Worked example

Deducting a bad debt – company that is owed debt joins consolidated group that later ceases to exist

Description

This example shows how the consolidation bad debt rules apply where a company seeks to claim a bad debt deduction for a debt that was owed to the company before it became a subsidiary member of a consolidated group and the company later left that consolidated group when the group ceased to exist.

Specifically, it shows how the continuity of ownership test (COT) in section 165-123 of the *Income Tax Assessment Act 1997* (ITAA 1997) is modified so that the company is taken to be owed the debt for more than one period of time.

Commentary

The consolidation bad debt rules are contained in Subdivision 709-D of the ITAA 1997.

Subdivision 709-D applies when determining whether an entity (the claimant) can deduct a bad debt where the debt has been owed:

- to an entity (whether the claimant or another entity) for a period (the debt test period) when the entity was a member of a consolidated group, and
- to an entity (whether the claimant or another entity) for a period (which is also a debt test period) when the entity was not a member of that consolidated group.

In determining each of the debt test periods the entry and exit history rules are ignored.[1] Each debt test period is identified as the period in which the entity is taken to be owed the debt for tax purposes. In some cases the debt is taken to be owed to the entity because of the single entity rule.

Effectively, Subdivision 709-D looks at each entity that is owed the debt to determine (based on certain assumptions) whether that entity would have been able to claim a bad debt deduction. The claimant is only able to deduct the debt if, for each debt test period, the entity that was owed the debt could have deducted it for the relevant 'debt test income year', assuming the debt was written off as bad at the end of the debt test period.

Example

Facts

On 12 November 2001, an $8,500 debt begins to be owed to a company, SubCo. The amount of the debt is brought to account by SubCo as assessable income in the income year ended 30 June 2002.

On 1 July 2002, a consolidated group is formed with HeadCo as the head company. SubCo joins the consolidated group at the time the group is formed.

[1] Subsection 709-205(3).

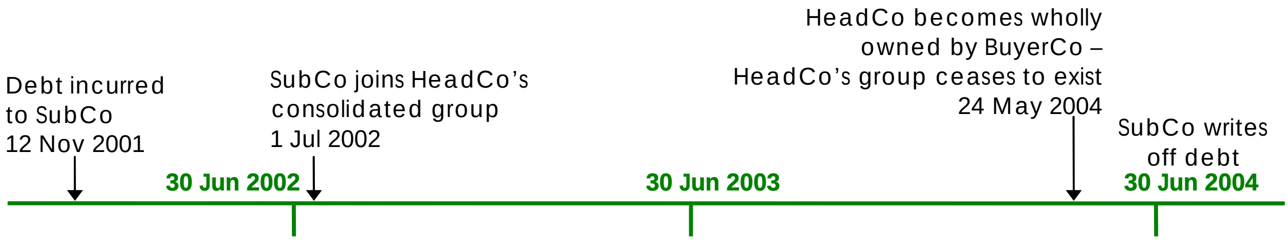
On 24 May 2004, HeadCo becomes a wholly-owned subsidiary of BuyerCo (an Australian resident company that is not a member of a consolidated group) as a result of BuyerCo acquiring 10% of HeadCo's membership interests.

HeadCo is therefore no longer eligible to be the head company of a consolidated group and the group ceases to exist. No new consolidated group is formed.

On 30 June 2004, the $8,500 debt that is owed to SubCo is written off as bad in SubCo's books of account. SubCo seeks to claim a bad debt deduction for this debt in the year ended 30 June 2004.[2]

SubCo (the claimant) can deduct the debt if the condition in subsection 709-205(2) is met for each debt test period – namely, that SubCo or HeadCo could have each deducted the debt for their respective debt test income years, based on certain assumptions.

Figure 1: Timeline of events



Calculation

In this example, SubCo has two debt test periods as it is taken to have been owed the debt for two different periods of time. Each debt test period has a separate debt test income year.

