Worked example

Effect of exit history rule

Description

This example shows how the exit history rule may affect the tax liabilities of an entity after it leaves a consolidated group.

Commentary

The exit history rule applies for the core purposes of working out an entity's income tax liability or loss for any period after it ceases to be a subsidiary member of a consolidated group. → subsection 701-40(1), *Income Tax Assessment Act 1997* (ITAA 1997)

The exit history rule applies to assets, liabilities or any business that becomes that of an entity when it ceases to be a subsidiary member of a group. Everything that happened in relation to those assets etc. while part of the consolidated group is taken to have happened to the assets etc. as if they had been assets etc. of the leaving entity. This includes any history that the head company may have inherited under the entry history rule. → subsection 701-40(3)

The history that is inherited by a leaving entity is the history relating to:

- any assets
- any liabilities, including anything that is treated as a liability according to generally accepted accounting concepts, and
- any businesses,

that the entity takes when it leaves the group. To this extent, the exit history rule is more limited in scope than the entry history rule. → subsection 701-40(2)

The exit history rule provides that a leaving entity may be entitled to deductions for expenditure incurred by the head company in regard to assets, liabilities or businesses that leave the group with the entity. For example, the leaving entity may be entitled to deductions for 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. The leaving entity may also be entitled to a deduction for a debt it takes with it that subsequently goes bad.

An entity that has left a consolidated group may also need to include in its assessable income amounts relating to such things as prepayments made to the head company for services to be provided by the entity after it has left the group. An entity may also be assessable on amounts received as a recoupment of expenditure previously made by the head company. In addition, a former subsidiary would also need to include amounts in its assessable income where:

- the head company had previously elected to defer tax on the profit from the disposal or death of livestock or elected to defer the inclusion of the profit on a second wool clip, and
- the business that relates to these items left the group with the leaving entity.

Other effects of the exit history rule include:

- The pre-CGT status of assets that a leaving entity takes with it is inherited by that entity. (However, the pre-CGT status of interests in the asset would be lost if any disposal of membership interests in the entity resulted in the ultimate owners not continuing to hold majority underlying interest in the asset.)
- Private binding income tax rulings issued to the head company may apply to the leaving entity where they relate to particular assets, liabilities or businesses that a leaving entity takes out of a group. A private binding ruling will apply to the leaving entity insofar as the relevant facts and arrangements have not changed either by reason of the entity ceasing to be a member of a consolidated group or otherwise.

Situations where history is not inherited

The history in relation to the cost of an asset is not inherited where its cost is set under the exit cost setting rules (such assets include intragroup loan assets and membership interests).

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

- rules covering the treatment of franking credits and losses → section 701-85
- rules for certain elections made by controlled foreign corporations (CFCs), foreign investment funds (FIFs) and foreign life assurance policies (FLPs) → Subdivision 717-G
- rules relating to the entitlement to the R&D tax offset → section 73BACA, ITAA1936, and the R&D incremental concession → section 73BAD, ITAA 1936.

Example

Facts

- ACo is a 100% subsidiary of HCo and operates a computer retail business.
- In the 2000-01 income year, ACo sells goods to one of its customers for $10,000 but does not receive payment. In its 2000-01 income tax return, ACo includes the amount of $10,000 in its assessable income.
- HCo forms a consolidated group on 1 July 2002. The subsidiary members include ACo and BCo.
- Under consolidation, HCo is taken to hold all the assets of ACo, including the debt.
- In May 2003 it becomes apparent that there is no likelihood of the debt being recovered. HCo writes off the $10,000 as a bad debt and claims a deduction of $10,000 under subsection 25-35 of the ITAA 1997 in the group's 2002-03 income tax return.
- In July 2003, HCo restructures its operations and transfers the computer retail business to BCo. As part of the transfer agreement, BCo assumes responsibility for collecting all outstanding debts that are owing to ACo. Adjustments to the purchase price are made for these outstanding debts, but there is no adjustment made for the $10,000 bad debt as it has been written off.

- On 1 August 2003, HCo sells its shares in BCo, which ceases to be a member of the consolidated group. BCo continues to operate the computer retail business.
- On 1 December 2003, BCo unexpectedly receives a payment of $2500 in respect of the debt that had been written off as bad.

Because of the exit history rule in section 701-40, everything that happened in relation to the computer retail business in the hands of HCo is taken to have happened to it in the hands of BCo. This means that the bad debt claimed as a deduction by HCo in relation to the business is taken to have been claimed by BCo. Because BCo is taken to have claimed the deduction, the recoupment is assessable to BCo under Subdivision 20-A of the ITAA 1997.

In its 2003-04 tax return, BCo must include the amount of $2,500 in its assessable income.

References

Income Tax Assessment Act 1997, Subdivision 20-A

Income Tax Assessment Act 1997, sections 701-40 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, 2.11, 2.13, 2.30, 2.38 - 2.47 and 2.81

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

New Business Tax System (Consolidation and Other Measures) Bill (No 2) 2002 – Dec 2002, Subdivision 717-G

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, section 25-25

Income Tax Assessment Act 1936, section 73BACA; as amended by the *Taxation Laws Amendment (No. 2) Act 2004* (No. 20 of 2004), Schedule 8 item 11

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

Revision history

Section C9-5-810 first published 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Reference to rules relating to R&D tax offset and R&D incremental concession as modifying the application of the exit history rule, p. 2.	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).