TD 2004/D30 - 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 (ACA) of the higher-tier entity?

Draft 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 (ACA) of the higher-tier entity?

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. 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 fail paragraph 705-90(6)(a) 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'.

4. Subdivisions 705-B, 705-C and 705-D modify the provisions of the basic case in subdivision 705-A. The policy intent as expressed in the objects clauses of these three 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.

5. 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 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.

6. It would be incorrect to add at step 3 of the ACA profits that are reflected in the step 1 amount. To add the amount at step 3 of the ACA would result in the profit being counted twice. Once in the price paid for the membership interests reflecting the underlying assets of the higher-tier entity and then again 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 above). An inflated TCSA may result in a capital loss or reduced capital gain where no economic loss was sustained.

7. 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.

8. 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.

Example:

9. HCo acquires all of the membership interests in ACo on 1 July 2001 for $150,000.00. At that time ACo owns all of the membership interests in BCo which has accumulated profits (after tax) of $50,000.00. On 30 June 2002 BCo distributes the profit of $50,000.00 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.

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

[1] Section 705-105 of the ITAA 1997 explains what is meant by the expression `membership interests that the head company held 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.

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

11. 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

12. 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		
	• paragraph 705-90(6)(a) extent undistributed profits accrued to joined group: 0	0	
	LESS		
	• paragraph 705-90(6)(b) extent of the undistributed profits accrued to joined group that recouped losses accrued to group: (0)	(0)	0
Step 8	ACA		150,000

13. 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 $50,000.00. However the profits would fail paragraph 705-90(6)(a) as they would not be profits that accrued to the joined group. If you were to add the profits here at step 3 you would be counting the profits again. HCo paid $150,000.00 for the membership interest of ACo (step 1) which reflects a value for the profits distributed to it by BCo.

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

15. The tax cost setting amount for ACo's retained cost base assets (cash) is $50,000.00. The balance of ACA is allocated to ACo's reset cost base asset (membership interests in BCo) of $100,000.00. There is no shortfall or excess of ACA.

16. 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

17. 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).

18. The total amount of the ACA is allocated to BCo's reset cost base asset (Asset 1) of $100,000.00. 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)(a): *profit accruing to the joined group before the joining time*. The profits would be effectively represented in the TCSA of ($150,000.00) 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.

Alternative view

19. An alternative view is that, in this example, 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. We think, however, that 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 profits would be duplicated.

Date of Effect

20. 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

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

Due date: **20 August 2004**

Contact officer: **Sophia Savva**

E-mail address: **Sophia.Savva@ato.gov.au**

Telephone: **(02) 9374 1693**

Facsimile: **(02) 9374 1629**

Address: **12-22 Woniora Road Hurstville NSW 2220**

Commissioner of Taxation
21 July 2004

Previous draft:

Not previously issued in draft form

Related Rulings/Determinations:

TR 92/20

Subject references:

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

Legislative references:

- TAA 1953 Part IVAAA
- ITAA 1997 Div 149
- ITAA 1997 Subdiv 705-A
- 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 705-90(7)
- ITAA 1997 Subdiv 705-B
- 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

ATO references

NO: 2004/9630
ISSN: 1038-8982