Worked example

Treatment of trading stock brought into the group

Description

This worked example shows the income tax treatment for trading stock brought into a consolidated group by a joining entity.

Note

The examples assume that an asset's character as trading stock does not change merely because the single entity rule starts to apply. However, in some circumstances this can occur. → 'Single entity treatment', C9-1-110

Commentary

When an entity holds trading stock and joins a consolidated group, the treatment of its trading stock will depend on whether or not the entity is a continuing majority-owned entity or a chosen transitional entity, as shown in the following table:

Entity characteristics	Treatment of trading stock
Continuing majority-owned entity (A 'continuing majority-owned entity' is an entity that was majority owned at all times by a person or persons from the start of 27 June 2002 until the entity became a subsidiary member of a consolidated group. (This period includes the joining date.) → paragraph 701A-1, IT(TP)A 1997; Taxation Determination TD 2004/88	Trading stock brought into a group by a continuing majority-owned entity under these provisions is treated as a retained cost base asset with its tax cost setting amount equal to the joining entity's terminating value for the trading stock. → section 701A-5, IT(TP)A 1997; worked example 'Applying the continuing majority-owned entity test to multi-tiered structures', C2-4-855 The purpose of this integrity measure is to prevent the trading stock receiving an uplift in tax value resulting in a deferral of tax for the group. → EM to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, paragraphs 1.123 – 1.130
Basic case (not a continuing majority-owned entity)	The ordinary cost setting rules apply. The head company treats trading stock as a reset cost base asset. The tax cost setting amount for trading stock (as well as depreciating assets and revenue assets) is subject to a limit – it cannot exceed the greater of the asset's market value or the joining entity's terminating value for the asset. → section 705-40, ITAA 1997 The joining entity, on the other hand, must value the trading stock at a tax-neutral amount just before the joining time, so that no income tax consequences arise merely because the entity becomes a subsidiary member of the group. → section 701-35, ITAA 1997
Chosen transitional entity (transitional option) (The head company can use this option on the group's formation provided the entity is wholly owned on or before 30 June 2003 (and once wholly owned after 1 July 2002 it must remain so until the group consolidates). → Division 701, IT(TP)A 1997	The joining entity's assets, including trading stock, are brought into the group at their existing tax values and the cost setting rules do not apply. → Division 701, IT(TP)A 1997 The choice to treat an entity as a chosen transitional entity takes precedence over the continuing majority-owned entity rules. The head company inherits the history of the trading stock, including its tax value, under the entry history rule. → section 701-5, ITAA 1997

Example 1: continuing majority-owned entity

Facts

TradingCo is a subsidiary member of HeadCo's consolidatable group. All of TradingCo's shares have been held by the group since 1996.

At 30 June 2002, TradingCo has no trading stock on hand.

A year later, at 30 June 2003, TradingCo holds 1,000 units of trading stock that it produced during the income year at a cost of $5 per unit. Each item has a market selling value of $10 and a replacement value of $6 at that time.

HeadCo chooses to consolidate the group with effect from 1 July 2003, and it does not choose to treat TradingCo as a chosen transitional entity.

All of the units of trading stock are sold during the 2003-04 income year for $10 each. HeadCo has no other trading stock to account for during the year.

TradingCo's 2002–03 return

Since TradingCo was majority-owned by the group from the start of 27 June 2002 up to the date it joined the consolidated group, it is a continuing majority-owned entity and special transitional provisions apply to its trading stock on entry. → Division 701A, IT(TP)A 1997

TradingCo is free to elect a value for its stock on hand at 30 June 2003 in accordance with the rules for valuing closing stock set out in Division 70. It may elect to value each item at cost, replacement value or market selling value.

→ subsection 701A-5(2), IT(TP) Act 1997; section 70-45, ITAA 1997

Assume that TradingCo elects to value each of the 1,000 units of its stock on hand at its replacement value of $6.

In respect of the trading stock, TradingCo is entitled to deduct its cost of production of $5 per unit, i.e. an amount of $5,000. Under section 70-35, TradingCo is required to include in its assessable income the amount of $6,000, being the excess of the value of closing stock over opening stock. The net effect for TradingCo is that its taxable income for the 2002-03 income year is increased by $1,000.

