TD 2004/53 - Income tax: consolidation tax cost setting rules: are distributions paid up a chain of entities sourced from profits in a lower-tier entity that did not accrue to the joined group added at step 3 of the entry allocable cost amount of the higher-tier entity?

This document has changed over time. This is a consolidated version of the ruling which was published on *16 August 2006*

Taxation Determination

Income tax: consolidation tax cost setting rules: are distributions paid up a chain of entities sourced from profits in a lower-tier entity that did not accrue to the joined group added at step 3 of the entry allocable cost amount of the higher-tier entity?

Preamble

*The number, subject heading, date of effect and paragraph 1 to paragraph 12 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.*

[Note: This is a consolidated version of this document. Refer to the Tax Office Legal Database (http://law.ato.gov.au) to check its currency and to view the details of all changes.]

1. No. A profit of a higher-tier entity in the group will not be held to have accrued to the group where it has arisen from a dividend paid by a lower-tier entity out of profits that did not accrue to the group. That is, the profits would not be within subsection 705-90(6) of the *Income Tax Assessment Act 1997* (ITAA 1997).

2. This determination will be relevant for calculating the step 3 amount of the entry allocable cost amount (ACA) for groups of entities forming a consolidated group (Subdivision 705-B), consolidated group acquired by another consolidated group (Subdivision 705-C) or multiple-linked entities joining a consolidated group at the same time (Subdivision 705-D).

3. The term 'profit accrued to the joined group before the joining time' is set out in subsection 705-90(7). This subsection states:

> A profit accrued to the joined group before the joining time if, on the following assumptions:
>
> (a) that it was distributed to holders of *membership interests as it accrued; and
>
> (b) that entities interposed between the *head company and the joining entity successively distributed any of it immediately after receiving it;
>
> it would have been received by the entity that is the head company at the joining time in respect of membership interests that it held continuously until that time either directly or indirectly through interposed entities. **[emphasis added]**

4. Steps 3, 5, 6 and 7 in working out the ACA use the concept of accrued rather than earned, so that amounts that are taken into account are by reference to the amount accruing over a period in which membership interests are held not just when the amount is

realised (see paragraph 1.43 of the Explanatory Memorandum to the New Business System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002 (June EM).

5. When determining whether the profit accrued could be distributed immediately **as it accrued** would require the taxpayer to effectively look through any lower level tiers to the entity that made the profit to test whether that profit would have accrued to the head company. Refer to Example 2 and Example 3 for the exception to the rule.

6. Subdivisions 705-B, 705-C and 705-D modify the provisions of the basic case in Subdivision 705-A. Broadly speaking, the policy intent of these subdivisions is to ensure that where on becoming subsidiary members, entities hold assets consisting of membership interests in other subsidiary members joining the group at the same time, the tax cost setting amount (TCSA) of each entity that becomes a subsidiary member, reflects the cost of the group of acquiring the entities.

7. Where membership interests are acquired indirectly, by acquiring the membership interest of an interposed subsidiary (or Division 149 was triggered after the profits were made),[1] the value of the profits made by the lower tier entity will be reflected in the amount paid by the group for the interposed entity, counted in step 1 of the ACA for that entity, and then pushed down to the lower-tier entity for its step 1 amount (subsection 705-145(2) and subsection 705-225(2)). The profits are effectively counted in the step 1 amount.

8. To add the amount at step 3 of the ACA would result in the profit being counted twice – first in the price paid for the membership interests reflecting the underlying assets of the higher-tier entity and then as accumulated retained earnings. This would be the case even if the profit had been distributed to the higher-tier entity after the group acquired the higher-tiered entity. The inflated ACA, when allocated to the assets, would not reflect the true cost to the group of acquiring the entity and would be contrary to the policy intent (see paragraph 4). An inflated TCSA may result in a capital loss or reduced capital gain where no economic loss was sustained.

9. Accordingly, to ensure this double counting does not occur, the profits are treated as retaining their character as acquired profits while being distributed up the chain of ownership.

