TD 2005/D25 - Income tax: consolidation: how is a consolidated group's allocable cost amount in a leaving entity worked out under section 711-20 of the Income Tax Assessment Act 1997 in respect of an asset that is treated as if it were a CGT asset under subsection 705-30(5)?

This document has been finalised by TD 2006/53.

Draft Taxation Determination

Income tax: consolidation: how is a consolidated group's allocable cost amount in a leaving entity worked out under section 711-20 of the *Income Tax Assessment Act* 1997 in respect of an asset that is treated as if it were a CGT asset under subsection 705-30(5)?

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 IVAAA of the ***Taxation Administration Act 1953****. It is only final Taxation Determinations that represent authoritative statements by the Australian Taxation Office.*

1. In working out a consolidated group's allocable cost amount (ACA) in a leaving entity in respect of an asset that is treated as if it were a CGT asset under subsection 705-30(5) of the *Income Tax Assessment Act 1997* (ITAA 1997), consideration needs to be given to the application of Parts 3-1 and 3-3 of the ITAA 1997 ('the CGT rules') and any other income tax provisions that adjust the cost base or reduced cost base of the asset.

2. For the assets referred to in subsection 705-30(5), the terminating value under step 1 in section 711-25 of the ITAA 1997 is calculated according to the cost base rules for CGT assets in Subdivision 110-A. Where subsection 711-20(2) applies and a reduced cost base is to be calculated, the rules in Subdivision 110-B apply. Provisions that adjust the outcome of these provisions such as Division 112 also apply.

Explanation

3. Where a subsidiary leaves a consolidated group, the tax cost setting amount (TCSA) is worked out under Division 711 of the ITAA 1997. The TCSA for each membership interest in the leaving entity that the members of the consolidated group held is worked out under section 711-15.

4. Paragraph 711-15(1)(a) of the ITAA 1997 provides that the consolidated group's ACA for the leaving entity is worked out in accordance with section 711-20. In working out the consolidated group's ACA (referred to in the provisions as the '*old group's*' ACA) there is a series of steps under section 711-20 which need to be followed.

5. Step 1 of a consolidated group's ACA for the leaving entity is worked out under section 711-25 of the ITAA 1997. Subsection 711-25(1) provides that the step 1 amount is worked out by:

> …adding up the *head company's *terminating values of all the assets that the head company holds at the leaving time because the leaving entity is taken by subsection 701-1(1) (the single entity rule) to be part of the head company.

6. The meaning to be given to terminating value of an asset held by a head company is addressed in section 711-30 of the ITAA 1997. Specifically, subsection 711-30(2) provides that the terminating value of an asset at the leaving time is worked out in a corresponding way to the terminating value calculation under section 705-30 for an asset that the joining entity holds at the joining time.

7. Section 705-30 deals with trading stock, qualifying securities, depreciating assets, other CGT assets, and 'other' assets. Trading stock and qualifying securities mentioned in subsections 705-30(1) and (2) respectively are CGT assets and subsection 705-30(4) applies to CGT assets not covered by the preceding subsections. Subsection 705-30(3) deals with all assets recognised under Division 40 of the ITAA 1997. Subsection 705-30(5) therefore deals with assets that are neither CGT assets nor Division 40 assets.

8. Accordingly, if the asset of the leaving entity is *not* trading stock, a qualifying security, a depreciating asset or a CGT asset as referred to in subsections 705-30(1) to (4) of the ITAA 1997 respectively, then subsection 711-30(5) operates to require that the leaving entity's terminating value for any other asset that it holds is the amount that would be the asset's cost base just before the leaving time if it *were* an asset covered by subsection 711-30(4).

9. The 'other assets' referred to in subsection 705-30(5) which are required to be treated as if they were CGT assets are assets that would be regarded as commercial or business assets of the leaving entity as discussed in Taxation Ruling TR 2004/13. They are not recognised as assets under the CGT rules or for Division 40 purposes. These would include some knowledge or information assets and future income tax benefit assets (FITBA's). While most FITBA's that could be regarded as commercial or business assets cannot leave a consolidated group, some, such as attribution credits, transport infrastructure offsets and deductions for borrowing expenses, can be relevant assets of the leaving entity at the leaving time.