To determine whether SubCo and HeadCo could have each deducted the debt for their relevant debt test income year(s), it is necessary to identify, for each entity:

1. **The debt test period(s):** This is identified in section 709-205.
2. **The debt test income year(s):** This is identified in the table in subsection 709-215(3).
3. **The continuity periods:** To determine whether an entity has satisfied the COT in section 165-123 of the ITAA 1997, the continuity periods are identified under subsection 709-215(4) and not subsection 165-120(2). Note that subsection 709-215(2) modifies a number of the provisions that would normally apply in determining whether a company would be able to deduct a bad debt for the debt test income year if the company had written off the debt as bad at the end of the debt test period.

[2] The entity that owes the debt is not an associate of SubCo or HeadCo for the period 12 November 2001 to 30 June 2004.

SubCo prior to joining consolidated group

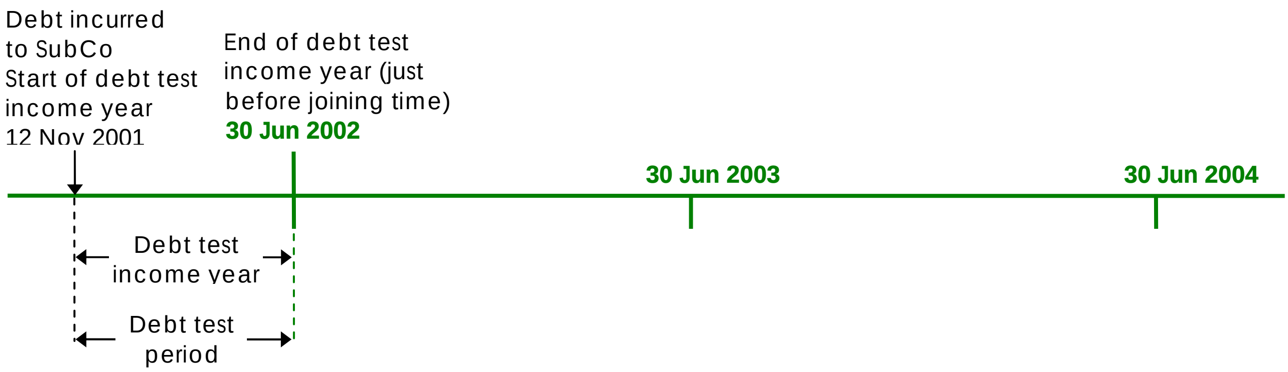
Step 1: Identify the debt test period

SubCo's debt test period is from 12 November 2001 to just before the time that SubCo joins the consolidated group on 1 July 2002. → section 709-205

Step 2: Identify the debt test income year

Item 2 of the table in subsection 709-215(3) applies because, while SubCo is the claimant, the debt test period ends before SubCo writes off the debt. The start of the debt test income year is 12 November 2001, which is the start of the debt test period (because this is later than 12 months before the end of the debt test period). The end of the debt test income year is the end of the debt test period, which is just before the joining time on 1 July 2002.

Figure 2: SubCo's debt test period and debt test income year (before SubCo joins HeadCo's consolidated group)