10. Where the profits in question have been used to source a dividend paid all the way up the chain to the head company, they will be subtracted only once under step 4, at the level of direct interests held by the head company (see modification rules in sections 705-155 and 705-230). The lower ACA at this level is then pushed down the chain, to achieve the appropriate outcome at all levels. If this subtraction were not made, the step 1 amount would be overstated because it would count the cost of assets that are no longer in the chain of subsidiaries. This implies that in the absence of this modification rule, dividends out of profits that have not accrued to the group retain their character as they flow up the chain of entities, and would be subtracted at step 4 when working out the ACA for each subsidiary in the chain.

Exception

11. Where:

- the entity that made the profit does not join the group at the same time as the higher-tier entity; and

[1] Section 705-105 of the ITAA 1997 modifies what is meant in subsection 705-90(7) by membership interests that the head company holds continuously. Where Division 149 has applied to the membership interests, those membership interests are taken not to have been held prior to the application of Division 149.

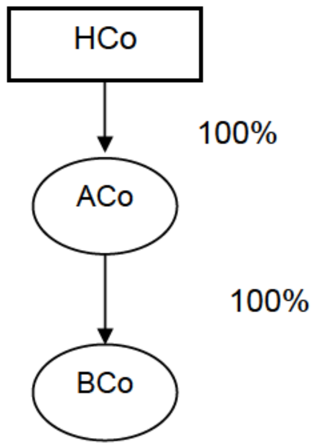
- it is not reasonably ascertainable by the Head company (HCo) that the profit as it accrued was reflected in the cost of the higher tier entities membership interests,

then the dividend may be treated as a profit that accrued to the group when working out step 3 of the ACA of the higher-tiered entity.

12. This exception is provided to reduce the cost of compliance.

Example 1

13. HCo acquires all of the membership interests in ACo on 1 July 2001 for $150,000. At that time ACo owns all of the membership interests in BCo which has accumulated profits (after tax) of $50,000. On 30 June 2002 BCo distributes the profit of $50,000 to ACo (fully franked divided). No further profits or losses accrue to either entity and on 1 July 2002 HCo, ACo and BCo form a consolidated group. The market values of ACo and BCo at the joining time are $150,000 and $100,000 respectively.



14. ACo's financial position at 1 July 2002 is shown in Table 1.

Table 1: ACo – Financial Position at 1 July 2002 ($)

Cash	50,000	Equity	100,000
Membership interest in BCo	100,000	Retained earnings (profit after tax)	50,000
	150,000		150,000

15. BCo's financial position at 1 July 2002 is shown in Table 2.

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

Cash	0	Equity	100,000
Asset 1 (market value 100,000)	100,000	Retained earnings	0
	100,000		100,000

16. ACo's ACA would be as follows:

Table 3: ACA calculation for ACo ($)

Step 1	Add cost of membership interests		150,000
Step 3	Add undistributed profits • subsection 705-90(2) undistributed profits: 50,000; • subsection 705-90(3) extent to which undistributed profits could be distributed franked: 50,000; and • subsection 705-90(6) extent to which undistributed profits accrued to the joined group: 0	0	
Step 8	ACA		150,000

17. In the above table the Step 3 amount is $0. The total undistributed profits, and the extent to which these profits could be distributed franked by ACo is $50,000. However the profits would not satisfy subsection 705-90(6) as they would not be profits that accrued to the joined group. HCo paid $150,000 for the membership interest of ACo (step 1) which reflects a value for the profits distributed to ACo by BCo.

18. The profits retain their character as acquired profits when they are distributed up the chain of ownership. This ensures that duplication does not occur.

19. The tax cost setting amount for ACo's retained cost base assets (cash) is $50,000. The balance of ACA is allocated to ACo's reset cost base asset (membership interests in BCo) of $100,000. There is no shortfall or excess of ACA.

20. BCo's ACA would be as follows:

Table 4: ACA calculation for BCo ($)

Step 1	Add cost of membership interests	100,000
Step 3	Add undistributed profits	0
Step 8	ACA	100,000

21. The step 1 amount is the TCSA for the membership interests in BCo, held by ACo. The TCSA becomes BCo's step 1 amount (section 705-145).

