TD 2004/59 - Income tax: consolidation tax cost setting rules: how do you work out the amount subtracted at step 5 of the allocable cost amount where the loss taken into account under subsection 705-100(1) of the Income Tax Assessment Act 1997 has also reduced the step 3 amount?

Taxation Determination

Income tax: consolidation tax cost setting rules: how do you work out the amount subtracted at step 5 of the allocable cost amount where the loss taken into account under subsection 705-100(1) of the *Income Tax Assessment Act 1997* has also reduced the step 3 amount?

Preamble

The number, subject heading, date of effect and paragraph 1 to paragraph 3 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. Subsection 705-100(2) of the *Income Tax Assessment Act 1997* (ITAA 1997) excludes from the step 5 amount of the allocable cost amount (ACA) certain losses to the extent they reduced the undistributed profits comprising the step 3 amount in the table in section 705-60 (working out the joined group's ACA for the joining entity).

2. The purpose of subsection 705-100(2) is to prevent double counting. To the extent that an unused loss for income tax purposes is reflected in an accounting loss that has reduced the amount that would otherwise be added at Step 3 of the ACA, the loss will not also be subtracted at Step 5 of the ACA.

3. Of course, double counting will only occur where losses for income tax purposes have actually caused a reduction in the step 3 amount from what it would otherwise be. In working out the relevant amount, take into account the extent to which accounting expenditure also gave rise to tax losses and any deferred tax assets that may have been created as a result of any tax losses.

Example 1

4. On 1 July 2002 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 an after tax profit of $70,000. In the second year A Co incurs $100,000 expenditure on research and development (R&D). The corresponding tax deduction for R&D was $125,000, resulting in the tax loss of $125,000. The accounting loss was

$62,500 (after creation of a deferred tax asset (DTA) of $37,500) in respect of the tax loss). On 1 July 2004 HCo and ACo consolidate. At the joining time ACo's market value was $107,000.

5. ACo's financial position at 1 July 2004 is shown in Table 1.

Table 1: ACo -– Financial Position at 1 July 2004 ($)

Cash	70,000	Equity	100,000
DTA (re loss)	37,500	Retained earnings	7,500
	107,500		107,500

6. 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: 7,500;		
	• subsection 705-90(3) limit: 7,500; and		
	• subsection 705-90(6) extent to which the subsection 705-90(3) amount includes profits accrued to joined group: 7,500	7,500	
			7,500
Step 5	Less losses accrued to joined group		
	• subsection 705-100(1) losses for income tax purposes accrued to the joined group and unused at the joining time: 125,000	125,000	
	Exclude		
	• subsection 705-100(2) any losses to the extent they reduced the step 3 amount: 62,500	(62,500)	(62,500)
Step 8	ACA		45,000

7. In Table 2 the Step 3 amount is $7,500. Total taxed profits accrued to the joined group in the first year were $70,000 (the accounting profit was $100,000 all of which was taxable). In the second year there was $100,000 R&D expenditure and a DTA of $37,500 was created in respect of the tax loss of $125,000. This resulted in a net loss of $62,500 reducing the retained earnings balance to $7,500. The step 3 amount has therefore been reduced by an accounting loss of $62,500.

8. The following summary illustrates the relevant amounts:

	30/6/03	30/6/04	Tax paid	totals
Retained profits balance at 30 June	70,000	7,500		
Accounting profit (loss)				
Taxed	70,000		30,000	
Untaxed	0			
	70,000	(62,500)		
Less:				
Amount absorbed by subsequent year loss	(62,500)			
Balance				
Taxed	7,500			7,500
Untaxed	0			
	7,500			7,500
Covered by s.705-90(3) limit				
Taxed	7,500			7,500
Untaxed	0			0
	7,500			7,500

9. The Step 5 amount in Table 2 is $62,500. The total unused losses for income tax purposes that accrued to the joined group before the joining time were $125,000. As can be seen above, the accounting expenditure for R&D of $100,000 contributed to the accounting loss of $62,500. The common element that contributed to both an accounting and tax loss is therefore the $100,000 actual expenditure on R&D. However, the maximum amount that the tax loss can be reflected in the accounting loss is $62,500. This amount is further limited to the extent that the tax loss contributed to a reduced undistributed profit amount (retained earnings). The common element net of any DTA created in respect of tax losses results in a common loss (that is, the extent the accounting loss reflects a tax loss) of $62,500 ($100,000 - $37,500). The amount excluded from the Step 5 amount by subsection 705-100(2) is therefore $62,500.

10. The tax cost setting amount of the retained cost base assets (cash) is $70,000. As the retained cost base assets exceed the ACA there is a shortfall in the ACA of $25,000. This will be taxed as a capital gain under section 104-510 (CGT event L3). The joined group will be taxed on $25,000, because the purpose of step 3 of the ACA calculation is to give credit in the ACA only for taxed undistributed profits accrued to the joined group.

