TD 2004/67 - Income tax: consolidation: capital gains: does the determination of a capital gain or loss under section 104-530 (CGT event L7) of the Income Tax Assessment Act 1997 require a full reconstruction of the allocable cost amount in relation to the relevant liability?

Taxation Determination

Income tax: consolidation: capital gains: does the determination of a capital gain or loss under section 104-530 (CGT event L7) of the *Income Tax Assessment Act 1997* require a full reconstruction of the allocable cost amount in relation to the relevant liability?

Preamble

The number, subject heading, date of effect and paragraphs 1 to 9 of this document are a 'public ruling' for the purposes of Part IVAAA of the ***Taxation Administration Act 1953*** *and are legally binding on the Commissioner.*

1. Yes. In order to determine a capital gain or loss under section 104-530 (CGT event L7) of the *Income Tax Assessment Act 1997* (ITAA 1997), a full reconstruction of the allocable cost amount (ACA) is required. This ensures that the full impact of the discharged amount of a liability is reflected in working out the amount of any capital gain or loss.

2. For CGT event L7 to happen to the head company of a consolidated group, the conditions specified in subsection 104-530(3) of the ITAA 1997 must be satisfied for a liability.

3. Paragraphs 104-530(3)(a) and (b) of the ITAA 1997 require that the amount of a liability that was taken into account in working out the ACA for an entity at the time it becomes a member of the consolidated group (the original ACA), is later discharged for a different amount (the realised amount).

4. Further, paragraph 104-530(3)(c) of the ITAA 1997 requires the original ACA to be different to what it would have been (referred to as the true ACA) if the realised amount had been taken into account in working out the ACA. A capital gain will arise if the ACA would have been smaller had the realised amount been taken into account in working it out. Alternatively, a capital loss will arise if the ACA would have been greater.

5. Paragraph 104-530(3)(c) of the ITAA 1997 does not set out how to determine the true ACA. The existence of the condition in this paragraph however indicates the need for a full reconstruction to arrive at the true ACA. This involves going beyond merely working out the difference in ACA that flows from using the realised amount rather than the amount of the liability taken into account in the original ACA. The true ACA is worked out by substituting the realised amount of the liability for the amount used in the original ACA and

taking into account the changes that would flow from this. This will involve a notional recasting of the statement of financial position.

6. These changes could affect step 2 of the ACA calculation (see sections 705-70 to 705-85 of the ITAA 1997) and subsequent ACA steps (see sections 705-90 to 705-115 of the ITAA 1997). An example is where the realised amount is less than the amount of the liability reflected in the original ACA and there would have been an increase in tax payable because of an increase in the taxable income arising from a decrease in the liability. In this case, the reconstructed step 2 amount should reflect the realised amount of the liability and a liability for the additional tax that would have been payable.

7. As well, discharged liabilities, such as provisions for employee entitlements, that are subject to section 705-75 and/or section 705-80 of the ITAA 1997 at the joining time, would be subjected to these provisions again under a full reconstruction in order to work out the true ACA and the capital gain or loss under CGT event L7.

8. The way in which subsections 104-530(4) and 104-530(5) of the ITAA 1997 apply also supports the full reconstruction view. In order to work out the capital gain or loss under CGT event L7, these subsections require the head company to work out the difference between the original ACA and the true ACA, as opposed to merely working out the difference between the amount of the liability taken into account in the original ACA and the realised amount of the liability.

9. In addition, the Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002 (the EM) supports the view that a full reconstruction is necessary. This is illustrated by examples 5.4 and 5.5 in paragraphs 5.40 and 5.41 respectively. In both examples, even though no workings are shown, a reconstruction of the step 2 amount, (including the corresponding impact on step 5 and step 6 of the ACA calculation), is required to arrive at the true ACA figures shown. There is also an inference in paragraph 5.41 of the EM that a full reconstruction of the ACA is required. This paragraph notes that the change in the amount of a liability may not affect the amount of the ACA because the ACA calculation '…factors in future tax effects for the liability and, taking those into account, there may be no net change in the ACA'.

