TD 2005/D22 - Income tax: consolidation: what is the meaning of 'liability owed' in section 711-40 of the Income Tax Assessment Act 1997?

Draft Taxation Determination

Income tax: consolidation: what is the meaning of ‘liability owed’ in section 711-40 of the *Income Tax Assessment Act 1997*?

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. ‘Liabilities owed by *members of the old group to the leaving entity at the leaving time’ that correspond to assets of the leaving entity for the purposes of section 711-40 of the *Income Tax Assessment Act 1997* (ITAA 1997) is a reference to the commercial or business liabilities and the corresponding assets that would be identified, matched and valued by a reasonable valuer in accordance with the generally accepted valuation principles that apply in Australia.

Explanation

2. When a subsidiary member leaves a consolidated group with an asset that represents a liability owed by a remaining group member, section 711-40 gives an amount that is added to the head company’s exit ACA at step 3.

3. The section gives recognition to the economic relationship, not recognised while both parties are members of the consolidated group, that represents the cost to the group of the liability it now owes to a third party – its former subsidiary member.

4. ‘Liabilities owed’ in this section refers to the economic cost to the group that corresponds to the value in the leaving entity of the ‘corresponding assets’. The meaning of ‘asset’ in Part 3-90 of the ITAA 1997 is set out in Taxation Ruling TR 2004/13, and refers to something of economic value to the joining entity for which a purchaser of its membership interests would be willing to pay (paragraph 5). A ‘liability owed’ that corresponds to an asset is a commercial or business liability of corresponding economic disadvantage or detriment to the group in accordance with the generally accepted valuation principles that apply in Australia.

5. The business or commercial liabilities owed by members of a consolidated group to a leaving entity are things that would be taken into account under these principles, and would be expected to be identified by a prudent vendor and purchaser as having value to the leaving entity, and as diminishing the value of the group, in the making of a sale agreement in respect of the membership interests in that entity and its business.

6. What is a commercial or business liability that corresponds to a commercial or business asset is a question of fact. Such liabilities could include:

- a) present indebtedness, being obligations to give money, property or services (see Example 1); and
- b) contracts that are, in economic terms, 'out of the money' (see Example 2); so, a contract that is 'in the money' for the leaving entity and 'out of the money' for the group will be an asset of the leaving entity and a corresponding liability of the group.

Present indebtedness – subsection 711-40(1)

7. Subsection 711-40(1) sets out when the section will apply. It provides that the step 3 amount is the total, for all liabilities owed by members of the old group to the leaving entity, of the market values of the corresponding assets of the leaving entity.

8. For a 'present indebtedness' liability, subsection 711-40(1) provides that the step 3 amount is the market value of the corresponding asset. So, for example:

- a) where the member of the old group has a liability which is a borrowing from the leaving entity: the old group member has a 'liability owed' to the leaving entity and the loan asset of the leaving entity is the 'corresponding asset' in the hands of the leaving entity. The step 3 amount is the market value of the loan asset;
- b) where the member of the old group has been billed by the leaving entity for goods or services that have been provided before the leaving time, and the bill has not been paid at the leaving time (that is, the liability is a trade debt): the old group member has a 'liability owed' to the leaving entity and the receivable of the leaving entity is the 'corresponding asset' in the hands of the leaving entity. The step 3 amount is the market value of the receivable; and
- c) where the leaving entity has prepaid the member of the old group for goods or services and those goods or services have not been provided at the leaving time: the old group has a 'liability owed' to the leaving entity to provide the goods or services and the right to receive them is the 'corresponding asset' of the leaving entity. The step 3 amount is the market value of that asset.

Example 1

9. Head Co is the head company of a consolidated group. On 1 July 2004, it incorporates two wholly owned subsidiaries A Co, a finance company, and B Co, a trading company. At the time of their incorporation their financial positions are as follows:

A (Finance Co)

Cash	$5,000	Equity	$5,000
	$5,000		$5,000

B (Trading Co)

Cash	$500	Equity	$500
	$500		$500

On 1 July 2004, A Co and B Co enter into a loan contract under which A Co lends to B Co $2,000 on arm's length terms and conditions. No costs are incurred in relation to the creation of the contract.

