Worked example

Adjustments for losses (ACA steps 5 and 6)

Description

This example shows the calculations at steps 5 and 6 of the allocable cost amount (ACA) calculation:

- Step 5 deducts amounts for 'owned' losses – that is, losses incurred by the joining entity that accrued to a head company during the period before the joining time in which it continuously held membership interests in the joining entity.
- Step 6 reduces the entry ACA to the extent of the future tax benefit embedded in an unused loss of any sort[1] that did not accrue to the joined group and was transferred to it by the joining entity.

Commentary

The purpose of step 5 is to prevent a double benefit being obtained from these losses by the group and to ensure that losses that cannot be transferred, or whose transfer has been cancelled by the head company, are not reinstated.

→ section 705-100, *Income Tax Assessment Act 1997* (ITAA 1997)

The adjustment at step 6 is to stop the group getting a double benefit through both higher acquisition payments for the joining entity's assets and losses transferred to the head company. → section 705-110, ITAA 1997

Step 5 subtracts an amount for the joining entity's unused losses of any sort whether or not those losses are transferred or transferable to the head company. A loss is included at step 5 if it accrued to membership interests in the joining entity that were directly or indirectly owned by the head company and were continuously held by it until the joining time.

The amount of the loss that accrued to a membership interest is the amount that would be distributed (before the joining time) to that membership interest, as the loss accrued, if it were a profit instead of a loss.

However, an accrued loss is *not* included at step 5 to the extent to which it is used to reduce undistributed profits added to the ACA at step 3.

→ Taxation Determination TD 2004/59

A transferred loss is included for the purposes of **step 6** if it *did not* accrue to membership interests in the joining entity that were directly or indirectly owned by the head company and were continuously held by it until the joining time – that is, it includes losses that are effectively acquired. Step 6 does not include unused losses that have not been transferred to the group or for which the transfer has been cancelled by the head company.

[1] A sort of loss is defined as a tax loss, a film loss and a net capital loss (see A3 'Glossary of terms').

The step 6 amount is calculated as follows:

Carry-forward transferred losses that did not accrue to the group joined	X	General company tax rate

Example 1: step 5

Facts

In 1998, HCo subscribes $60 for 60% of the membership interests in a new company, BCo. The other 40% is subscribed for $40 by CCo. BCo acquires two assets for $40 and $60 respectively.

Table 1: BCo – financial position at 1 July 1998

Asset 1	$40	Equity	$100
Asset 2	$60		
	$100		$100

In 1999, BCo disposes of asset 2 for its market value of $20, realising a net capital loss of $40.

On 1 July 2003, HCo acquires the remaining 40% of BCo's membership interests for $24 and consolidates BCo into its group.

Table 2: BCo – financial position at 1 July 2002

Asset 1 (MV $40)	$40	Equity	$100
Cash	$20	Loss	($40)
	$60		$60

Note: MV = market value

Calculation

All of the loss in value of Asset 2 on which the net capital loss is realised occurs while HCo holds 60% of the membership interests in BCo. Therefore $24 of BCo's loss (60% x $40) accrues in relation to the membership interests held by HCo. The amount to be deducted at step 5 is therefore $24.

The remaining $16 (40% x $40) of the loss is considered at step 6.

Example 2: step 6

Facts

In 2001, ACo subscribes $100 for all the membership interests in BCo, a new company. BCo acquires two assets for $40 and $60 respectively.

Table 3: BCo – financial position at 1 July 2000

Asset 1 (MV $40)	$40	Equity	$100
Asset 2 (MV $60)	$60		
	$100		$100

In 2002, BCo disposes of Asset 2 for its market value of $20, realising a net capital loss of $40.

BCo's financial position at 30 June 2002 is shown in Table 4.

Table 4: BCo – financial position at 30 June 2002

Asset 1 (MV $40)	$40	Equity	$100
Cash	$20	Loss	($40)
	$60		$60

On 1 July 2003, HCo acquires 100% of BCo's membership interests for $72, ($60 for the assets and $12 for the losses).[2] It consolidates BCo into its group. The same business test (SBT) is passed in relation to BCo so the $40 is transferred to HCo as head company. None of the loss is cancelled by the head company.

Calculation

There is no incremental acquisition of the membership interests in BCo by HCo, so none of the transferred losses accrue while HCo holds interests in BCo. The amount by which the entry ACA is reduced at step 6 is therefore $12, i.e. acquired losses transferred from BCo ($40) x 30%.