Step 3: Identify the continuity periods

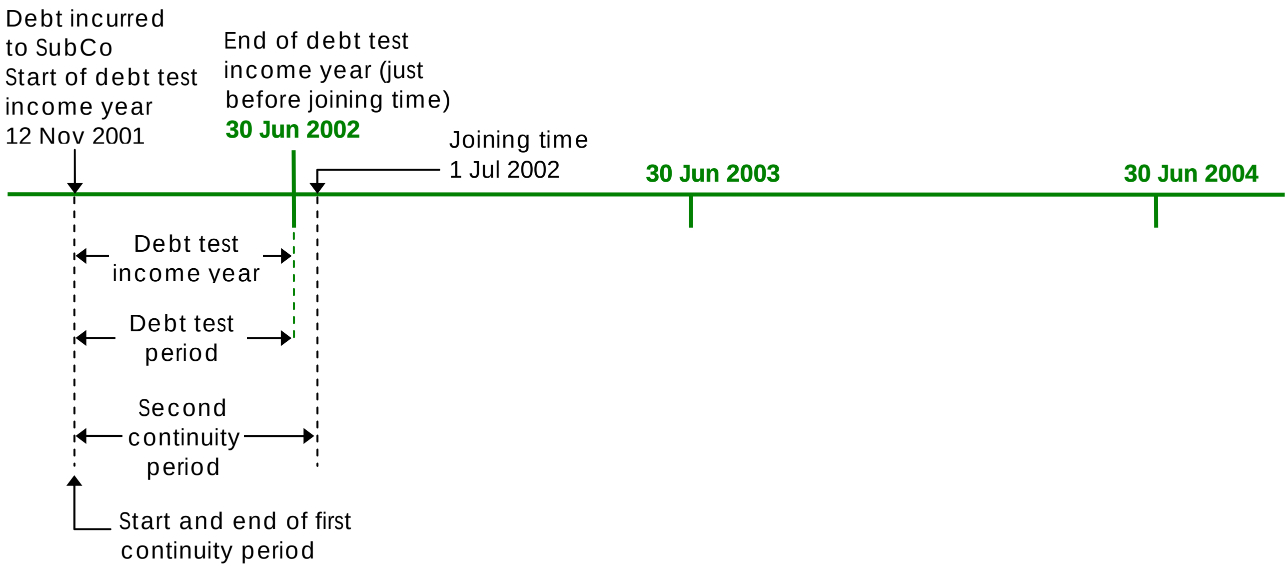
SubCo's first continuity period
Item 3 in the table in subsection 709-215(4) applies because SubCo's debt test period:

- does not start when SubCo ceases to be a member of a consolidated group, and
- ends when SubCo becomes a member of a consolidated group.

The start of the first continuity period is the start of the debt test period (12 November 2001). Paragraph 709-215(4)(a) identifies the end of the first continuity period as the start of the debt test income year (also 12 November 2001).

SubCo's second continuity period
The second continuity period starts at the start of the debt test income year (12 November 2001) and ends at the time identified in the table in subsection 709-215(4). Item 3 in this table identifies the end of the second continuity period as just after the end of the debt test period. As SubCo's debt test period ends just before the joining time, the second continuity period ends at the joining time on 1 July 2002.

Figure 3: SubCo's continuity periods for the purposes of the COT (before SubCo joins HeadCo's consolidated group)



To determine if SubCo has satisfied the COT its ownership is examined from the start of the first continuity period to the end of the second continuity period (i.e. from 12 November 2001 to the joining time on 1 July 2002).

If SubCo has not satisfied the COT for this period it would not be able to claim a bad debt deduction in the debt test income year[3] unless it satisfies the same business test (SBT) in section 165-126.[4]

→ For an explanation of how the SBT applies to an entity seeking to deduct a bad debt where Subdivision 709-D applies see 'Deducting a bad debt – company that is owed debt experiences majority ownership change when it joins consolidated group', C9-5-351.

HeadCo

Step 1: Identify the debt test period

HeadCo's debt test period is from the time that SubCo joins the consolidated group (1 July 2002) to just before the time that the group ceases to exist (24 May 2004). → section 709-205