10. There are several pathways by which 'other assets' can be brought into a consolidated group:

a) they may be brought into a consolidated group by the head company;

b) they may be acquired by the head company (during consolidation);

c) they may be assets of a chosen transitional entity under section 701-5 of the *Income Tax (Transitional Provisions) Act 1997*;

d) they may be brought into the consolidated group by a joining entity as an excluded asset under subsection 705-35(2) of the ITAA 1997; or

e) they may be brought into a consolidated group by a joining entity and are not excluded assets.

The following paragraphs discuss whether 'other assets' have a cost under subsection 705-30(5) in the different circumstances that arise in a consolidated group.

11. The definition of the term 'cost base' in subsection 705-30(5) of the ITAA 1997 is found at subsection 995-1(1) of the ITAA 1997 and is worked out in accordance with Subdivision 110-A of the ITAA 1997. Subsection 711-20(2) of the ITAA 1997 extends the reference to the term 'cost base' to include the reduced cost base worked out under Subdivision 110-B of the ITAA 1997:

> If it is necessary to work out whether the *head company makes a capital loss for a *CGT event that happens at or after the leaving time in relation to any of the *membership interests, the old group's allocable cost amount for the leaving entity is instead worked out as if the head company's *terminating value for any asset covered by subsection 705-30(4) (as if it applies for the purposes of section 711-30) were instead equal to the asset's *reduced cost base just before the leaving time.

Accordingly, the cost base or reduced cost base of an asset of a leaving entity will be calculated according to Subdivision 110-A or 110-B. Hence its terminating value, will reflect any changes to it from the time the asset commenced to be held by the consolidated group.

12. The approach taken for working out the cost base or reduced cost base (terminating value) of CGT assets under subsection 705-30(4) of the ITAA 1997 is dealt with more specifically in draft Taxation Determination TD 2005/D24.

13. Section 110-25 of the ITAA 1997 sets out the five elements that comprise the cost base of a CGT asset. Subsection 110-25(2) provides that the first element is the total of:

> (a) the money you paid, or are required to pay, in respect of *acquiring it; and
>
> (b) the market value of any other property you gave, or are required to give, in respect of acquiring it (worked out as at the time of the acquisition).

14. For the purposes of working out the step 1 amount for a leaving entity under section 711-25 of the ITAA 1997, it is necessary therefore to consider whether it can be posited that the money paid or required to be paid is in respect of acquiring the 'other asset' that the leaving entity takes with it when leaving the consolidated group in order to determine whether there is a first element cost under subsection 110-25(2).

15. In determining whether money paid or required to be paid is in respect of the 'other asset' in question, consideration is required as to whether there is a direct and substantial link between the money paid or required to be paid and the acquisition of the asset. Paragraph 101 of Taxation Ruling TR 95/35 provides a list of matters to consider in determining whether there is such a direct and substantial link. In the case of an FITBA in respect of expenditure incurred in borrowing money, the expenditure will not be in relation to the acquisition of an FITBA but, rather, would be in respect of obtaining the loan finance. In Taxation Determination TD 93/1 it was concluded that borrowing expenses are attributable to the act of obtaining finance rather than being 'in respect of acquiring' the asset that is acquired with the borrowed funds. As such, the expenditure does not fall under the first, second or third elements of the cost base of the asset acquired with the funds. Similarly, it cannot be said that the expenditure forms part of the first, second or third elements of a cost base of the FITBA. Obtaining a future tax deduction is merely an incidental outcome of making the expenditure.

16. Accordingly, as money paid or required to be paid in circumstances that give rise to an FITBA could only be regarded as paid or required to be paid 'in respect of' acquiring an income tax law benefit in situations where sufficient connection can be established between the making of the payment and acquisition of the FITBA *and* it can leave the group with the leaving entity, it is expected that such circumstances would rarely if ever occur. This means that such assets that are brought into the group by pathways a), b), c) and d) referred to in paragraph 10 would rarely, if ever, have a terminating value for the purposes of step 1 of the table at subsection 711-20(1) of the ITAA 1997.