The next day A Co is sold by the head company for $5,000 and consequently leaves the consolidated group. The financial positions of A Co and B Co on A's leaving are as follows:

A (Finance Co)

Cash	$3,000	Equity	$5,000
Receivable	$2,000		
	$5,000		$5,000

B (Trading Co)

Cash	$2,500	Equity	$500
		Liability	$2,000
	$2,500		$2,500

When A Co leaves the group, subsection 711-40(1) applies to the arrangement as it represents a present indebtedness, or money that B Co must pay to A Co, for no further consideration by A Co (that is, the contract is fully executed from A's point of view). A Co has an economic asset that corresponds to the economic detriment to B Co arising from its obligation to pay the loan principal plus interest.

Subsections 711-40(2) & (3) do not apply as there would, but for the single entity rule, have been no CGT event for B Co (the member of the old group) (section 104-35(5)) when the liability arose.

Subsection 711-40(1) will therefore apply to give a step 3 amount of the market value of the loan, being $2,000.

The group's exit ACA for A Co is:

Step 1	$3,000
Step 3	$2,000
ACA	$5,000

The group has invested $5,000 and has received $5,000 for the leaving entity. There is no economic gain or loss. For income tax purposes there will be no taxable gain or loss ($5,000 capital proceeds less $5,000 exit ACA).

‘Out of the money’ contracts – subsections 711-40(2) and (3)

10. However, if subsection 711-40(3) applies to any of the liabilities, the step 3 amount is the ‘cost amount’ in accordance with that subsection rather than the market value of the corresponding asset as per subsection (1): (subsection 711-40(2)). Subsection 711-40(3) applies where a member of the consolidated group other than the leaving entity (‘member of the old group’ would have made a capital gain or capital loss for the CGT event that, disregarding subsection 701-1(1) of the ITAA 1997 (the single entity principle), would have happened when the liability arose.

11. These subsections restrict the step 3 amount to the lesser of this ‘cost amount’ and the market value of the liability (subsection 711-40(3)).

12. ‘Market value of the liability’ in this context clearly relates to the number worked out under subsection 711-40(1), that is, the market values of the assets of the leaving entity that correspond to the liabilities of members of the old group.

13. The step 3 amount is the lesser of this ‘cost amount’ and the market value of the asset corresponding to the liability.

Example 2

14. Head Co is the head company of a consolidated group. On 1 July 2004, it incorporates two wholly owned subsidiaries: A Co, a management services company, and B Co, a trading company. At the time of their incorporation their financial positions are as follows:

A (Management Co)

Cash	$200	Equity	$200
	$200		$200

B (Trading Co)

Cash	$5,000	Equity	$5,000
	$5,000		$5,000

On 1 July 2004, A Co and B Co enter into a service contract under which A Co is to provide B Co with management services. The contract is a valuable one for A Co with market value of $100, and is economically disadvantageous contract for B Co. At the time of entering into the agreement, A Co pays B Co a premium of $80 and B incurs legal costs of $50.

The next day A Co is sold by the head company for $220 and leaves the consolidated group. At the leaving time, their financial positions are as follows:

A (Management Co)

Cash	$120	Equity	$200
		Retained earnings	($80)
	$120		$120

B (Trading Co)

Cash	$5,030	Equity	$5,000
		Retained earnings	$30
	$5,030		$5,030

When A Co leaves, subsection 711-40(1) applies to the management contract. It is an economically detrimental obligation or 'negative asset' (liability owed), by the old group member to the leaving entity.

Subsection 711-40(3) applies because CGT event D1 would have happened to B Co (the member of the old group) but for the SER. B Co would have made a capital gain of $30, being the extent to which the amount of the premium of $80 exceeded the legal costs of $50. Subsections 711-40(2) and 711-40(3) will therefore apply to give the incidental cost of $50 as the step 3 'cost amount'.

The group's exit ACA for A Co is:

Step 1	$120
Step 3	$50
ACA	$170

The group has invested $5,200, and now has $5,250 (proceeds on sale of A Co of $220 and cash in B Co of $5,030) and made an economic gain of $50. For income tax purposes the group will have a taxable gain of $50 ($220 capital proceeds less $170 exit ACA = $50).

Date of Effect

15. 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

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

Due date:	**29 July 2005**
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Commissioner of Taxation
29 June 2005

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 92/20; TR 2004/13

Subject references:

- asset
- consolidated group
- consolidation – exiting
- consolidation – liabilities
- leaving entity
- leaving time
- liability owed
- step 3

Legislative references:

- ITAA 1997 104-35(5)
- ITAA 1997 701-1(1)
- ITAA 1997 711-40
- ITAA 1997 711-40(1)
- ITAA 1997 711-40(2)
- ITAA 1997 711-40(3)
- ITAA 1997 Pt 3-90
- TAA 1953 Pt IVAAA

ATO references

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