TD 2004/D29 - Income tax: consolidation: capital gains: does the determination of a capital gain or loss under section 104-530 (CGT event L7) of the Income Tax Assessment Act 1997 require a full reconstruction of the allocable cost amount at the joining time in relation to the relevant liability?

Draft Taxation Determination

Income tax: consolidation: capital gains: does the determination of a capital gain or loss under section 104-530 (CGT event L7) of the *Income Tax Assessment Act 1997* require a full reconstruction of the allocable cost amount at the joining time in relation to the relevant liability?

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. Yes. In order to determine a capital gain or loss under section 104-530 (CGT event L7) of the *Income Tax Assessment Act 1997* (ITAA 1997), a full reconstruction of the allocable cost amount (ACA) is required. This ensures that the full impact of the discharged amount of a liability is reflected in working out the amount of any capital gain or loss.

2. In order for CGT event L7 to happen to the head company of a consolidated group, the conditions specified in subsection 104-530(3) of the ITAA 1997 need to be satisfied in relation to a liability (see subsection 104-530(1) of the ITAA 1997). Paragraphs 104-530(3)(a) and (b) of the ITAA 1997 require that a liability that was taken into account in working out the ACA for a joining entity at its joining time (the original ACA) is later discharged for a different amount (the ***'realised amount'***). Further, paragraph 104-530(3)(c) of the ITAA 1997 requires the original ACA to be different to what it would have been (referred to as the ***'true ACA'***) if the realised amount had been taken into account in working out the ACA. Paragraph 104-530(3)(c) of the ITAA 1997 does not set out how to determine the true ACA.

3. The existence of the condition in paragraph 104-530(3)(c) of the ITAA 1997 indicates a need for a full reconstruction to arrive at the true ACA. This involves going beyond merely working out the difference in ACA that flows from using the realised amount rather than the amount of the liability taken into account in the original ACA. The provision requires that the true ACA be worked out by substituting the realised amount of the liability for the amount used in the original ACA and taking into account any other changes that would have flowed from this. These changes could affect step 2 of the ACA calculation (see sections 705-70 to 705-85 of the ITAA 1997) and subsequent ACA steps (see sections 705-90 to 705-115 of the ITAA 1997). An example is where the realised amount is less than the amount of the liability reflected in the original ACA and there would have been an increase in tax payable because of an increase in the taxable income arising from a decrease in the liability. In this case, the reconstructed step 2 amount should reflect the realised amount and the additional tax that would have been payable at the joining time.

4. As well, discharged liabilities, such as provisions for employee entitlements and liabilities denominated in foreign currency, that are subject to section 705-75 and/or section 705-80 of the ITAA 1997 at the joining time, would be subjected to these provisions again under a full reconstruction in order to work out the true ACA and the capital gain or loss under CGT event L7.

5. The way in which subsections 104-530(4) and 104-530(5) of the ITAA 1997 apply also supports the full reconstruction view. In order to work out the capital gain or loss under CGT event L7, these subsections require the head company to work out the difference between the original ACA and the true ACA as opposed to merely working out the difference between the liability taken into account at the joining time and the realised amount of the liability.

6. In addition, the Explanatory Memorandum to the *New Business Tax System (Consolidation and Other Measures) Bill (No.2) 2002* (EM) supports the view that a full reconstruction is necessary. This is illustrated by examples 5.4 and 5.5 in paragraphs 5.40 and 5.41 respectively. In both examples, even though no workings are shown, a reconstruction of the step 2 amount, including the corresponding impact on step 5 and step 6, of the ACA calculation is required to arrive at the true ACA figures shown (see below). There is also an inference in paragraph 5.41 of the EM that a full reconstruction of the ACA is required. This paragraph notes that the change in the amount of a liability may not affect the amount of the ACA because the ACA calculation '…factors in future tax effects for the liability and, taking those into account, there may be no net change in the ACA'.

Example

7. The following example explains the calculations in example 5.4 in the EM referred to above.

Year 1 Trister Insurance deducted $100 million for estimated outstanding claims. Profit/loss and financial position statements are as follows:

Profit and Loss Statement for y/e X1

	$m
Increase in Outstanding Claims Liability (OCL)	(100)
TAX LOSS	(100)

Statement of financial position as at end of X1

	$m			*$m*
Cash	100	Liabilities	OCL	100
Investments	100			
DTA	30	Capital		200
		Accumulated loss		(70)
	230			230

Year 2 Struher group acquires all the membership interests in Trister Insurance for $130 million (that is, net asset value being $230 million – $100 million).

Year 3 Trister Insurance increased the OCL provision to $150 million. Profit/loss and financial position statements are as follows:

Profit and Loss Statement for y/e X3	*$m*
Increase in Outstanding Claims Liability (OCL)	(50)
TAX LOSS	(50)

Statement of financial position as at end of X3

	$m			*$m*
Cash	100	Liabilities	OCL	150
Investments	100			
DTA	45	Capital		200
		Accumulated loss		(105)
	245			245

Consolidation takes place.
Assume X1 loss and X3 loss can be transferred into the group.

Allocable Cost Amount (ACA) at joining time

		$m	
	Step 1	$130	
Add	**Step 2**	$150	
Subtract	**Step 5**	$ 50	(Loss made in X3 was an ‘owned’ loss)
Subtract	**Step 6**	$ 30	(Loss made in X1 was an ‘acquired’ loss. The tax benefit of this loss is the Step 6 amount)
	Original ACA	$200	

Assume the OCL is discharged in year 4 for $80.

RECONSTRUCTED Profit and Loss Statement for y/e X3	*$m*
Decrease in Outstanding Claims Liability	20
PROFIT	20
Less X1 loss	(20)
NET PROFIT / TAXABLE INCOME	0

NOTE: The X1 tax loss ($100 million) has not been fully utilised in this financial year. $80 million may be carried forward and utilised against future taxable income.

RECONSTRUCTED Statement of financial position as at end of X3

	$m			$m
Cash	100	Liabilities	OCL	80
Investments	100			
DTA	24	Capital		200
		Accumulated loss		(56)
	224			224

RECONSTRUCTED Allocable Cost Amount (ACA) at joining time

		$m
	Step 1	$130
Add	**Step 2**	$ 80
Subtract	**Step 6**	$ 24
	True ACA	$186

There will be a capital gain under CGT event L7 in year 4 equal to $14 million (that is, $200 million - $186 million).

Date of Effect

8. 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

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

Due date: **13 August 2004**

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Commissioner of Taxation
14 July 2004

Previous draft:

Not previously issued in draft form

Related Rulings/Determinations:

TR 92/20

Subject references:

- accounting liabilities
- CGT event L7
- CGT events
- consolidation
- consolidation – capital gains tax
- consolidation - liabilities
- discharge of liabilities

Legislative references:

- TAA 1953 Pt IVAAA
- ITAA 1997 104-530
- ITAA 1997 104-530(1)
- ITAA 1997 104-530(3)
- ITAA 1997 104-530(3)(a)
- ITAA 1997 104-530(3)(b)
- ITAA 1997 104-530(3)(c)
- ITAA 1997 104-530(4)
- ITAA 1997 104-530(5)
- ITAA 1997 705-70
- ITAA 1997 705-75
- ITAA 1997 705-80
- ITAA 1997 705-85
- ITAA 1997 705-90
- ITAA 1997 705-93
- ITAA 1997 705-95
- ITAA 1997 705-100
- ITAA 1997 705-105
- ITAA 1997 705-110
- ITAA 1997 705-115

Other references:

- Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No.2) 2002

ATO references

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