Example

10. *H co (the head company of a consolidated group) acquired 100% of Sub co for $120,000 just after the end of X1. Sub co became a member of the consolidated group at that time. The profit and loss and financial position statements at the time were as follows:*

Profit and Loss Statement for y/e X1	***$k***
Profit before provision	*200*
Provision for long service leave (LSL)	*100*
Profit before income tax expense	*100*
Tax expense	*30*
Profit	*70*

Statement of financial position as at end of X1

	$k			**$k**
Cash	*100*	*Liabilities*	*LSL*	*100*
Assets	*150*		*Tax*	*60*[1]
DTA	*30*	*Capital*		*50*
		Retained earnings		*70*
	280			*280*

Allocable Cost Amount (ACA) at joining time

		$k
	Step 1	*120*
Add	***Step 2***	*130*[2]
	Original ACA	*250*

Assume the long service leave liability is discharged in year 4 for $20,000.

RECONSTRUCTED Profit and Loss Statement for y/e X1	**$k**
Profit before provision	*200*
Provision for long service leave (LSL)	*20*
Profit before income tax expense	*180*
Tax expense	*54*
Profit	*126*

RECONSTRUCTED Statement of financial position as at end of X1

	$k			**$k**
Cash	*100*	*Liabilities*	*LSL*	*20*
Assets	*150*		*Tax*	*60*
DTA	*6*	*Capital*		*50*
		Retained earnings		*126*
	256			*256*

RECONSTRUCTED Allocable Cost Amount (ACA) at joining time

		$k
	Step 1	*120*
Add	***Step 2***	*74*[3]
	True ACA	*194*

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[1] *Tax liability is based on tax payable, at a rate of 30%, on taxable income of $200,000. The provision for long service leave is not deductible for tax purposes.*

[2] *The accounting liability of $100,000 (provision for long service leave) is reduced by $30,000 to $70,000, under subsection 705-75(1) of the ITAA 1997, being a reduction for the future tax deduction in respect of the long service leave ($100,000 x 30%). The application of section 705-80 of the ITAA 1997 in this instance would not result in a further adjustment as the hypothetical ACA worked out under this provision would also be $250,000.*

[3] *The realised amount of the liability is reduced by $6,000 ($20,000 x 30%), to $14,000, when re-applying subsection 705-75(1) of the ITAA 1997 on reconstruction. The re-application of section 705-80 of the ITAA 1997 in this instance would not result in a further adjustment as the hypothetical ACA worked out under this provision would also be $194,000.*

There will be a capital gain under CGT event L7 in year 4 equal to $56,000 (that is, $250,000 - $194,000).

Date of Effect

11. This Determination applies to years commencing both before and after its date of issue. However, it does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of the Determination (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Commissioner of Taxation
3 November 2004

Previous draft:

TD 2004/D29

Related Rulings/Determinations:

TR 92/20

Subject references:

- accounting liabilities
- CGT event L7
- CGT events
- consolidation
- consolidation – capital gains tax
- consolidation – liabilities
- discharge of liabilities

Legislative references:

- TAA 1953 Pt IVAAA
- ITAA 1997 104-530
- ITAA 1997 104-530(3)
- ITAA 1997 104-530(3)(a)
- ITAA 1997 104-530(3)(b)
- ITAA 1997 104-530(3)(c)
- ITAA 1997 104-530(4)
- ITAA 1997 104-530(5)
- ITAA 1997 705-70
- ITAA 1997 705-75
- ITAA 1997 705-75(1)
- ITAA 1997 705-80
- ITAA 1997 705-85
- ITAA 1997 705-90
- ITAA 1997 705-93
- ITAA 1997 705-95
- ITAA 1997 705-100
- ITAA 1997 705-105
- ITAA 1997 705-110
- ITAA 1997 705-115

Other references:

- Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002

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