Example 2

11. HCo incorporates BCo with $100,000 on 1 July, 2002. In its first year of operation, BCo makes an after tax profit of $105,000. In the second year BCo makes a tax loss of $62,500 resulting from R&D tax deduction. In that same year BCo, in addition to its actual R&D expenditure ($50,000) makes a provision for long service leave (LSL) of $10,000 (which is not tax deductible). This resulted in an accounting loss of $38,250 (after the creation of DTA in respect of the tax losses and LSL), and a retained earnings balance of $66,750. On 1 July 2004 HCo and BCo consolidate.

12. BCo's financial position at 1 July 2004 is shown in Table 3.

Table 3: BCo – Financial Position at 1 July 2004 ($)

Cash	155,000	Equity	100,000
DTA (re loss)	18,750	Retained earnings	66,750
DTA (re LSL)	3,000	Provision for LSL	10,000
	176,750		176,750

13. BCo's First ACA would be as follows:

Table 4: FIRST ACA calculation for BCo ($)

Step 1	Add cost of membership interests		100,000
Step 2	Add liabilities		
	• subsection 705-70(1) accounting liability: 10,000 Prov LSL	10,000	
	Reduction		
	• section 705-75(1) reduction for future deduction: $3,000 (10,000 × 30%)	(3,000)	7,000
Step 3	Add undistributed profits		
	• subsection 705-90(2) undistributed profits: 66,750;		
	• subsection 705-90(3) limit: 66,750; and		
	• subsection 705-90(6) extent to which subsection 705-90(3) amount includes profits accrued to joined group: 66,750	66,750	
			66,750
Step 5	Less losses accrued to joined group		
	• subsection 705-100(1) losses for income tax purposes accrued to the joined group and unused at the joining time: 62,500	62,500	

	Exclude		
	• subsection 705-100(2) losses to the extent they reduced the step 3 amount: 31,250	(31,250)	(31,250)
Step 8	ACA		142,500

14. In Table 4 the Step 3 amount is $66,750. Total taxed profits accrued to the group in the first year were $105,000 (the accounting profit was $150,000 all of which was taxable). In the second year there were tax losses of $62,500, giving rise to a DTA in recognition of the future tax benefit of $18,750 which is reflected in the retained profits of BCo. The retained profits also reflect a DTA in respect of the accounting deduction for the provision for LSL of $3,000. The retained earnings balance was $66,750 [$105,000 - $50,000 R&D expense – $10,000 Provision for LSL + DTA ($18,750 loss + $3,000 LSL)]. The step 3 amount is therefore less than it otherwise would have been by an accounting loss of $38,250 ($105,000 - $66,750).

	30/6/03	**30/6/04**	**Tax paid**	**totals**
Retained profits balance at 30 June	105,000	66,750		
Accounting profit (loss)				
Taxed	105,000		45,000	
Untaxed	0			
	105,000	(38,250)		66,750
Less:				
Amount absorbed by subsequent year loss	(38,250)			
Balance				
Taxed	66,750			66,750
Untaxed	0			
	66,750			66,750
Covered by s.705-90(3) limit				
Taxed	66,750			66,750
Untaxed	0			0
	66,750			66,750

15. The Step 5 amount in Table 4 is $31,250. The total losses for income tax purposes that had not been utilised by the joining entity and accrued to the joined group before the joining time were $62,500. The accounting loss is $38,250. The common element that contributed to both the accounting and tax loss is the $50,000 R&D expenditure for which there was also a tax deduction. However, the maximum amount that the tax loss can be reflected in the accounting loss is $38,250. This amount is further limited to the extent that the tax loss has actually contributed to a reduced undistributed profit amount (retained earnings). That is, the common element, net of any DTA created in respect of tax losses, results in a common loss of $31,250 ($50,000 - $18,750). The extent to which the step 3 amount of the ACA was reduced by a tax loss that is also reflected by an accounting loss is $31,250 and is therefore the amount that is excluded from the step 5 amount under subsection 705-100(2).

16. As there is a timing difference between income tax provisions and accounting standards in recognising a liability, a notional ACA calculation is required (section 705-80 of the ITAA 1997). The notional ACA is calculated by assuming the liability had been taken into account for income tax purposes at the same time as it is taken into account for accounting purposes. This may in turn require a notional reconstruction of the joining entity's accounting and tax positions for the years in which the liability arose in order to align them.

17. Under a reconstruction in this example, there is a variation at step 5 of the ACA calculation. If there was a tax deduction for the provision for LSL, the loss for tax purposes would increase from $62,500 to $72,500. There would be no DTA in respect of the LSL but the DTA in respect of the loss would increase to $21,750.

18. Note that this variation is only for the purposes of the calculation required by section 705-80. For a full discussion of section 705-80 and the administrative shortcut where insufficient information is available for an accurate reconstruction, refer to the *Consolidation Reference Manual*, Technical Folder, C2-4-245.