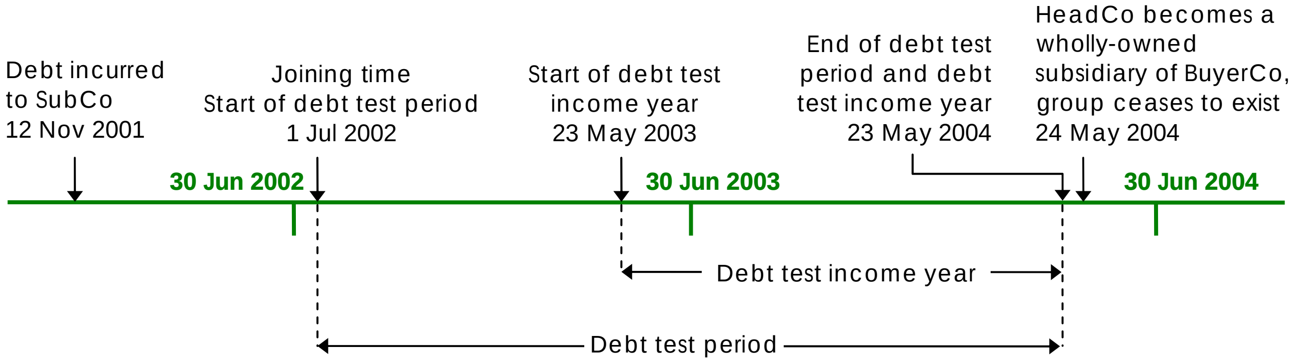
[3] Remembering that SubCo has two debt test periods as it is taken to have been owed the debt for two different periods of time.

[4] Assuming that the discretion in paragraph 165-120(1)(b) is not favourably exercised by the Commissioner of Taxation.

Step 2: Identify the debt test income year

Item 2 in the table in subsection 709-215(3) applies because HeadCo is not the claimant. The start of the debt test income year is 23 May 2003 (i.e. 12 months before the end of the debt test period) because this is later than the start of the debt test period. The end of the debt test income year is the end of the debt test period (which is just before the group ceases to exist on 24 May 2004).

Figure 4: HeadCo's debt test period and debt test income year



Step 3: Identify the continuity periods

HeadCo's first continuity period

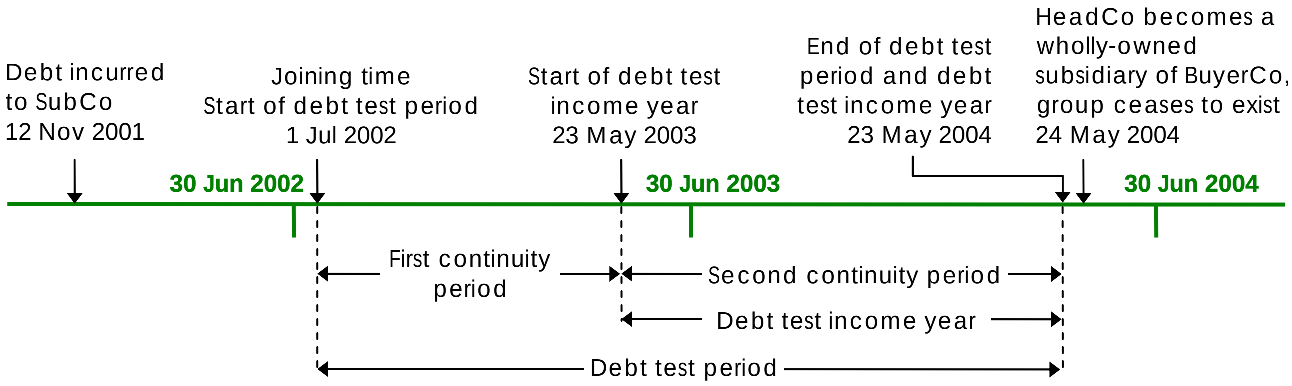
Item 4 of the table in subsection 709-215(4) applies because HeadCo is the head company of a consolidated group for the debt test period that ends when HeadCo ceases to be a member of the consolidated group without becoming a member of another consolidated group. The start of the first continuity period is the start of the debt test period (1 July 2002).

Paragraph 709-215(4)(a) identifies the end of the first continuity period as the start of the debt test income year (23 May 2003).

HeadCo's second continuity period

The second continuity period starts at the start of the debt test income year (23 May 2003) and ends at the time identified in the table in subsection 709-215(4). Item 4 in this table identifies the end of the second continuity period as the end of the debt test period (23 May 2004).

Figure 5: HeadCo's continuity periods for the purposes of the COT



To determine if HeadCo has satisfied the COT its ownership is examined from the start of the first continuity period to the end of the second continuity period (i.e. from 1 July 2002 to 23 May 2004).

