

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. → Subdivision 709-D; worked examples, C9-5-350, C9-5-351, C9-5-352; paragraphs 6.30 to 6.55 of the Explanatory Memorandum to the Tax Laws Amendment (2004 Measures No. 7) Bill 2004

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 relating to the entitlement to the R&D tax offset → section 73BACA, ITAA1936, and the R&D incremental concession → section 73BAD, ITAA 1936.
- a rule requiring that the exit 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 exit history rule is also modified by rules which permit an entity leaving a consolidated group to remake certain irrevocable elections or choices made by the head company after the entity became a member of the group

→ Subdivision 715-K, ITAA 1997. These fall into three categories:

1. Resettable elections

Where an entity leaves a consolidated group and the head company was eligible to make a choice in this category (see list below) in relation to an income year starting before the leaving time, the head company's choice (or absence of it) is ignored for the purposes of the leaving entity's income tax affairs for income years ending after the leaving time, and the leaving entity may make the choice, if it is eligible.

The leaving entity has until the later of the time allowed under the choice provision and 90 days after the leaving time 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 entity left the group before that date, the 90 day limit mentioned above is taken to be 90 days after 21 March 2005. → section 715-699, IT(TP)A 1997

The choice has effect from the leaving time (or from the income year containing the leaving 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 715-700, ITAA 1997; paragraphs 1.197 – 1.199 of the Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004; ‘Effect of entry history rule’, C9-5-150

2. Limited resettable elections to overcome inconsistencies

Where an entity leaves a consolidated group and there is an inconsistency because either:

- there was a choice in this category made by the entity that was in effect just before the entity joined the group and there was not such a choice by the head company having effect just before the leaving time, or
- the converse applied,

the choice (or absence of it) of the head company is ignored for the purposes of the leaving entity’s income tax affairs, and the leaving entity may make the choice, if it is eligible.

The time limit for the leaving entity to make the choice is the same as for resettable elections (see above). The choice has effect from the leaving time (or from the income year containing the leaving 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 leaving time. (For contracts made before the leaving time, the leaving entity is taken to have made the same decision as the head company made – or was taken to have made – 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 715-705, ITAA 1997; paragraphs 1.214 – 1.219 of the Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004; 'Effect of entry history rule', C9-5-150

3. Choices with ongoing effect

Where an entity leaves a consolidated group and there were, just before the leaving time, any choices in effect in this category in relation to any assets, rights, liabilities or obligations that the entity leaves with, those choices continue in effect. If a choice was made originally by the head company, the leaving entity will inherit the choice as per the normal exit history rule.

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

→ paragraph 1.225 of the Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004; 'Effect of entry history rule', C9-5-150

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. (As a claimant, HCo will need to take into account the modifications to the bad debt rules contained in Subdivision 709-D, ITAA 1997, 'Deducting bad debts' → worked examples C9-5-350, C9-5-351, C9-5-352.)
- 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

Income Tax Assessment Act 1997, Subdivision 715-K; 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 1.197 – 1.199, 1.214 – 1.219 & 1.225

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

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.
26.10.05	Changes and new material in 'Commentary' on rules that modify the exit 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).