HeadCo's 2003–04 return

HeadCo is taken to hold the trading stock from 1 July 2003 under the single entity rule.

Since TradingCo is a continuing majority-owned entity, HeadCo must treat each unit of the trading stock as a retained cost base asset with a tax cost setting amount equal to the value used by TradingCo at 30 June 2003.

→ subsection 701A-5(3), IT(TP)A 1997

The tax cost setting amount for each unit is therefore $6.

HeadCo includes in its stock on hand at the start of its income year a value equal to the tax cost setting amount of $6,000. → subsection 701-55(3), ITAA 1997

As the trading stock is sold for its market value of $10 per unit during the year, HeadCo must include sales revenue of $10,000 in its assessable income. For the purposes of section 70-35, the value of stock on hand at the start of the income year is $6,000 and the value of stock on hand at the end of the income year is nil.

Applying section 70-35, HeadCo can deduct the amount of $6,000, being the excess of the value of opening stock over closing stock.

The net result is that HeadCo's taxable income is increased by $4,000.

Example 2: basic cost setting case

Facts

TradingCo holds 1,000 units of trading stock at 31 July 2004, 500 of which were included in its stock on hand at 1 July 2004 at a value of $5 each and 500 of which were manufactured during July 2004 at a cost of $5.50 each.

On 1 August 2004, all of TradingCo's shares are acquired by the HeadCo consolidated group. TradingCo also meets all the other eligibility requirements and becomes a subsidiary member of the consolidated group.

The market value of TradingCo's trading stock at 31 July 2004 is $8,000, i.e. the price that would be negotiated for the trading stock if TradingCo's business was sold at arm's length in an open and unrestricted market. TradingCo did not adopt the short cut option for market valuing trading stock.

→ 'Valuation short cut 3' in 'Market valuation guidelines', C4-1

All the units of trading stock are sold between 1 August 2004 and 30 June 2005 for $10 each. No further trading stock is manufactured during the year.

TradingCo's 2004–05 return

TradingCo is a subsidiary member of the consolidated group for some but not all of the income year. It must therefore lodge an income tax return for the 2004-05 income year. However, TradingCo includes only taxable income that is attributable to the non-membership period 1 July to 31 July 2004 and treats those dates as if they were the start and end of an income year.

→ section 701-30, ITAA 1997

As TradingCo is not a continuing majority-owned entity, its items of trading stock have their tax costs determined under the ordinary cost setting rules.

For the purpose of working out its taxable income and income tax, or a loss, for the period 1 July to 31 July 2004, TradingCo is required to value its trading stock at 31 July 2004 at a tax neutral amount. → section 701-35, ITAA 1997

The tax neutral amount is as follows:

- for each of the 500 items that was stock on hand at the start of the income year: its value at that time of $5 ($2,500 in total) → paragraph 701-35(4)(a)

- for each of the 500 items produced between 1 July 2004 to 31 July 2004: the amount of the outgoing incurred in connection with its acquisition, $5.50 ($2,750 in total) → paragraph 701-35(4)(c)

The total value of stock on hand at 31 July 2004 is therefore $5,250.

Applying section 70-35 as if the non-membership period 1 July to 31 July 2004 were an income year, TradingCo includes the excess of $2,750 (stock on hand at 31 July 2004 less stock on hand at 1 July 2004) in its assessable income for that period.

In addition, TradingCo is entitled to deduct the outgoings of $2,750 incurred in manufacturing the trading stock in July 2004.

The result is tax-neutral for TradingCo.

Note:

The choice to consolidate from the start of an income year may be made at any time up to the date of lodgement of the head company's return for that year. If a subsidiary member did not use tax-neutral values for trading stock in its return for the period up to the joining time, it may be required to amend that return to give effect to section 701-35(4).

HeadCo's 2004–05 return

Since TradingCo is not a continuing majority-owned entity, HeadCo applies the ordinary cost setting rules to its assets, including trading stock (subject to the ceiling rules for revenue-like assets). Items of trading stock are treated as reset cost base assets.