17. However, FITBA's consisting solely of an entitlement to a future deduction do contribute to the ACA of the membership interests of the leaving entity under step 2 of the table at subsection 711-20(1) of the ITAA 1997 in accordance with the value of the future deductions available because of section 711-35. FITBA's that consist solely of an entitlement to future tax credits or offsets may contribute to the value of the ACA of the membership interests of the leaving entity under step 1 if it can be shown that they would have a cost base or reduced cost base at the leaving time if they were CGT assets. Again, it is expected that such circumstances would rarely, if ever, occur.

18. The cost of an excluded asset brought into a group referred to in pathway d) at paragraph 10 is not reset at the joining time. The entry history rule in section 701-5 of the ITAA 1997 applies so that any money expended by a subsidiary member in respect of such an asset would be treated as having been expended by the head company. However, as with assets coming into the group by pathways a), b) and c) set out in paragraph 10, such expenditure would not be in respect of the excluded asset.

19. For 'other assets' where the tax cost is set under subsection 701-10(4) of the ITAA 1997 and the asset is not an excluded asset under subsection 705-35(2), [referred to in pathway e) at paragraph 10], subsection 701-55(6) provides:

> If any provision of this Act that is not mentioned above [that is, provisions in respect of depreciating assets, trading stock, qualifying securities and the capital gains tax provisions] is to apply in relation to the asset, the expression means that the provision applies as if the asset's cost at that time were equal to its *tax cost setting amount.

20. Because subsection 705-30(5) requires the terminating value of 'other assets' to be worked out as if they were the assets referred to in subsection 705-30(4), that is, CGT assets not addressed in preceding provisions of the section, the terminating value in these circumstances is the cost base or reduced cost base worked out the same way as for the assets referred to in subsection 701-55(5) as adjusted by the CGT rules and any other income tax provisions that adjust the cost base or reduced cost base. Refer to Draft Taxation Determination TD 2005/D24 for a more detailed discussion of the application of these rules in this situation.

21. Where the 'other asset' has had its tax cost set in circumstances referred to in paragraph 20, the asset will have a terminating value worked out in accordance with subsection 705-30(5) of the ITAA 1997 equal to its cost base just before the leaving time. This will be the asset's terminating value for the purposes of working out the step 1 amount under section 711-25.

22. An amount that is included under step 1 of the consolidated group's ACA for the leaving entity cannot also be included under another step, such as step 2 which is about increasing the ACA by the value of deductions inherited by the leaving entity. The converse is also true with amounts included under step 2 being excluded from step 1. It follows that a value is included at step 2 for the FITBA's that are not excluded assets but no value is included at step 1.

23. Other assets that are neither CGT assets nor Division 40 assets, such as knowledge and information assets, can come into a consolidated group along any of the pathways taken by FITBA's referred to in paragraph 10 except that they cannot be excluded assets. Where such assets have a tax cost set under subsection 701-10(4) of the ITAA 1997 their cost base or reduced cost base at that time would be their TCSA as if they were CGT assets. Consequently, this would be their terminating value at that time. Money paid or required to be paid in respect of such assets by a head company after the joining time would form part of the asset's cost base or reduced cost base to the extent that would be the case for assets identified under subsection 705-30(4) of the ITAA 1997. Similarly, adjustments are made to the cost base or reduced cost base on the same basis as for CGT assets.

Examples

Example 1: borrowing expenses

24. *Sub X is leaving the consolidated group a month after the group's financial year end with a business loan which was drawn down during consolidation and which was used to finance Sub X's operations. The head company incurred borrowing expenses in relation to the loan in the month before Sub X leaves the group. The amount of borrowing expenses incurred total $2,000.00*

25. *Under section 25-25 of the ITAA 1997, the borrowing expenses will be deductible over a period of 5 years, which is the term of the loan.*

26. *As Sub X is taking the loan liability with it, it is also taking the FITBA which comprises the entitlement to future deductions for the borrowing expenses.*

27. *In working out the TCSA for each membership interest in the leaving entity held by the group under section 711-15 of the ITAA 1997, the old group's ACA needs to be worked out in accordance with the table in subsection 711-20(1) of the ITAA 1997.*

