TD 2004/D38 - Income tax: consolidation tax cost setting rules: step 3 of the allocable cost amount: should tax losses or net capital losses transferred to a joining entity be taken into account when determining whether an amount should be excluded at paragraph 705-90(6)(b)?

This document has been finalised by TD 2004/61.

Draft Taxation Determination

Income tax: consolidation tax cost setting rules: step 3 of the allocable cost amount: should tax losses or net capital losses transferred to a joining entity be taken into account when determining whether an amount should be excluded at paragraph 705-90(6)(b)?

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. Losses transferred to a joining entity (income company) by another member of a wholly-owned group (loss company) prior to the joining entity becoming a member of a consolidated group are not treated as losses of the joining entity accruing to the group for the purposes of paragraph 705-90(6)(b) of the *Income Tax Assessment Act 1997* (ITAA 1997). Instead, adjustments may be made at step 1 and/or step 2 of the allocable cost amount (ACA) for the loss company (see subsection 705-65(3) and 705-75(3) respectively). Adjustments may also be made at step 1 for the income company (see subsection 705-65(3). See paragraph 5.60 and Table 5.2 of the *Explanatory Memorandum* to the *New Business Tax System (Consolidation) Act (No.1) 2002*.

Example

Cost setting process for the income company

2. On 1 July 2000 Beta Co is incorporated as a wholly-owned subsidiary of HCo for $100,000.00. In the year ended 30 June 2001 Beta Co had assessable income of $100,000.00 ($66,000.00 after-tax profits).

3. Beta Co's financial position at 1 July 2001 is shown in Table 1.

Table 1: Beta Co – Financial Position at 1 July 2001 ($)

Cash	166,000	Equity	100,000
		Retained earnings (loss)	66,000
	166,000		166,000

4. In the year ended 30 June 2002 Beta Co makes a tax loss of $50,000.00 and an accounting loss of $35,000.00 (after the creation of a deferred tax asset (DTA) of $15,000.00 in respect of the tax loss).

5. Beta's Co's financial position at 1 July 2002 is shown in Table 2.

Table 2: Beta Co – Financial Position at 1 July 2002 ($)

Cash	116,000	Equity	100,000
DTA	15,000	Retained earnings	31,000
	131,000		131,000

6. The retained earnings balance is made up of taxed profits of $66,000.00 from the year ended 30 June 2001 less current year losses of $35,000.00.

7. In the year ending 30 June 2003 Beta Co makes assessable income of $100,000.00. In addition to the tax deduction for the previous year's tax loss of $50,000.00, Beta Co had a tax deduction for $50,000.00 (being a tax loss transferred from Alpha Co, another wholly owned subsidiary of HCo). This resulted in Beta Co having a taxable income of $Nil. Beta Co had an accounting profit of $70,000.00 (after reversing for the DTA and making a subvention payment of $15,000.00 to Alpha Co in respect of the transferred tax loss).

8. Beta Co's financial position at 1 July 2003 is shown in Table 3.

Table 3: Beta Co – Financial Position at 1 July 2003 ($)

Cash	201,000	Equity	100,000
		Retained earnings	101,000
	201,000		201,000

9. The retained earnings balance is made up of taxed profits of $31,000.00 from the year ended 30 June 2001 and current year untaxed profits of $70,000.00.

10. For the year ending 30 June 2004 Beta Co had a taxable income of $100,000.00 and an accounting profit after tax of $70,000.00.

11. Beta's Co's financial position at 1 July 2004 is shown in Table 4.

Table 4: Beta Co – Financial Position at 1 July 2004 ($)

Cash	271,000	Equity	100,000
		Retained earnings	171,000
	271,000		271,000

12. The retained earnings balance is made up of taxed profits of $31,000 from the year ended 30 June 2001, untaxed profits of $70,000 from the year ended 30 June 2003 and $70,000 current year taxed profits.

13. Beta Co's ACA would be as follows:

Table 5: ACA calculation for Beta Co ($)

Step 1	Add cost of membership interests Subsection 705-65(1): compare the cost base & reduced cost base [adjusted as appropriate under subsection 705-65(3)] and market value: • Cost base *plus* increase in market value on loss transfer (if any): 100,000 (100,000 +0) • Reduced cost base *plus* increase in market value on loss transfer (if any): 100,000 (100,000 + 0) • Market value: 271,000	100,000	100,000
Step 3	Add undistributed profits • subsection 705-90(2) undistributed profits: 171,000; • subsection 705-90(3) limit, representing taxed undistributed profits: 149,333; and • paragraph 705-90(6)(a) extent to which subsection 705-90(3) includes profits accrued to joined group: 149,333	149,333	
	LESS • paragraph 705-90(6)(b) extent of the undistributed profits that accrued to joined group that recouped losses accrued to the group: (24,167)	(24,167)	125,166
Step 8	ACA		225,166

14. When determining the step 1 amount under subsection 705-65(1), certain adjustments are required to the cost base (CB) and reduced cost base (RCB) of each membership interests. In Table 5 the CB, RCB and market value for each share are equal and the shares have been grouped for convenience. In Table 5 the CB and RCB used in working out the step 1 amount under subsection 705-65(1) are increased to the extent the market value of each membership interest increased as a result of the loss transfer under subsection 705-65(3). These are the adjustments that would have occurred under subdivision 170-C had the membership interests been disposed of prior to the joining time. In this case there was no increase in market value of Beta Co's membership interests as a result of the loss transfer because of the subvention payment made.

15. Once the relevant adjustments (if any) are made to the CB and RCB of each membership interest, they are then compared against the relevant market value of the membership interest at the joining time. The final step 1 amount is the sum of the following amounts for each membership interest. If the market value is:

- Equal to or greater than its CB = use its CB;
- Less than CB but greater than RCB = use its market value; or
- Less than or equal to RCB = use its RCB.

