


TD 2004/D85 - Income tax: consolidation: can the head company of a consolidated group claim a deduction, under section 8-1 or section 25-95 of the Income Tax Assessment Act 1997, for the tax cost setting amount of partly performed work which has not yet given rise to a recoverable debt?

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Draft Taxation Determination

Income tax: consolidation: can the head company of a consolidated group claim a deduction, under section 8-1 or section 25-95 of the *Income Tax Assessment Act 1997*, for the tax cost setting amount of partly performed work which has not yet given rise to a recoverable debt?

Preamble

*This document is a draft for industry and professional comment. As such, it represents the preliminary, though considered views of the Australian Taxation Office. This draft may not be relied on by taxpayers and practitioners as it is not a ruling for the purposes of Part IVA of the **Taxation Administration Act 1953**. It is only final Taxation Determinations that represent authoritative statements by the Australian Taxation Office.*

1. No. The head company of a consolidated group cannot claim a deduction under section 8-1 or section 25-95 of the *Income Tax Assessment Act 1997* (ITAA 1997) for the tax cost setting amount of the partly performed work. (In this determination the partly performed work will be referred to as work in progress). However, the tax cost setting amount of the work in progress may be taken into account in some limited circumstances where it is appropriate to use an 'estimated profits basis' of returning taxable income.

Explanation

2. An entity may have partially performed a contract for the supply of services which has not yet given rise to a recoverable debt. The entity may become a subsidiary member of a consolidated group, either when the consolidated group is formed or at a later time. At that time ('the joining time'), the head company, for head company core purposes in subsection 701-1(2) of the ITAA 1997, begins to hold the work in progress as its own.

3. That is, the work in progress will be an asset for consolidation purposes if it would be recognised in commerce and business as having economic value for which an acquirer of an entity would be willing to pay (refer to Taxation Ruling TR 2004/13). However, work in progress is not a CGT asset as defined in section 108-5 of the ITAA 1997. This is because it has not progressed to that point where a recoverable debt has arisen. At best, there exists under the contract for services between the joining entity and the consumer an amalgam of inchoate rights and obligations in respect of the work done and to be done. Accordingly, there can be no CGT implications for the tax cost setting amount of the work in progress.

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4. At the joining time, the work in progress is not a retained cost base asset under paragraph 705-25(5)(b) of the ITAA 1997, because there is no recoverable debt present at that time, and therefore there is no right to a specified amount of Australian currency. Accordingly, the work in progress will be a reset cost base asset under subsection 705-35(1) of the ITAA 1997 and under subsection 701-10(4) of the ITAA 1997 its tax cost will be set at its tax cost setting amount.

5. Section 701-55 of the ITAA 1997 sets out how the setting of a tax cost affects the application of the other provisions of the income tax legislation.

6. Subsection 701-55(6), which operates if any provision of the ITAA 1997 that is not mentioned elsewhere in the section is to apply in relation to the asset, states that any such provision is to apply as if the asset's cost at the joining time were equal to its tax cost setting amount. The other relevant provisions of the ITAA 1997 which might apply in relation to the work in progress are:

- (i) section 6-5;
- (ii) section 8-1; and
- (iii) section 25-95.

7. Section 6-5 of the ITAA 1997 includes income according to ordinary concepts in assessable income. In some limited circumstances, for example where the head company is engaged in long term construction and is entitled to return income on the estimated profits basis (as set out in Income Tax Ruling IT 2450), it may be necessary to take the cost of the performed work into account in order to arrive at an estimated profits figure. In such a case, subsection 701-55(6) will operate so that the tax cost setting amount of the work in progress asset is the cost which the head company of the group may use to arrive at that part of the estimated profit from a particular contract that it is to return as its income after the joining time.

8. Section 8-1 of the ITAA 1997 provides a deduction from assessable income for, so far as relevant, a loss or outgoing which is incurred and is not a loss or outgoing of capital. The fact that the tax cost of the work in progress may have been set at its tax cost setting amount at the joining time does not mean that expenditure for the work in progress is incurred at that time by the head company of the group. The expenditure has already been incurred and was deductible to the joining entity prior to the joining time.