If HeadCo has not satisfied the COT for this period it would not be able to claim a bad debt deduction in the debt test income year unless it satisfies the SBT.[5]

→ For an explanation of how the SBT applies to an entity seeking to deduct a bad debt where Subdivision 709-D applies see 'Deducting a bad debt – company that is owed debt experiences majority ownership change when it joins consolidated group', C9-5-351.

SubCo from when group ceases to exist

SubCo has a second debt test period for the time from when HeadCo's consolidated group ceases to exist. The steps need to be repeated for this period.

Step 1: Identify the debt test period

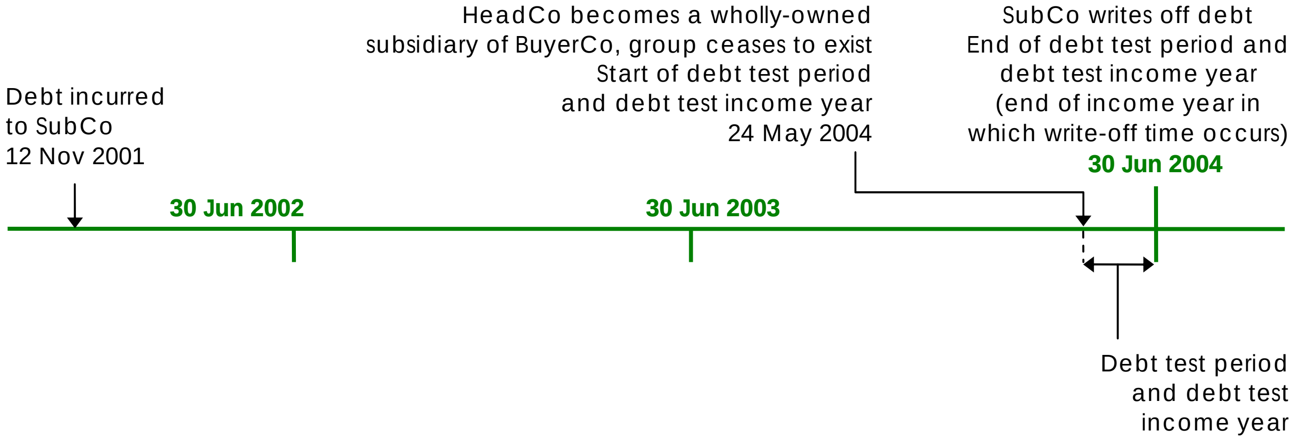
SubCo's debt test period is from the time that HeadCo's consolidated group ceases to exist (24 May 2004) to the time that SubCo writes off the debt as bad (30 June 2004). → section 709-205

Step 2: Identify the debt test income year

Item 1 of the table in subsection 709-215(3) applies because SubCo is the claimant and the debt test period ends when SubCo actually writes off the debt. The start of the debt test income year is 24 May 2004 because this is later than the start of the income year in which the write-off time occurs. The end of the debt test period is the end of the income year in which the write-off time occurs, which is 30 June 2004.

[5] Assuming that the discretion in paragraph 165-120(1)(b) is not favourably exercised by the Commissioner of Taxation.

Figure 6: SubCo's debt test period and debt test income year (from when HeadCo's group ceases to exist)



