


***TD 2004/D33 - Income tax: consolidation tax cost setting rules: step 3 of the allocable cost amount (ACA): how do you work out the paragraph 705-90(6)(b) amount where only some of the undistributed profits have recouped losses prior to the joining time?***

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This document has been finalised by TD 2004/56.



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## Draft Taxation Determination

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Income tax: consolidation tax cost setting rules: step 3 of the allocable cost amount (ACA): how do you work out the paragraph 705-90(6)(b) amount where only some of the undistributed profits have recouped losses prior to the joining time?

### **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. When working out the amount added at step 3 of the allocable cost amount (ACA) you start with the accounting profits as determined under subsection 705-90(2) of the *Income Tax Assessment Act 1997* (ITAA 1997). This amount is limited by the reference to the franking account under subsection 705-90(3). The subsection 705-90(3) amount consists of taxed profits first and then untaxed profits where the retained profit amount is made up of both. You then work out the extent to which the profits after subsection 705-90(3) are profits that accrued to the group [paragraph 705-90(6)(a)]. This amount is reduced to the extent that it recouped a loss for income tax purposes that accrued to the group [paragraph 705-90(6)(b)].

2. The purpose of step 3 in the ACA calculation is, consistent with the imputation system, to prevent double taxation of profits by allowing a consolidated group a cost for retained taxed or taxable profits that accrue to membership interests that were held by the consolidated group [see paragraph 5.84 of the Explanatory Memorandum to the *New Business Tax System (Consolidation) Bill (No 1) 2002* ('the May EM') and paragraph 5.113 of the Explanatory Memorandum to the *New Business Tax System (Consolidation and Other Measures) Bill (No 2) 2002* ('the Dec EM')]. This is done by increasing the ACA by an amount that reflects the undistributed taxed profits in the joining entity that accrued to the joined group at the joining time (see Step 3, column 2 in the table in section 705-60 of the ITAA 1997).

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3. Subsection 705-90(3) and (4) operate so that the amount added to the ACA under step 3 is calculated by reference to a notional franking account balance at the joining time. The notional franking account is grossed up using the formula in subsection 705-90(3) in order to isolate that portion of the undistributed profits of the joining entity that represents taxed profits. The amount of taxed profits worked out using the formula cannot exceed the amount of undistributed profits of the joining entity at the joining time determined under subsection 705-90(2). See paragraphs 5.114, 5.115 and 5.116 of the Dec EM.

4. Step 3 is not intended to prevent the double taxation of profits derived under the classical system of company taxation that existed before the imputation system was introduced (see paragraph 5.84 of the May EM). That is, even if pre-1987 profits may have been taxed we do not add them at step 3 to the extent to which they are represented in the undistributed profits under subsection 705-90(2).

**Example**

5. HCo incorporates ACo with \$100,000.00 on 1 July 2003. In its first year of operation, ACo makes a loss for income tax purposes of \$50,000.00. ACo makes an accounting loss of \$35,000.00 (after creation of a deferred tax asset of \$15,000.00 in respect of the tax loss). In the year ending 30 June 2005 ACo has an assessable income of \$200,000.00. ACo's taxable income is reduced to \$150,000.00 after deducting the tax loss of \$50,000.00. ACo, therefore pays \$45,000.00 tax. ACo's profits for this year are \$140,000.00 (after reversing for the DTA and paying income tax). On 1 July 2005 HCo and ACo consolidate.

6. ACo's financial position at 1 July 2005 is shown in Table 1.

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

Cash	205,000	Equity	100,000
		Retained earnings	105,000
	<u>205,000</u>		<u>205,000</u>

7. The ACA would be as follows:

**Table 2: ACA calculation for A Co (\$)**

Step 1	Add cost of membership interests		100,000
Step 3	Add undistributed profits		
	<ul style="list-style-type: none"> <li>• subsection 705-90(2) undistributed profits: 105,000;</li> <li>• subsection 705-90(3) limit, representing taxed undistributed profits: 105,000; and</li> <li>• paragraph 705-90(6)(a) extent to which subsection 705-90(3) amount includes profits accrued to joined group: 105,000</li> </ul>	105,000	
	<i>LESS</i>		
	<ul style="list-style-type: none"> <li>• paragraph 705-90(6)(b) extent to which subsection 705-90(6)(a) amount includes profits accrued to joined group that recouped losses accrued to group (0)</li> </ul>	(0)	105,000
Step 8	ACA		<u>205,000</u>

8. In Table 2 above the Step 3 amount is \$105,000.00. Total profits were \$200,000.00 out of which only \$150,000.00 were taxable. The other \$50,000.00 was untaxed as it recouped a tax loss of \$50,000.00. The amount after subsection 705-90(3) is said to consist of taxed profits (\$150,000.00 - \$45,000.00 tax) first. Therefore, when considering subsection 705-90(6), the profits that accrued to the group [paragraph 705-90(6)(a)] did not include those profits that recouped losses that accrued to the group and hence no amount is excluded from the step 3 amount under paragraph 705-90(6)(b).

9. The tax cost setting amount for retained cost base assets (cash) is \$205,000. There is no shortfall or excess of ACA.

### **Alternative View**

10. An alternative approach to working out the paragraph 705-90(6)(b) amount is to take the view that the profits covered by the subsection 705-90(3) limit cannot be dissected into profits that have been taxed and profits that have not been taxed. The result of such an approach would be to apportion the subsection 705-90(3) amount of \$105,000.00 on a pro-rata basis. That is, the subsection 705-90(3) amount of \$105,000.00 would be apportioned between the net profit of \$35,000.00 (\$50,000.00 assessable income - \$15,000.00 tax) that recouped a loss and the net profit of \$105,000.00 (\$150,000.00 assessable income - \$45,000.00 tax) that did not recoup the loss. The subsection 705-90(6)(b) amount would therefore be \$26,250.00 [ $(\$35,000.00/\$140,000.00) \times \$105,000.00$ ]. The step 3 amount would be \$78,750.00 (\$105,000.00 - \$26,250.00). The ACA would only be \$178,750.00.

11. The outcome under this alternative view is inappropriate. The preferred approach is consistent with the policy intent set out in section 705-10.

### **Date of Effect**

12. 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**

13. 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  
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# TD 2004/D33

## Commissioner of Taxation

21 July 2004

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*Previous draft:*

Not previously issued in draft form

*Related Rulings/Determinations:*

TR 92/20

*Subject references:*

- ACA
- allocable cost amount
- consolidation
- cost setting
- losses
- profits
- recouped losses
- retained profits
- step 3
- tax cost setting amount
- taxed profits
- undistributed profits
- untaxed profits

*Legislative references:*

- TAA 1953 Pt IVAAA
- ITAA 1997 705-10
- ITAA 1997 705-60
- ITAA 1997 705-90
- ITAA 1997 705-90(2)
- ITAA 1997 705-90(3)
- ITAA 1997 705-90(4)
- ITAA 1997 705-90(6)(a)
- ITAA 1997 705-90(6)(b)

*Other references:*

- Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No 1) 2002
  - Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No 2) 2002
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ATO references

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