TD 2004/54 - Income tax: consolidation tax cost setting rules: is the amount of the adjustment under paragraph 705-90(6)(b) of the Income Tax Assessment Act 1997 different depending upon whether the recouped losses are economic or non-economic losses?

Taxation Determination

Income tax: consolidation tax cost setting rules: is the amount of the adjustment under paragraph 705-90(6)(b) of the *Income Tax Assessment Act 1997* different depending upon whether the recouped losses are economic or non-economic losses?

Preamble

*The number, subject heading, date of effect and paragraph 1 of this document are a 'public ruling' for the purposes of Part IVAAA of the **Taxation Administration Act 1953** and are legally binding on the Commissioner.*

1. No. Under paragraph 705-90(6)(b) of the *Income Tax Assessment Act 1997* (ITAA 1997), profits that accrued to a consolidated group (owned profits) which recouped losses for income tax purposes (whether economic or not) that accrued to the group (owned tax losses) 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 effective reinstatement of losses for income tax purposes through higher reset tax costs for a joining entity's assets.

2. When working out the amount added at step 3 of the ACA you start with the accounting profits as determined under subsection 705-90(2) of the ITAA 1997. This amount is limited by reference to the franking account under subsection 705-90(3). The subsection 705-90(3) amount operates as a cap when identifying how much of the undistributed profits accrued to the group under paragraph 705-90(6)(a). The paragraph 705-90(6)(a) amount is then reduced under paragraph 705-90(6)(b) to the extent that the undistributed profits recouped owned tax losses.

3. When determining the subsection 705-90(6)(b) amount regard must be given to which profits recouped owned tax losses. An owned tax loss can only be 'recouped' by a later profit.

Example 1 – Joining entity had profits when acquired by HCo

4. On 1 July 2003, ACo is incorporated as a wholly owned subsidiary of XCo with an initial capitalisation of $100,000.00 (100 shares at $1,000.00 each). 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. 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. At the joining time ACo's market value was $180,000.00.

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

6. 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

7. 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	45,000
	145,000		145,000

8. 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	80,000
	180,000		180,000

9. The ACA would be as follows:

Table 4: ACA calculation for ACo ($)

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: 10,000	10,000	
	LESS		
	• paragraph 705-90(6)(b) extent of the undistributed profits that accrued to joined group that recouped losses accrued to the group: (10,000)	(10,000)	0
Step 8	ACA		170,000

10. In Table 4 the Step 3 amount is $0. Total retained profits were $80,000.00. The maximum retained earnings amount that can be considered for step 3 of the ACA, after applying the limit, calculated by the formula under subsection 705-90(3) is $70,000.00. The total of undistributed profits that accrued to the joined group (owned profits) is $10,000.00 ($35,000 profit for 2005-06 year less accounting loss of $25,000 for 2004-2005 year). This amount is less than the limit under subsection 705-90(3) and therefore will be the amount carried as the paragraph 705-90(6)(a) amount. However, all of the undistributed owned profits recouped a tax loss that accrued to the group. Therefore, $10,000 is excluded from the Step 3 amount under paragraph 705-90(6)(b) as profits that accrued to the group and recouped losses that accrued to the group.

11. 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 which were sheltered by non-economic losses being reflected in the ACA.

Date of effect

12. This Determination applies to years commencing both before and after its date of issue. However, it does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of the Determination (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Commissioner of Taxation
27 October 2004

Previous draft:

TD 2004/D31

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