCo is entitled to deduct in the 2002–03 income year is based on its cap of $120,000, established in the 1999–2000 income year.
→ subsection 82KZMC(1), ITAA 1936

(Note that HeadCo can claim a deduction for prepaid expenditure incurred by CCo in the 2002–03 income year even though CCo did not incur prepaid expenditure in the income year when the cap was established.)

In the 2002–03 income year, HeadCo is entitled to deduct 20% of its later year amounts, subject to its prepayment cap of $120,000:

$120,000 x 20% = $24,000

→ subsection 82KZMB(5), table item 4, column 2

The amount that HeadCo is entitled to deduct in the 2003–04 income year consists of two elements:

- First, HeadCo is entitled to deduct the remaining 80% of the 2002–03 later year amount, up to the limit of the cap:

  $120,000 x 80% = $96,000

  → subsection 82KZMB(5), table item 4, column 3

- Second, HeadCo is entitled to claim the excess of the 2002–03 later year amount over the cap:

  $130,000 – $120,000 = $10,000

  → subsections 82KZMC(4) to (6)

HeadCo's total deduction for the 2003–04 income year in respect of the prepaid expenditure incurred on 30 June 2003 is:

$96,000 + $10,000 = $106,000

References

Income Tax Assessment Act 1997 – as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002) and *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), sections 701-1, 701-5

Income Tax Assessment Act 1936, sections 82KZMB, 82KZMC

Revision history

Section C9-5-330 first published 3 December 2003.