22. The total amount of the ACA is allocated to BCo's reset cost base asset (Asset 1) of $100,000. There is no shortfall or excess of ACA. If, for example, the profits were not distributed to ACo, the profits would not be counted at step 3 of the entry ACA calculation for BCo as the profits would not satisfy the requirements of subsection 705-90(6): *profit accruing to the joined group before the joining time*. The profits would be effectively represented in the TCSA ($150,000) for the membership interests in BCo held by ACo (the step 1 amount for BCo's ACA calculation). If the ACA for BCo is calculated the same result would be achieved for Asset 1.

Example 2

23. HCo acquires all of the membership interests in ACo on 1 July 2001 for $157,000. At that time ACo's sole assets were 100% of the membership interests in BCo, at a cost of $100,000. The assets of BCo consist of 80% of the membership interests in XCo at a cost of $80,000, and less than 2% of the shares in ZCo, a listed public company, at a cost of $20,000. At the time HCo acquires its interests in ACo, XCo has accumulated taxed profits of $70,000, and a total market value of $170,000. BCo's membership interests in XCo have a market value of $136,000. The market value of BCo's interest in ZCo had increased to $21,000.

24. During the year ended 30 June 2002, XCo paid a fully franked dividend of $56,000 to BCo from the previous year's profits, and ZCo paid a fully franked dividend of $500. It is not known whether ZCo's dividend was paid out of current or prior year profits. These dividends were used by BCo to fund a dividend of $56,500 to ACo. On 1 July 2002 HCo, ACo and BCo formed a consolidated group. ACo's financial position at 1 July 2002 is shown in Table 1.

Table 1: ACo – Statement of Financial Position at 1 July 2002 ($)			
Cash	56,500	Equity	100,000
Shares in BCo	100,000	Retained earnings	56,500
	156,500		156,500

25. BCo's financial position at 1 July 2002 is shown in Table 2.

Table 2: BCo – Statement of Financial Position at 1 July 2002			
Cash	0	Equity	100,000
Shares in XCo	80,000	Retained earnings	0
(market value 80,000)			
Shares in ZCo	20,000		
(market value 20,500)			
	100,000		100,000

26. ACo's ACA would be as follows:

Table 3: ACA calculation for ACo ($)

Step 1	Add cost of membership interests			157,000
Step 3	Add owned undistributed profits			
	• subsection 705-90(2) undistributed profits	56,500		
	• subsection 705-90(3) cap	56,500		
	• extent to which profits accrued to group (owned)	500	500	
				500

Step 8	ACA			157,500

27. In Table 3, the step 3 amount is $500. The total undistributed profits at the joining time under the accounting standards is $56,500. The cap under subsection 705-90(3) is $56,500. When applying subsection 705-90(6), you need to look through any lower tier entities to the entity that made the original profit to test whether that profit accrued before or after the head company acquired its indirect interests in that entity. It is reasonably ascertainable by HCo that $56,000 of the dividend was sourced in profits made by XCo before HCo acquired its indirect interests in XCo, and reflected in the cost of membership interests counted at step 1 for ACo. However, it is assumed that HCo could not reasonably ascertain that $500 of the dividend, ultimately sourced in the dividend from ZCo, was not paid out of profits that accrued after HCo acquired its indirect interests in that listed public company. Accordingly, HCo may rely on the exception rule in paragraph 11, and treat $500 of the dividends as representing profits that accrued to the group, and count them at step 3.

28. The tax cost setting amount for ACo's retained cost base assets (cash) is $56,500. The remainder of the ACA of $101,000 is allocated to ACo's reset cost base assets, the shares in BCo.

29. BCo's ACA would be as follows:

Table 4: ACA calculation for BCo ($)

Step 1	Add cost of membership interests (just worked out)			101,000
Step 8	ACA			101,000

30. The step 1 amount is the TCSA for the membership interests in BCo held by ACo: section 705-145.

31. The ACA is apportioned between BCo's reset cost base assets according to their market values. The TCSA for the shares in XCo will be $80,398, and the shares in ZCo will have a TCSA of $20,602. If these assets were sold immediately for their respective market values of $80,000 and $20,500 HCo would make CGT losses totalling $500. Although this represents a loss the group did not make, it is a result of the exception rule in paragraph 11.

Example 3: application of exception rule in ACA step 4 situations

32. The facts are the same as in Example 2, except that ACo uses the funds from the dividend received from BCo to pay a dividend of $56,500 to HCo just before the consolidated group is formed. ACo's financial position at 1 July 2002 is shown in Table 5.