9. Section 25-95 of the ITAA 1997 provides for a deduction for expenditure on a 'work in progress amount' where a recoverable debt has arisen in the year of income or is reasonably expected to arise within 12 months of the payment. The remainder (if any) is deducted in the following year of income. The fact that the tax cost of the work in progress asset may have been set at its tax cost setting amount at the joining time does not mean that payment for the work in progress has been made at that time or a later time by the head company of the group. Accordingly, no deduction under section 25-95 is available to the head company for the tax cost of the work in progress.

10. The income derived (including the appropriate amount of an estimated profit) after the joining time from the provision of the work under the service contract is assessable income of the head company of the group because of the operation of the single entity rule in section 701-1 of the ITAA 1997.

Example

11. On 1 July 2005 Sub Co is incorporated as a wholly owned subsidiary of Head Co with an initial capitalisation of \$100,000. In its first year of operation Sub Co acquires a CGT asset for \$70,000, enters into, in the ordinary course of its business, a number of contracts for the supply of services with unrelated parties and under these contracts incurs deductible expenditure of \$30,000 which gives rise to a tax loss for the income year 2005/2006. Also, these contracts are incomplete and no right to any payments under the contracts are available on 30 June 2006. As at 30 June 2006 Sub Co has accounted for gross revenue under the contracts of \$40,000, reduced by the expenditure of \$30,000.

12. Sub Co and Head Co form a consolidated group on 1 July 2006. The financial position of Sub Co on 1 July 2006 is shown in Table 1.

Table 1: Sub Co – Financial Position at 1 July 2006

CGT Asset	70,000	Equity	100,000
Work in progress	40,000	Retained earnings (untaxed)	16,000
DTA	9,000	DTL	3,000
	<u>119,000</u>		<u>119,000</u>

13. The allocable cost amount (ACA) for Sub Co would be as shown in Table 2.

Table 2: ACA Calculation for Sub Co

Step 1	Add cost of membership interests	100,000
Step 2	Add liabilities [ignoring ss. 705-70(1A)]	3,000
Step 5	Deduct tax losses that accrued to the joined group	(30,000)
Step 8	ACA	<u>73,000</u>

14. The tax cost setting amounts for the assets would be as shown in table 3 assuming that the market value as at 1 July 2006 of the CGT asset and work in progress is \$70,000 and \$50,000 respectively.

Table 3: Tax cost setting amount for the assets of Sub Co

CGT asset	42,583
Work in progress	30,417

15. During the 2006/2007 income year all of the contracts are completed and \$60,000 is received by Sub Co in full settlement of the contracts. Under the single entity rule in section 701-1 of the ITAA 1997 Head Co will be assessed on this amount under section 6-5 of the ITAA 1997 and no deduction will be allowable for the tax cost setting amount of the work in progress under sections 8-1 or 25-95 of the ITAA 1997. (Otherwise allowable

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expenditure since the joining time on performing the agreed services will have been deducted by Head Co).

Date of Effect

16. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Your comments

17. We invite you to comment on this draft Taxation Determination. Please forward your comments to the contact officer by the due date.

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Commissioner of Taxation

15 December 2004

Previous draft:

Not previously issued in draft form

Related Rulings/Determinations:

IT 2450; TR 92/20; TR 2004/13

Subject references:

- allowable deductions
- assets
- capital gains tax
- CGT asset
- consolidation
- cost setting rules
- joining entity
- joining time
- property development industry

- tax cost is set
- tax cost setting amount

Legislative references:

- TAA 1953 Pt IVA
- ITAA 1997 6-5
- ITAA 1997 8-1
- ITAA 1997 25-95
- ITAA 1997 108-5
- ITAA 1997 701-1
- ITAA 1997 701-1(2)
- ITAA 1997 701-10(4)
- ITAA 1997 701-55
- ITAA 1997 701-55(6)
- ITAA 1997 705-25(5)(b)
- ITAA 1997 705-35(1)

ATO references

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