TD 2004/D31 - Income tax: consolidation tax cost setting rules: should profits that accrue to a consolidated group be counted under step 3 of the allocable cost amount where those profits recouped non-economic losses that accrued to the group?

Draft Taxation Determination

Income tax: consolidation tax cost setting rules: should profits that accrue to a consolidated group be counted under step 3 of the allocable cost amount where those profits recouped non-economic losses that accrued to the group?

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. No. Under paragraph 705-90(6)(b) of the *Income Tax Assessment Act 1997* (ITAA 1997), profits that accrued to a consolidated group which recouped losses (whether economic or not) that accrued to the group are precluded from being added at Step 3 when working out the allocable cost amount (ACA). The purpose of this adjustment is to prevent the reset costs for a joining entity's assets reflecting untaxed profits that accrued to the group.

Example 1 – Joining entity had profits when acquired by HCo

2. XCo incorporates ACo with $100,000.00 on 1 July, 2003. In its first year of operation, ACo makes after tax profits of $70,000.00 ($100,000.00 before tax). On 1 July 2004 HCo acquires ACo for $170,000.00. For the year ended 30 June 2005 ACo makes an accounting loss of $25,000.00 (after creation of a deferred tax asset (DTA) of $15,000.00 in respect of the tax loss). In the same year ACo makes a tax loss of $50,000.00. The tax loss included a non-economic component of $10,000.00 for additional research and development (R&D) tax incentive deductions. For the year ended 30 June 2006 ACo makes an accounting profit of $35,000.00 (after reversing for the DTA). ACo has assessable income of $100,000.00 and tax deductions of $50,000.00 for expenditure and for the tax loss of $50,000.00 resulting in taxable income of $nil. HCo forms a consolidated group on 1 July 2006.

3. ACo's franking account balance on formation is $30,000.00.

4. ACo's financial position when HCo acquired 100% of ACo is shown in Table 1.

Table 1: ACo – Financial Position at 1 July 2004 ($)

Cash	170,000	Equity	100,000
		Retained earnings	70,000
	170,000		170,000

5. ACo's financial position at 30 June 2005 is shown in Table 2.

Table 2: ACo – Financial Position at 1 July 2005 ($)

Cash	130,000	Equity	100,000
Deferred tax asset (re loss)	15,000	Retained earnings - acquired taxed profits (70,000) - owned loss (25,000)	45,000
	145,000		145,000

Note: Profits that did not accrue to HCo are referred to as 'acquired' profits and profits that did accrue to HCo are referred to as 'owned' profits.

6. ACo's financial position at formation time is shown in Table 3.

Table 3: ACo – Financial Position at 1 July 2006 ($)

Cash	180,000	Equity	100,000
		Retained earnings - Acquired taxed profits (45,000) - Owned untaxed profits (35,000)	80,000
	180,000		180,000

7. The Allocable cost amount (ACA) would be as follows:

Table 4: ACA calculation for A Co ($)

Step 1	Add cost of membership interests		170,000
Step 3	Add undistributed profits • subsection 705-90(2) undistributed profits: 80,000; • subsection 705-90(3) limit, representing taxed undistributed profits: 70,000; and • paragraph 705-90(6)(a) extent to which the subsection 705-90(3) amount includes profits accrued to joined group: 25,000	25,000	
	LESS • paragraph 705-90(6)(b) extent of the undistributed profits that accrued to joined group that recouped losses accrued to the group: (25,000)	(25,000)	0
Step 8	ACA		170,000

8. In Table 2 above the Step 3 amount is $nil. Total retained profits were $80,000.00. The Step 3 amount after applying the limit in subsection 705-90(3) is $70,0000. This is treated as taxed profits to the extent possible. The only taxed profits in the retained earnings are acquired profits of $45,000.00. It follows that the remainder of the $70,000.00 must be owned profits. The Step 3 amount after applying paragraph 705-90(6)(a) is $25,000.00. However, all of the owned profits recouped a tax loss that accrued to the group. Therefore, all the profits after paragraph 705-90(6)(a) recouped losses that accrued to the group and are excluded from the Step 3 amount under paragraph 705-90(6)(b).

9. The following summary illustrates the relevant amounts:

	30/6/04	**30/6/05**	**30/6/06**	**Tax paid**	**totals**
Retained profits balance at 30 June	70,000	45,000	80,000		
Accounting profit (loss)					
• Taxed	70,000		0	30,000	
• Untaxed	0		35,000		
	A 70,000	(25,000)	**O** 35,000		
Less: Amount absorbed by subsequent year loss	(25,000)				
Balance					
• Taxed	45,000		0		45,000
• Untaxed	0		35,000		35,000
	A 45,000		**O** 25,000		80,000
Covered by s.705-90(3) limit					
• Taxed	45,000		0		45,000
• Untaxed	0		25,000		25,000
	A 45,000		**O** 25,000		70,000

Note: 'A' refers to acquired and 'O' refers to owned.