Table 5: ACo – Statement of Financial Position at 1 July 2002 ($)			
Cash	0	Equity	100,000
Shares in BCo	100,000	Retained earnings	0
	100,000		100,000

33. BCo's financial position at 1 July 2002 is shown in Table 6.

Table 6: BCo – Statement of Financial Position at 1 July 2002			
Cash	0	Equity	100,000
Shares in XCo	80,000	Retained earnings	0
(market value 80,000)			
Shares in ZCo	20,000		
(market value 20,500)			
	100,000		100,000

34. ACo's ACA would be as follows:

Table 7: ACA calculation for ACo ($)

Step 1	Add cost of membership interests			157,000
Step 4	Subtract distributions of acquired profits		56,000	
	and: owned profits that recouped owned losses		0	56,000
Step 8	ACA			101,000

35. The distribution of $56,500 by ACo to HCo must be examined to determine whether it was made out of profits that did not accrue to the joined group. Where such profits are distributed to the head company, they are only subtracted at step 4 of the ACA of the entity making that distribution (section 705-155). It is reasonably ascertainable by HCo that $56,000 of the dividend was sourced in profits made by XCo before HCo acquired its indirect interests in XCo, and reflected in the cost of membership interests counted at step 1 for ACo. However, it is assumed that HCo could not reasonably ascertain that $500 of the dividend, ultimately sourced in the dividend from ZCo, was not paid out of profits that accrued after HCo acquired its indirect interests in that listed public company. Accordingly, HCo may rely on the exception rule in paragraph 11, and treat $500 of the dividends as representing profits that accrued to the group, and not subtract them at step 4. The ACA of $101,000 is allocated to ACo's reset cost base assets, the shares in BCo.

36. BCo's ACA would be as follows:

Table 4: ACA calculation for BCo ($)

Step 1	Add cost of membership interests (just worked out)			101,000
Step 8	ACA			101,000

37. The step 1 amount is the TCSA for the membership interests in BCo held by ACo: section 705-145.

38. The ACA is apportioned between BCo's reset cost base assets according to their market values. The TCSA for the shares in XCo will be $80,398, and the shares in ZCo will have a TCSA of $20,602. If these assets were sold immediately for their respective market values of $80,000 and $20,500 HCo would make CGT losses totalling $500. Although this represents a loss the group did not make, it is a result of the exception rule in paragraph 11.

Alternative view

39. An alternative view is that, in Example 1, the dividend received by ACo after ACo was acquired by HCo should be counted at step 3 of the ACA for ACo. The view is that the dividend received by the higher-tier subsidiary did not accrue to the group until that higher-tier subsidiary received the dividend. However, this interpretation is not consistent with the broad objects of the asset rules because the value of the assets now represented by the dividend in the hands of the higher-tier subsidiary will be counted already in step 1 as the cost of membership interests. If it is counted again at step 3 the amount would be counted twice.

Date of effect

40. 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).

Note: The Addendum to this Determination that issued on 16 August 2006 applies on and from 1 July 2002.

Commissioner of Taxation
27 October 2004

Previous draft:

TD 2004/D30

Related Rulings/Determinations:

TR 92/20

Subject references:

- ACA
- allocable cost amount
- consolidation
- cost setting
- forming
- higher tier entity
- interposed subsidiary entity
- lower tier entity
- multiple linked entities
- profits
- profits accrued
- retained earnings
- step 3
- tax cost setting amount
- undistributed profits

Legislative references:

- TAA 1953 Pt IVAAA
- ITAA 1997 Div 149
- ITAA 1997 Subdiv 705-A
- ITAA 1997 705-90(2)
- ITAA 1997 705-90(3)
- ITAA 1997 705-90(6)
- ITAA 1997 705-90(7)
- ITAA 1997 705-105
- ITAA 1997 Subdiv 705-B
- ITAA 1997 705-145
- ITAA 1997 705-145(2)
- ITAA 1997 705-155
- ITAA 1997 Subdiv 705-C
- ITAA 1997 Subdiv 705-D
- ITAA 1997 705-225(2)
- ITAA 1997 705-230

Other references:

- Explanatory Memorandum to the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002

ATO references
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