TD 2004/52 - Income tax: consolidation tax cost setting rules: why are adjustments made under steps 3 and 4 of the allocable cost amount calculation in respect of the profits and losses of a joining entity that have accrued to the joined group?

Taxation Determination

Income tax: consolidation tax cost setting rules: why are adjustments made under steps 3 and 4 of the allocable cost amount calculation in respect of the profits and losses of a joining entity that have accrued to the joined group?

Preamble

The number, subject heading, date of effect and paragraphs 24 to 28 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.*

Background and Overview

1. The object of the tax cost setting rules is set out in section 705-10 of the *Income Tax Assessment Act 1997* (ITAA 1997). The costs of assets are aligned with the cost of membership interests by allocating the ACA to assets of the joining entity. Broadly, the ACA calculation starts with the cost of membership interests, adds the liabilities of the joining entity, then adds taxed profits that accrued to the joined group, and subtracts certain distributions, losses and inherited deductions (section 705-60 of the ITAA 1997 sets out each of the ACA steps and its particular purpose). Their overall purpose is to work out the real cost to the group of acquiring the joining entity's assets, and to allocate that cost over all of the joining entity's assets, so that when those assets are sold, the group will be taxed on the real economic gain it makes (or obtain relief for the real economic loss it makes). The rules aim at preventing double taxation of gains and duplication of losses made by the consolidated group in respect of its interests in a joining entity.

2. Certain undistributed profits are added at step 3 of the ACA, and certain distributed profits are subtracted at step 4 of the ACA. In this Determination, profits that accrued to the joined group before the joining time are described as 'owned profits'. Profits that did not accrue to the joined group before that time are described as 'acquired profits'. Similarly, losses for tax purposes that accrued to the joined group before the joining time are described as 'owned losses', and losses for tax purposes that did not accrue to the joined group before then are described as 'acquired losses'.

3. Undistributed, taxed, owned profits are added at step 3 of the ACA. The calculation of the amount added at step 3 of the ACA commences with (accounting) profits as determined under subsection 705-90(2). This amount is limited under subsection 705-90(3) by reference to the franking account. The subsection 705-90(3) amount operates as a cap when identifying the undistributed owned profits accrued to the joined

group to be counted 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.

4. Where undistributed owned profits have recouped owned losses, an adjustment is required under paragraph 705-90(6)(b) to ensure that the ACA is not overstated where owned losses are not subtracted at ACA step 5 because they have been used. Owned losses are subtracted at step 5 to prevent a double benefit arising through the cost setting process.

5. Distributions of owned profits that recouped owned losses are subtracted at step 4 of the ACA, under subparagraph 705-95(b)(ii). The purpose of this adjustment is similar to the step 3 adjustment under paragraph 705-90(6)(b). It is to prevent the ACA from reflecting an amount paid for membership interests in the joining entity that was later (but before that entity became a member of the joined group) lost and, following the recoupment of the loss, the profit that recouped the loss is distributed. In the absence of this adjustment the loss for income tax purposes would be reinstated in an unrealised form. See the discussion in paragraph 5.87 and the last paragraph of example 5.10 in the Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002.

6. The adjustments for owned profits recouping owned losses under steps 3 and 4 require working out whether accounting profits have recouped losses for income tax purposes. The word ‘recoup’ carries a connotation of replacing something that has been lost. It has been used to deal with the situation where the cost of membership interests in step 1 does not reflect subsequent losses borne by the group, but where no amount is subtracted at step 5. Where the profits that recouped the loss are undistributed, you do not count those profits at step 3. Where the profits that recouped the loss have been distributed, you subtract those profits at step 4. Both types of adjustments deal with the situation where the relevant loss is not subtracted at step 5 because the loss has been utilised.

7. Steps 3, 4 and 5 have a commonality in that they deal with ‘losses of any sort’. The phrase is defined in subsection 701-1(4) and encompasses, broadly, tax losses within Division 36 and certain other particular kinds of losses calculated under the *Income Tax Assessment Act* 1936 and ITAA 1997. Step 5 deals with losses that have not been utilised (in the sense that a deduction or other set-off has not been allowed in respect of them) but a loss is not to be taken into account under step 5 to the extent that it has reduced the undistributed profits comprising the step 3 amount. That is, where the loss has been deducted or otherwise set-off, it will have been considered in working out the step 3 amount [and that can only be under paragraph 705-90(6)(b)] so it cannot therefore be considered again under step 5.

Step 3

8. The reason for adding undistributed owned taxed profits is clear enough. Steps 1 and 2 are about working out the **cost** of acquiring the joining entity. Step 1 is about the amount actually paid and step 2 is about adding to that amount the amount of the joining entity’s liabilities. These are, speaking generally, the further amounts that will be required to be paid for the entity’s assets and which should therefore be reflected in the ACA as part of the **tax cost** of its assets.