19. The notional ACA is then compared with the first ACA which was calculated without applying section 705-80. If:

Notional ACA < first ACA: reduce the step 2 amount by the difference;

Notional ACA > first ACA: increase the step 2 amount by the difference; or

Notional ACA = first ACA: no adjustment to step 2 amount is required.

20. The amounts calculated at each step of the first ACA calculation, other than the step 2 amount, will remain the relevant amounts for the final ACA calculation.

21. BCo's notional financial position at 1 July 2004 is shown in Table 5.

Table 5: BCo – NOTIONAL Financial Position at 1 July 2004 (section 705-80)

Cash	155,000	Equity	100,000
DTA (re loss)	21,750	Retained earnings	66,750
DTA (re LSL)	0	Provision for LSL	10,000
	176,750		176,750

22. The BCo's Notional ACA would be as follows:

Table 6: NOTIONAL ACA calculation for BCo ($) (section 705-80)

Step 1	Add cost of membership interests		100,000
Step 2	Add liabilities		
	• subsection 705-70(1) accounting liability: 10,000 Prov LSL	10,000	
	Reduction		
	• section 705-75(1) reduction for future deduction: 0	(0)	10,000
Step 3	Add undistributed profits		
	• subsection 705-90(2) undistributed profits: 66,750;		
	• subsection 705-90(3) limit: 66,750; and		
	• subsection 705-90(6) extent undistributed profits accrued to joined group: 66,750	66,750	
			66,750
Step 5	Less losses accrued to joined group		
	• subsection 705-100(1) losses for income tax purposes accrued to the group and unused at the joining time: 72,500	72,500	
	Exclude		
	• subsection 705-100(2) losses to the extent they reduced the step 3 amount: 38,250	(38,250)	(34,250)
Step 8	ACA		142,500

23. The Step 5 amount in the above table is $34,250. The total losses for income tax purposes accruing to the joined group under this notional calculation were $72,500. The common elements that contributed to both the accounting and tax loss were the $50,000 actual expenditure on R&D and $10,000 provision for LSL. Although the common elements totalled $60,000, these common elements are only reflected in the retained earnings figure net of any DTA created in respect of any tax loss. That is $38,250 ($60,000 - $21,750). The retained earnings were lower by an accounting loss (refer to discussion at paragraph 14) of $38,250. The extent to which the tax loss has reduced the step 3 amount is, therefore, $38,250.

24. The notional ACA is equal to the first ACA. There is no requirement under section 705-80 to make an adjustment to the liability under subsection 705-75(1). The first ACA is the final ACA for the liability amount at step 2.

25. BCo's Final ACA would be as follows:

Table 7: FINAL ACA calculation for BCo ($)

Step 1	Add cost of membership interests		100,000
Step 2	Add liabilities		
	• subsection 705-70(1) accounting liability: 10,000 Prov LSL	10,000	
	Reduction		
	• section 705-75(1) reduction for future deduction: 3,000 (10,000 × 30%)	(3,000)	
	Increase (decrease)		
	• subsection 705-80 adjustment for unrealised gains and losses: (0)	(0)	7,000
Step 3	Add undistributed profits		
	• subsection 705-90(2) undistributed profits: 66,750;		
	• subsection 705-90(3) limit: 66,750; and		
	• subsection 705-90(6) extent to which subsection 705-90(3) amount includes profits accrued to joined group: 66,750	66,750	
			66,750
Step 5	Less losses accrued to joined group		
	• subsection 705-100(1) losses for income tax purposes accrued to joined group and unused at the joining time: 62,500	62,500	
	Exclude		
	• Subsection 705-100(2) losses to the extent they reduced the step 3 amount: 31,250	(31,250)	(31,250)
Step 8	ACA		142,500

26. The TCSA for the retained cost base assets (cash) is $155,000. As the retained cost base asset exceed the ACA there is a shortfall in the ACA of $12,500. The $12,500 shortfall in the ACA will be taxed as a capital gain under section 104-510 (CGT event L3) of the ITAA1997.

Date of effect

27. 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/D36

Related Rulings/Determinations:

TR 92/20

Subject references:

- ACA
- accounting loss
- allocable cost amount
- consolidation
- cost setting
- deferred tax asset
- economic loss
- loss
- profits
- retained profits
- step 3
- step 5
- tax cost setting amount
- tax loss
- undistributed profits

Legislative references:

- TAA 1953 Pt IVAAA
- ITAA 1997 104-510
- ITAA 1997 705-60
- ITAA 1997 705-70(1)
- ITAA 1997 705-75(1)
- ITAA 1997 705-80
- ITAA 1997 705-90(2)
- ITAA 1997 705-90(3)
- ITAA 1997 705-90(6)
- ITAA 1997 705-100(1)
- ITAA 1997 705-100(2)

Other references:

- Consolidation Reference Manual, Technical Folder, C2-4-245

ATO references
NO: 2004/9760
ISSN: 1038-8982