Assume that HeadCo initially works out a tax cost setting amount of $7 for each item of TradingCo's trading stock. As this amount is less than the greater of the market value of each item ($8) and TradingCo's terminating value for each item ($5 and $5.50, respectively), it becomes the tax cost setting amount.
→ section 705-40, ITAA 1997

HeadCo includes in its stock on hand at the start of its income year a value equal to the tax cost setting amount of $7,000. → subsection 701-55(3), ITAA 1997

As the trading stock is sold for $10 per unit during the year, HeadCo must include sales revenue of $10,000 in its assessable income. Under section 70-35, the value of stock on hand at the start of the income year, 1 July 2004, is $7,000 and the value of stock on hand at the end of the income year, 30 June 2005, is nil.

Applying section 70-35, HeadCo can deduct the amount of $7,000, being the excess of the value of opening stock over closing stock.

The net result is that HeadCo's taxable income is increased by $3,000.

Example 3: chosen transitional entity

Facts

TradingCo is a subsidiary member of HeadCo's consolidatable group. All of TradingCo's shares have been held by the group since 1996.

At 30 June 2002, TradingCo has no trading stock on hand.

A year later, at 30 June 2003, TradingCo holds 1,000 units of trading stock that it manufactured during the income year at a cost of $5 per unit. Each item has a market selling value of $7 and a replacement value of $4 at that time.

HeadCo chooses to consolidate the group with effect from 1 July 2003 and also chooses to treat TradingCo as a chosen transitional entity.

All of the units of trading stock are sold during the course of the 2003-04 income year for $7 each. No other units of trading stock are manufactured.

TradingCo's 2002–03 return

As TradingCo is a chosen transitional entity, section 701-10 does not apply to reset the tax cost of its assets. Also, subsection 701-35(4), which requires a joining entity to choose a tax-neutral value for its trading stock just before the joining time, does not apply → section 701-15, IT(TP)A. Therefore, TradingCo is free to elect a value for its stock on hand at 30 June 2003 in accordance with the closing stock provisions. It may elect to value each item at cost, replacement value or market selling value. → section 70-45, ITAA 1997

Assume TradingCo elects to value its trading stock at replacement value of $4. Under section 70-35, it includes in its assessable income the amount of $4,000, since the value of stock on hand at 1 July 2002 was nil and the value chosen for stock on hand at 30 June 2003 is $4,000.

In addition, TradingCo can deduct the outgoings of $5,000 incurred in manufacturing the trading stock during the income year.

The net effect in relation to the trading stock is that TradingCo's taxable income is reduced by $1,000.

HeadCo's 2003–04 return

As HeadCo has chosen to treat TradingCo as a chosen transitional entity, its assets do not have their tax costs reset. HeadCo inherits the tax cost of each asset (and other history) under the entry history rule. → section 701-5, ITAA 1997

Applying the trading stock provisions, HeadCo includes in the value of its stock on hand at 1 July 2003 the value it inherits as the elected value at 30 June 2003, the end of the last income year. In this case, that elected value for each item is the replacement value of $4, giving a total opening value of $4,000 for the trading stock brought into the group by TradingCo. → section 70-40, ITAA 1997

HeadCo includes the sale proceeds of $7,000 in its assessable income.

Applying section 70-35, HeadCo can deduct the amount of $4,000, being the excess of the value of opening stock over closing stock.

The net effect for HeadCo is that its taxable income is increased by $3,000 in respect of the trading stock brought into the group by TradingCo.

References

Income Tax Assessment Act 1997, sections 70-35, 70-40, 70-45, 701-5, 701-55; as amended by:

- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2
- *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 23
- *Taxation Laws Amendment Act (No. 8) 2003*, (No. 107 of 2003) Schedule 2

Income Tax (Transitional Provisions) Act 1997, sections 701-15, 701A-5; as amended by:

- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 7
- *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 1
- *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 9

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, paragraphs 1.123 to 1.130

Taxation Determination TD 2004/88 – Income tax: consolidation: does the continuing majority-owned entity test in subsections 701A-1(1) and 701A-1(2) of the *Income Tax (Transitional Provisions) Act 1997* require tracing through interposed entities to the ultimate beneficial owners to determine whether there has been a change in the majority ownership of an entity during the period from 27 June 2002 until the entity becomes a subsidiary member of a consolidated group?

Revision history

Section C9-5-320 first published 8 June 2004. Further revisions are described below.

Date	Amendment	Reason
27.1.05	Changes to example 2.	For clarification and to correct errors.
26.10.05	Reference to new tax determination.	

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).