9. After the acquisition time, but before the joining time, the joining entity may have made profits that remain undistributed. In essence, the worth of the joining entity will have been enhanced to this extent (leaving aside the amount of tax paid on those profits) and this worth will be reflected in new assets held by the joining entity. This value should be

reflected in the tax cost of those new assets. Presuming tax to have been paid on the undistributed profits, if there is not a reflection of this enhanced value in the ACA, the full amount of the sale proceeds of those assets in the future will be subjected to tax should they be subsequently disposed of. That is, the post-acquisition gains subsequently reflected in the joining entity's assets will be taxed twice. (In the same vein, of course, no ACA uplift would be warranted for retained profits that have not borne tax because they would otherwise be permanently sheltered from tax in the form of the proceeds of sale of the notionally acquired assets in which they have become reflected).

10. Looking at step 3 another way, the undistributed profits could otherwise have been distributed as they accrued. Had they been re-invested and hence become reflected in the assets of the joining entity, that (after-tax) amount would form part of the step 1 amount as a cost to the shareholder of its membership interests.

11. That step 3 is concerned with undistributed 'taxed profits' is the key point. Assume the distributed profits referred to above were untaxed and carried no franking credits. The recipient shareholder in the absence, now, of the inter-corporate dividend rebate would receive, in economic value, only the after-tax amount. That is, only the net amount would be available for re-investment and would therefore be reflected in the ACA at step 1. So too, step 3 is dealing with the net or taxed amount of profits accruing between acquisition time and joining time. It is the same economic value to the shareholder that is being dealt with. In both cases it is the after-tax amount that is to be added.

12. Conceptually, therefore, it is the need to reconcile whether tax has been paid on the undistributed profits or whether they have been sheltered by a tax loss that sits behind the adjustment required by paragraph 705-90(6)(b).

13. The starting point for step 3 is the undistributed profits of the joining entity at the joining time: subsection 705-90(2). This is an accounting concept and in essence is a **net** amount in the sense that it may be an amalgam of accounting profits and accounting losses for the various accounting periods prior to the joining time (including pre-acquisition accounting periods). That is to say, a prior year undistributed accounting profit will be reduced by a subsequent accounting loss and a prior year accounting loss will be recouped by a subsequent undistributed accounting profit, both impacting on the (net) amount of undistributed profits at the joining time.

14. Step 3, however, does not subsequently deal with **all** undistributed profits. Firstly, subsection 705-90(3) limits the amount of undistributed profits to be dealt with by a formula which notionally grosses up the franking account balance. This puts a ceiling on the amount of undistributed profits that can be subsequently dealt with. Paragraph 705-90(6)(a) then requires the subsection (2) amount to be apportioned between pre-acquisition undistributed profits and owned (or post-acquisition) profits. (The cost to the group of pre-acquisition profits will already have been recognised at step 1).

15. Having completed the calculation thus far, it is clear that the remaining amount is the amount of 'owned' undistributed profits. Put another way, the amount remaining after the subsection (2) and (3) and paragraph 705-90(6)(a) calculations is the amount of undistributed profits that have accrued to the consolidated group as limited by the formula that has regard to the available amount of franking credits.

16. In practical terms, the 6(a) amount should equal the amount of undistributed profits at the joining time less the amount of undistributed profits at the acquisition time (if any). There may, of course, be less profits at the joining time and the number may, arithmetically, be a negative number in which case there will not be any owned profits. But if there are owned profits they cannot be more than the amount calculated under subsection (3). Again in, practical terms, the calculation may be seen as a netting-off of

accounting profits and accounting losses (if any) over the various accounting periods from the acquisition time to the joining time to see what proportion of the undistributed profits have accrued during that period and which are therefore 'owned' profits.

17. (Note however that the ascertainment of the amount of undistributed profits for the purposes of the step 3 calculation has been the subject of an announcement by the then Minister for Revenue and the Assistant Treasurer, Senator the Hon. Helen Coonan, on 4 December 2003 that it is intended to change the law to allow pre-acquisition economic losses to be reinstated in the net figure).

18. Paragraph 705-90(6)(b) then introduces the requirement to exclude from the step 3 amount those undistributed owned profits that have 'recouped losses of any sort'. In other words, it is a direction to exclude profits that have, in effect, not been taxed. A profit can only 'recoup' a loss of any sort if it has been included as part of the assessable income against which the loss of any sort has been allowed as a deduction or otherwise set-off.