16. As the market value of each membership interest is greater than both the CB and RCB, the CB is used as the step 1 amount [refer table in subsection 705-65(1)].

17. The step 3 amount under section 705-90 is $125,166.00. The maximum step 3 amount under subsection 705-90(3) is $149,333.00 (based on Beta Co's franking account balance of $64,000.00). The extent to which the $149,333.00 includes profits that accrued to the joined group is the whole amount of $149,333.00 (paragraph 705-90(6)(a)). Of this $149,333.00 only $101,000.00 was taxed ($31,000.00 from year ended 30 June 2001 and $70,000.00 from year ended 30 June 2004). The remainder of $48,333.00 was untaxed because tax losses were deductible against assessable income for the year ended 30 June 2003. Tax losses recouped consisted of $50,000.00 loss made by Beta Co and $50,000.00 transferred to Beta Co by Alpha Co. To the extent that the $48,333.00 relates to transferred losses an adjustment is not made under paragraph 705-90(6)(b). To the extent that the $48,333.00 relates to the loss Beta Co made, an amount is subtracted under paragraph 705-90(6)(b). Therefore the adjustment is $24,167.00 ($48,333.00 x $50,000.00/$100,000.00 rounded to nearest dollar).

18. The following summary illustrates the relevant amounts:

	30/6/01	**30/6/02**	**30/6/03**	**30/6/04**	**Tax paid**	**totals**
Retained profits balance at 30 June	66,000	31,000	101,000	171,000		
Accounting profit (loss)						
Taxed	66,000		0	70,000	64,000	
Untaxed	0		70,000	0		
	66,000	(35,000)	70,000	70,000		
Less: Amount absorbed by subsequent year loss	(35,000)					
Balance						
taxed	31,000		0	70,000		101,000
untaxed	0		70,000	0		70,000
	31,000		70,000	70,000		171,000
Covered by s.705-90(3) limit						
taxed	31,000		0	70,000		101,000
untaxed	0		48,333	0		48,333
	31,000		48,333	70,000		149,333

19. The tax cost setting amount (TCSA) for the retained cost base assets (cash) is $271,000.00. As the TCSA amount for retained cost bases assets exceeds the ACA there is a shortfall of $45,834.00 resulting in a capital gain at the joining time under section 104-510 (CGT event L3). This result prevents the reset cost for Beta Co's assets from reflecting untaxed profits that accrued to the group that were sheltered by the losses made by Beta Co.

Cost setting process for the loss company

20. On 1 July 2000 Alpha Co is incorporated as a wholly-owned subsidiary of HCo for $100,000.00. At the joining time Alpha Co had no unused losses for income tax purposes as they were transferred to Beta Co for which it received a subvention payment of $15,000.00.

21. Alpha Co's financial position at 1 July 2004 is shown in Table 6.

Table 6: Alpha Co – Financial Position at 1 July 2004 ($)

Cash	65,000	Equity	100,000
		Retained earnings (loss)	(35,000)
	65,000		65,000

22. Alpha Co's ACA would be as follows:

Table 7: ACA calculation for Alpha Co ($)

Step 1	Add cost of membership interests Subsection 705-65(1): compare the cost base & reduced cost base [adjusted as appropriate under subsection 705-65(3)] and market value: • Cost base *less*(loss transferred minus subvention payment): 65,000 ($100,000 – ($50,000 - $15,000) • Reduced cost base *less* (loss transferred minus subvention payment): 65,000 ($100,000 – ($50,000 - $15,000) • Market value: 65,000	65,000	65,000
Step 8	ACA		65,000

23. The step 1 amount of the CB or RCB is reduced for adjustments that would have occurred under Subdivision 170-C had the membership interests been disposed of just prior to the joining time, under subsection 705-65(3). In table 7 above, the CB, RCB and market value for each share are equal and the shares have been grouped for convenience. The CB and RCB is reduced by the amount of the loss, net of the subvention payment. After this adjustment the CB is $65,000.00 ($100,000.00 – ($50,000.00 - $15,000.00). This is the same for the RCB.

24. Once the relevant adjustments are made to the CB and RCB of each membership interest, they are then compared against the relevant market value of the membership interest at the joining time. In this case the CB, RCB and market value for each share are equal.

25. The tax cost setting amount for the retained cost base assets (cash) is $65,000.00. There is no shortfall or excess of ACA.

Date of Effect

26. 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

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

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Commissioner of Taxation
21 July 2004

Previous draft:

Not previously issued in draft form

Related Rulings/Determinations:

TR 92/20

Subject references:

- ACA
- allocable cost amount
- consolidation
- cost base
- cost setting
- deferred tax assets
- income company
- loss company
- losses
- market value
- profits
- recouped losses
- reduced cost base
- retained profits
- step 1
- step 2
- step 3
- tax losses
- undistributed profits
- untaxed profits
- wholly-owned group
- wholly-owned subsidiary

Legislative references:

- TAA 1953 Pt IVAAA
- ITAA 1997 104-510
- ITAA 1997 Subdiv 170-C
- ITAA 1997 705-65(1)
- ITAA 1997 705-65(3)
- ITAA 1997 705-75(3)
- ITAA 1997 705-90
- ITAA 1997 705-90(2)
- ITAA 1997 705-90(3)
- ITAA 1997 705-90(6)(a)
- ITAA 1997 705-90(6)(b)

Other references:

- Explanatory Memorandum to the New Business Tax System (Consolidation) Act (No.1) 2002.

ATO references
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