TD 2004/56 - Income tax: consolidation tax cost setting rules: step 3 of the allocable cost amount: how do you work out the paragraph 705-90(6)(b) of the Income Tax Assessment Act 1997 amount where only some of the undistributed profits of a year have recouped losses prior to the joining time?

Taxation Determination

Income tax: consolidation tax cost setting rules: step 3 of the allocable cost amount: how do you work out the paragraph 705-90(6)(b) of the *Income Tax Assessment Act 1997* amount where only some of the undistributed profits of a year have recouped losses prior to the joining time?

Preamble

The number, subject heading, date of effect and paragraph 1 to paragraph 5 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. 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 operates as a cap when identifying how much of the undistributed profits accrued to the group (owned profits) 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 a loss for income tax purposes that accrued to the group (owned loss).

2. Under paragraph 705-90(6)(b) of the ITAA 1997, owned profits which recouped owned losses are precluded from being added at Step 3 when working out the 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.

3. 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 Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002). That is, even if pre-1987 profits may have been taxed they are not added at step 3 to the extent to which they are represented in the undistributed profits under subsection 705-90(2).

4. In cases where only some of the owned profits in a year have recouped owned losses, this part of the profits will not have been taxed (untaxed profits). The part of the undistributed profits that did not recoup the owned tax loss will *prima facie* have been taxed. Where all of the paragraph 705-90(6)(a) amount reflects the amount of owned taxed

profits, it is assumed that it will not include any profits that are untaxed because they recouped owned tax losses.

5. The operation of paragraph 705-90(6)(b) in these situations is illustrated by the example below.

Example

6. On 1 July 2003, ACo is incorporated as a wholly owned subsidiary of HCo with an initial capitalisation of $100,000 (100 shares at $1,000 each). In its first year of operation, ACo makes a loss for income tax purposes of $50,000. ACo makes an accounting loss of $35,000 (after creation of a deferred tax asset of $15,000 in respect of the tax loss). In the year ending 30 June 2005 ACo has an assessable income of $200,000. ACo's taxable income is reduced to $150,000 after deducting the tax loss of $50,000. ACo, therefore pays $45,000 tax. ACo's profits for this year are $140,000 (after reversing for the DTA and paying income tax). On 1 July 2005 HCo and ACo consolidate. At the joining time ACo's market value is $250,000.

7. 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
	205,000		205,000

8. The ACA would be as follows:

Table 2: ACA calculation for ACo ($)

Step 1	Add cost of membership interests		100,000
Step 3	Add undistributed profits		
	• subsection 705-90(2) undistributed profits: 105,000;		
	• subsection 705-90(3) limit: 105,000; and		
	• paragraph 705-90(6)(a) extent to which subsection 705-90(3) amount includes profits accrued to joined group: 105,000	105,000	
	LESS		
	• 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)	(0)	105,000
Step 8	ACA		205,000

9. In Table 2 the Step 3 amount is $105,000. Total income in Year 2 was $200,000, all of which was reflected in current year profits of $140,000 that accrued to the group. After applying the formula under subsection 705-90(3), the maximum retained earnings that can be considered for step 3 of the ACA would be $105,000. Therefore, the total of the retained earnings satisfies paragraph 705-90(6)(a). As the paragraph 705-90(6)(a) amount does not exceed this amount, it is assumed that none of the paragraph 705-90(6)(a) amount recouped owned tax losses.

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

Date of effect

11. 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/D33

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 705-90(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) Bill (No. 1) 2002

ATO references

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