19. It has been said that a conceptual difficulty arises under paragraph 6(b) because it speaks in terms of undistributed profits, (an accounting concept embodying a netting, or running balance, reckoning) and the recoupment of tax losses, (a deduction or set-off against future assessable income). The two concepts can often sit comfortably, one within the other, but it is not necessarily always the case. For example, assume an accounting period and an income tax year are the same. Within an accounting profit for the period may be trading income and expenses that give rise to assessable income and allowable deductions for the same period, that coincide. But the taxable income may be less than the accounting profit. The reverse may also be true. Taxable income may be greater than the accounting profit (or loss). These mismatches can occur where, for example, accounting income that is recognised in a prior accounting period may not be recognised for tax purposes until a later year of income and vice versa. The same can be said of accounting expenses and allowable deductions.

20. The rules in steps 3 and 4 of the ACA combine both accounting and tax concepts. Strictly speaking, accounting profits do not recoup losses for income tax purposes. Under the income tax law, a tax loss is an allowable deduction against assessable income of a later year of income, and net capital losses are offset against net capital gains of a current or later year of income. On the other hand, the accounting framework requires that an accounting loss for a year reduces earlier retained profits (if any). That is, a running balance approach is adopted. This accounting treatment (that is, later accounting losses are absorbed by any earlier retained profits) must be applied in determining the subsection 705-90(2) and paragraph 705-90(6)(a) amounts.

21. In practical terms, then, it is possible that the undistributed owned profits referred to in paragraph (6)(a) can reflect the (accounting) expense generating the tax loss that will be offset in the tax assessment process in a later year and which (6)(b) requires to be counted again. This outcome arises because of the running balance nature of an undistributed profit. As such, the amount sought to be excluded by (6)(b) may otherwise have been reduced by a corresponding accounting expense for the purposes of determining the subsection (2) starting amount of undistributed profits.

Step 4

22. This step requires the subtraction of the sum of all distributions made by the joining entity before the joining time out of acquired profits or owned profits that recouped losses of any sort that accrued to the group before the joining time: section 705-95. It can be seen immediately that subparagraph 705-95(b)(ii) uses the same concept of owned profits recouping owned losses that is used in 705-90(6)(b).

23. The purpose of step 4 is to prevent the ACA reflecting the return of part of the amount paid to acquire the membership interests in the joining entity. For example, the cost to the group of the acquired profits will be reflected in the step 1 amount. If these are subsequently paid out prior to the joining time, the step 1 amount would be effectively overstated. An undistributed acquired profit may be reduced by a subsequent loss. A later profit effectively reinstates the earlier balance of undistributed profits. If the accounting loss gives rise to the loss of any sort referred to in 705-95(b)(ii) and assessable income is reflected in the accounting profit that recoups the earlier accounting loss, that profit will not have been taxed. If it is subsequently distributed before the joining time, in practical terms, it is the same as distributing an acquired profit. Accordingly, the ACA should be reduced to that extent.

Determination

24. As indicated above, 705-90(6)(b) and 705-95(b)(ii) employ similar wording to deal with the same concept of owned profits recouping owned losses. Relying on established approaches to statutory interpretation, they cannot be taken to mean different things in successive provisions that are so closely related to each other.

25. Moreover, Parliament must be presumed to have intended the effect of their plain words because, notwithstanding later amendments to 705-90 (in relation to franking credits) and 705-95, the substance of these parts of the two provisions was unchanged. And subsequent to their enactment, the *Income Tax (Transitional Provisions) Act 1997*, modifies step 3 and requires paragraph 705-90(6)(b) to be disregarded in certain circumstances. Absent those circumstances, the paragraph is not intended to be disregarded in step 3 and there is, therefore, no warrant for reading down the equivalent provision in step 4.

26. It should also be noted that unlike in step 5, there is no equivalent provision in step 3 or step 4 to subsection 705-100(2).

27. A paragraph 705-90(6)(b) reduction will also be required notwithstanding there may be franking credits within the joining entity that arose because acquired profits were taxed.

28. Finally, notwithstanding the policy behind the substitution of the existing section 705-90 made by the *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002) for the originally enacted provision in respect of the availability and use of franking credits is clear, [it is largely now achieved via subsection 705-90(3)], the re-enactment of paragraph 705-90(6)(b) in substantially the same words as the original reference to 'excluded profits' suggests that it was thought that there was an on-going need for the provision.

Date of effect

29. 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:

Not previously issued in draft form

Related Rulings/Determinations:

TR 92/20

Subject references:

- ACA
- accrued profits
- allocable cost amount
- consolidation
- step 3
- step 4
- step 5

Legislative references:

- TAA 1953 Pt IVAAA
- ITAA 1936
- ITAA 1997 Div 36
- ITAA 1997 701-1(4)
- 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(6)(a)
- ITAA 1997 705-90(6)(b)
- ITAA 1997 705-95
- ITAA 1997 705-95(b)(ii)
- ITAA 1997 705-100(2)
- IT(TP)A 1997
- New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002

Other references:

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

ATO references
NO: 2004/14978
ISSN: 1038-8982