[2] It is not necessary for an amount to have been included in the purchase price of an entity for its losses for those losses to be held as 'acquired' for the purposes of step 6. It is only necessary that the losses did not accrue to the joined group during the period in which the head company continuously held interests in the relevant joining entity.

Example 3: steps 5 and 6

Facts

On 1 July 2000, ACo is incorporated. Its financial position is shown in Table 5.

Table 5: ACo – financial position at 1 July 2000

Asset 1 (MV $300)	$300	Equity	$1,000
Asset 2 (MV $400)	$400		
Asset 3 (MV $300)	$300		
	$1,000		$1,000

On 1 July 2001, ACo disposes of Asset 3 for its market value at that time of $200, realising a $100 loss.

On 1 July 2002, HCo, the head company of a consolidated group, acquires 60% of ACo for $780 (net value of $1,300 x 60%). ACo's financial position at that date is shown in Table 6.

Table 6: ACo – financial position at 1 July 2002

Asset 1 (MV $700)	$300	Equity	$1,000
Asset 2 (MV $400)	$400	Loss (asset 3)	($100)
Cash	$200		
	$900		$900

On 1 July 2003, ACo disposes of Asset 2 for its market value at that time of $200, realising a loss of $200.

On 1 July 2004, HCo acquires the remaining 40% in ACo for $440 (net value of $1,100 x 40%) and consolidates ACo into its group. ACo's financial position is as shown in Table 7.

Table 7: ACo – financial position at 1 July 2002

Asset 1 (MV $700)	$300	Equity	$1,000
Cash	$400	Loss (asset 3)	($100)
		Loss (asset 2)	($200)
	$700		$700

The SBT is passed with respect to the loss on Asset 3 and the continuity of ownership test is passed with respect to the loss on Asset 2. All losses are therefore transferred to HCo as head company of the consolidated group. None of the losses are recouped by undistributed profits, nor are any of the transfers of losses cancelled by the head company.

Calculation of ACA

Step 1

The total amount paid by HCo for all the membership interests in ACo (the ACA step 1 amount) is $1,220 ($780 + $440).

Steps 2 to 4

There are no liabilities, no distributed or distributable profits, and no rollovers, so no adjustments need to be made for ACA steps 2 to 4.

Step 5

The loss from the disposal of Asset 3 was realised and therefore accrued before HCo held any interests in ACo. Therefore, this loss cannot be included at step 5 of the ACA calculation. However, this 'acquired' loss is transferred to HCo on consolidation, so it must be considered for the purposes of step 6 of the ACA.

All of the loss from Asset 2 has accrued while HCo continuously holds 60% of the membership interest in ACo. Therefore, the amount that accrues in relation to HCo's membership interest in ACo, to be subtracted at step 5, is $120 ($200 x 60%). The remaining $80 of the loss is transferred to HCo on consolidation, so it must be considered for the purposes of step 6 of the ACA.

The ACA after step 5 is therefore $1,100 ($1,220 – $120).

Step 6

The amount to be deducted at step 6 is the amount of carry-forward transferred losses that do not accrue to the joined group while it continuously holds interests in ACo multiplied by the general company tax rate.

The step 6 amount is therefore $54, i.e. ($100 + $80) x 30%.

The result after step 6 is therefore $1,046 ($1,100 – $54).

Step 7

HCo does not become entitled to any deductions on ACo joining the group, so no adjustment is required at this step.

The ACA available to be allocated to ACo's assets will therefore be:

Step 1 amount	$1,220
Less step 5 amount	$120
Less step 6 amount	$54
Final entry ACA	**$1,046**

References

Income Tax Assessment Act 1997, sections 705-90, 705-100, 705-105 and 705-110; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2

Explanatory Memorandum accompanying the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 5.88–95

Income Tax Assessment Act 1997, subsection 713-225(6A) as inserted by *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (No. 83 of 2004), Schedule 2, Part 5

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 2) Bill 2004, paragraphs 2.61 – 2.62

Taxation Determination TD 2004/59 – Income tax: consolidation tax cost setting rules: how do you work out the amount subtracted at step 5 of the allocable cost amount where the loss taken into account under subsection 705-100(1) of the *Income Tax Assessment Act 1997* has also reduced the step 3 amount?

Revision history

Section C2-4-300 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on recent and proposed changes to consolidation rules.	Recent and proposed legislative amendments.
26.10.05	Reference to new taxation determination and update of note in 'Commentary' on recent and proposed changes to consolidation rules.	Legislative amendments.
30.6.09	Minor changes including removal of note in Commentary to reflect new rules for treatment of foreign losses.	Legislative amendment.

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).