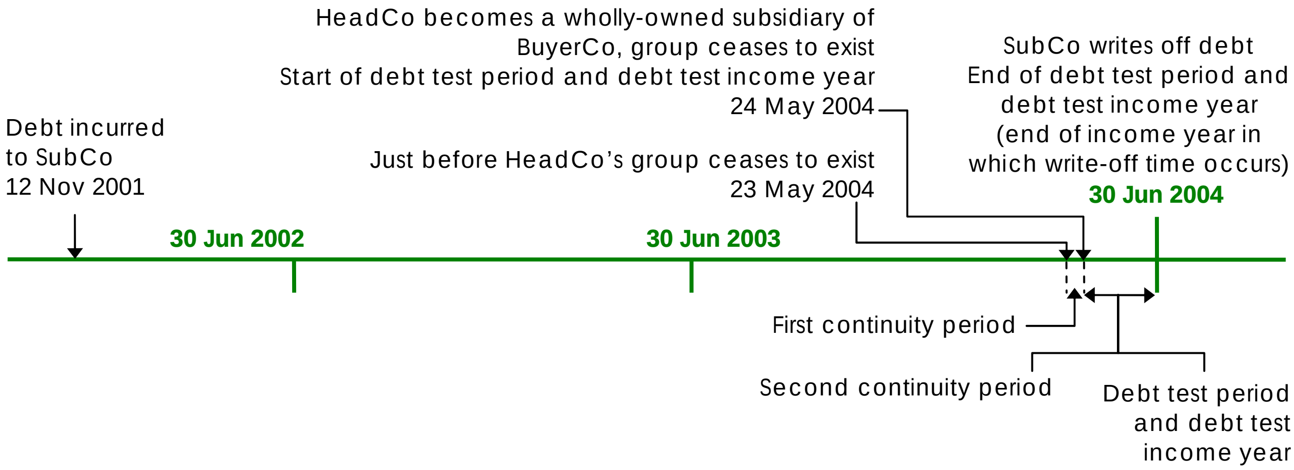
Step 3: Identify SubCo's continuity periods

SubCo's first continuity period
Item 2 of the table in subsection 709-215(4) applies because SubCo is the claimant, the debt test period ends when SubCo actually writes off the debt and SubCo is not the head company of a consolidated group at the write-off time. The start of the first continuity period is just before the start of the debt test period (which is just before the time that the group ceases to exist on 24 May 2004).

Paragraph 709-215(4)(a) identifies the end of the first continuity period as the start of the debt test income year (which is the time the group ceases to exist on 24 May 2004).

SubCo's second continuity period
The second continuity period starts at the start of the debt test income year (i.e. the time that the group ceases to exist on 24 May 2004) and ends at the time identified in the table in subsection 709-215(4). Item 2 in this table identifies the end of the second continuity period as the end of the income year in which the write-off time occurs (i.e. 30 June 2004).

Figure 7: SubCo's continuity periods for the purposes of the COT (from when HeadCo's group ceases to exist)



To determine if SubCo has satisfied the COT its ownership is examined from the start of the first continuity period to the end of the second continuity period (i.e. from 23 May 2004 to 30 June 2004). The 10% change in the membership interests of HeadCo on 24 May 2004 is relevant – because SubCo is a wholly-owned subsidiary of HeadCo – and needs to be taken into account in determining whether SubCo satisfies the COT.

If SubCo has not satisfied the COT for this period it would not be able to claim a bad debt deduction in the debt test income year unless it satisfies the SBT.[6]

→ For an explanation of how the SBT applies to an entity seeking to deduct a bad debt where Subdivision 709-D applies see 'Deducting a bad debt – company that is owed debt experiences majority ownership change when it joins consolidated group', C9-5-351.

Provided that both SubCo (for both the time before it becomes a member of HeadCo's consolidated group and for the time from when HeadCo's group ceases to exist) and HeadCo would have been able to deduct the debt for their respective debt test income years, SubCo is able to claim a bad debt deduction for the debt that was written off on 30 June 2004.

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[6] Assuming that the discretion in paragraph 165-120(1)(b) is not favourably exercised by the Commissioner of Taxation.

References

Income Tax Assessment Act 1997, Subdivision 165-C

Income Tax Assessment Act 1997 – as amended by *Tax Laws Amendment (2004 Measures No. 7) Act 2005*, Schedule 6:

- Subdivision 709-D

Explanatory Memorandum to the Tax Laws Amendment (2004 Measures No. 7) Bill 2004, Chapter 6

Revision history

Section C9-5-352 first published 3 August 2005.

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).