10. The tax cost setting amount for retained cost base assets (cash) is $180,000.00. There is a shortfall in the ACA as the retained cost base assets (that is, cash) exceed the ACA by $10,000.00. The shortfall will be taxed as a capital gain under section 104-510 (where tax cost setting amounts for retained cost base assets exceeds the ACA: CGT event L3). This result prevents the untaxed profits that accrued to the group that were sheltered by non-economic losses, being reflected in the tax cost setting amount of the joining entity's assets.

Example 2 – Joining entity always owned by HCo

11. HCo incorporates BCo with $100,000.00 on 1 July, 2003. In its first year of operation, BCo makes after tax profits of $70,000.00 ($100,000.00 before tax). For the year ended 30 June 2005 BCo makes an accounting loss of $25,000.00 (after creation of a DTA of $15,000.00 in respect of the tax loss). In the same year BCo makes a tax loss of $50,000.00. The tax loss included a non-economic component of $10,000.00 for additional R&D incentive deductions. For the year ended 30 June 2006 BCo makes an accounting profit of $35,000.00 (after reversing for the DTA). BCo has assessable income of $100,000.00 and tax deductions of $50,000.00 for expenditure and for the tax loss of $50,000.00 resulting in taxable income of $nil. HCo forms a consolidated group on 1 July 2006.

12. BCo's franking account balance on formation is $30,000.00.

13. BCo's financial position at 1 July 2006 is shown in Table 5.

Table 5: BCo – Financial Position at 1 July 2006 ($)

Cash	180,000	Equity	100,000
		Retained earnings	80,000
	180,000		180,000

14. The ACA would be as follows:

Table 6: ACA calculation for B Co ($)

Step 1	Add cost of membership interests		100,000
Step 3	Add undistributed profits • Subsection 705-90(2) undistributed profits (80,000); • subsection 705-90(3) limit, representing taxed undistributed profits (70,000); and • paragraph 705-90(6)(a) extent to which the subsection 705-90(3) amount includes profits accrued to joined group (70,000)	70,000	
	LESS paragraph 705-90(6)(b) extent of the undistributed profits that accrued to joined group that recouped losses that accrued to the group (25,000)	(25,000)	45,000
Step 8	ACA		145,000

15. In Table 6 above the Step 3 amount is $45,000.00. Total retained profits were $80,000.00. The Step 3 amount after applying the limit in subsection 705-90(3) is $70,000.00. The extent to which this amount includes profits that accrued to the group is $70,000.00 [paragraph 705-90(6)(a)]. However, only $25,000.00 of those profits could have recouped a tax loss that accrued to the group. That is, out of the $70,000.00, $45,000.00 can be attributed to the taxed profits from the 30 June 2004 year. The balance of $25,000.00 is therefore attributed to the profits from the 30 June 2006 year. Only profits from the 30 June 2006 year could recoup tax losses incurred in the prior year. These profits are essentially untaxed, but because of available franking credits are included in the subsection 705-90(3) limit.

16. The tax cost setting amount for retained cost base assets (cash) is $180,000.00. There is a shortfall in the ACA as the retained cost base assets (that is, cash) exceed the ACA by $35,000.00. The shortfall will be taxed as a capital gain under section 104-510 (CGT event L3).

Date of Effect

17. 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

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

Due date:	**20 August 2004**
Contact officer:	**Sophia Savva**
E-mail address:	**Sophia.Savva@ato.gov.au**
Telephone:	**(02) 9374 1693**
Facsimile:	**(02) 9374 1629**
Address:	**12-22 Woniora Road** **Hurstville NSW 2220**

Commissioner of Taxation
21 July 2004

Previous draft:

Not previously issued in draft form

Related Rulings/Determinations:

TR 92/20

Subject references:

- ACA
- accounting loss
- accounting profit
- acquired
- allocable cost amount
- consolidated group
- consolidation
- cost setting
- losses
- non-economic losses
- owned
- profits
- recouped losses
- retained profits
- step 3
- taxed profits
- undistributed profits

Legislative references:

- TAA 1953 Pt IVAAA
- ITAA 1997 104-510
- ITAA 1997 705-90(2)
- ITAA 1997 705-90(3)
- ITAA 1997 705-90(6)(a)
- ITAA 1997 705-90(6)(b)

ATO references

NO: 2004/9657
ISSN: 1038-8982