28. *Step 1 of the consolidated group's ACA for the leaving entity is worked out under section 711-25 of the ITAA 1997, which requires the addition of all of the head company's terminating values of all the assets that the head company held at the leaving time. The FITBA is categorised as an 'other asset' under subsection 705-30(5) of the ITAA 1997. As such, the terminating value is equal to the asset's cost base just before the leaving time as though it were a CGT asset. Therefore, Subdivision 110-A of the ITAA 1997, the cost base rules for CGT assets, applies.*

29. *Section 110-25 of the ITAA 1997 provides the five elements of an asset's cost base. Specifically, the first element in subsection 110-25(1) is the total of money paid or required to be paid in respect of acquiring the asset. This requires consideration as to whether the expenditure (that is, the borrowing expenses) is in respect of acquiring the FITBA. Consistent with the ATO view in TD 93/1, the borrowing expenses are not in respect of acquiring an asset but rather, are in respect of obtaining the loan or other finance. In addition, the expenditure will not be included in the second or third elements of the cost base under subsections 110-25(3) and (4). There is, therefore, no terminating value for the FITBA and consequently the step 1 amount is nil.*

30. *However, as the FITBA consists of an entitlement to a future deduction, the value of the deductions inherited by the leaving entity, Sub X, will be reflected in step 2 of the table at subsection 711-20(1) of the ITAA 1997.*

31. *Step 2 of the ACA under section 711-35 of the ITAA 1997 is worked out by identifying 'owned deductions' and 'acquired deductions' of the head company. As the entitlement to the borrowing expenses deductions arose in the head company during consolidation, the deductions are owned deductions. Applying the formula in subsection 711-35(1), the sum of the deductions will be added to comprise the step 2 amount. In this example, the step 2 amount will be $2,000.00 less any amount deducted by the head company.*

Example 2

32. *Subsidiary Y, a business services company, leaves a consolidated group. One of its business assets is a client list consisting of the contact details of 150 business clients of the company. The client list had been acquired from a company outside the group at a cost of $5,000.00 while subsidiary Y was a member of the group. No other money has been spent in respect of this asset nor have any amounts been deducted in respect of the asset subsequently.*

33. *The client list is not an asset of the type referred to in subsections 705-30(1), (2), (3) or (4). However it is an asset within the terms of 705-30(5) and has a terminating value of $5,000.00 for the purposes of step 1 in the table at subsection 711-20(1).*

Date of effect

34. 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

35. 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
20 July 2005

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 92/20; TR 95/35; TR 2004/13; TD 93/1; TD 2005/D24

Subject references:

- capital gains tax
- CGT cost base
- consolidation
- consolidation – assets
- consolidation – CGT
- consolidation exiting

Legislative references:

- TAA 1953 Pt IVAAA
- ITAA 1997 25-25
- ITAA 1997 Div 40
- ITAA 1997 Pt 3-1
- ITAA 1997 Subdiv 110-A
- ITAA 1997 110-25
- ITAA 1997 110-25(1)
- ITAA 1997 110-25(2)
- ITAA 1997 110-25(3)
- ITAA 1997 110-25(4)
- ITAA 1997 Subdiv 110-B
- ITAA 1997 Div 112
- ITAA 1997 Pt 3-3
- ITAA 1997 701-1(1)
- ITAA 1997 701-5
- ITAA 1997 701-10(4)
- ITAA 1997 701-55(5)
- ITAA 1997 701-55(6)
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- ITAA 1997 705-30(1)
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- ITAA 1997 705-30(3)
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- ITAA 1997 705-30(5)
- ITAA 1997 705-35(2)
- ITAA 1997 Div 711
- ITAA 1997 711-15
- ITAA 1997 711-15(1)(a)
- ITAA 1997 711-20
- ITAA 1997 711-20(1)
- ITAA 1997 711-20(2)
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- ITAA 1997 711-30(4)
- ITAA 1997 711-35
- ITAA 1997 711-35(1)
- ITAA 1997 995-1(1)
- IT(TP)A 1997 701-5

ATO references

NO:	2005/8294
ISSN:	1038-8982
ATOlaw topic:	Income Tax ~~ Consolidation ~~ exit history rule Income Tax ~~ Consolidation ~~ tax cost setting amount