TD 2004/D34 - Income tax: consolidation tax cost setting rules: will an amount be subtracted under step 4 of the allocable cost amount under subparagraph 705-95(b)(ii) of the Income Tax Assessment Act 1997 where there has been a distribution of profits accrued to the joined group that recouped losses accrued to the group?

Draft Taxation Determination

Income tax: consolidation tax cost setting rules: will an amount be subtracted under step 4 of the allocable cost amount under subparagraph 705-95(b)(ii) of the *Income Tax Assessment Act 1997* where there has been a distribution of profits accrued to the joined group that recouped losses accrued to the group?

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. Yes. The allocable cost amount (ACA) determines the aggregate of the reset cost for assets for an entity joining a consolidated group. This amount is intended to reflect the cost to the joined group of acquiring the joining entity. See paragraph 5.54 of the Explanatory Memorandum to the *New Business Tax System (Consolidation) Act 2002* (the May EM). Under subparagraph 705-95(b)(ii) of the *Income Tax Assessment Act 1997* (ITAA 1997), distributions of profits that accrued to the joined group which recouped losses that accrued to the group before the joining time are subtracted at Step 4 when working out the ACA. The purpose of this adjustment is to prevent the reset costs for a joining entity's assets reflecting an amount paid for the membership interests in the entity that was later lost. In the absence of this adjustment the loss for income tax purposes would effectively be reinstated. See paragraph 5.87 (and the last paragraph of Example 5.10) of the May EM.

Example 1 – payment of an unfranked interim dividend

2. On 1 July 2005 Beta Co is incorporated as a wholly-owned subsidiary of HCo for $100,000.00. In the year ended 30 June 2006 Beta Co made a tax loss of $50,000.00. Beta Co made an accounting loss of $35,000.00 (after creation of a deferred tax asset (DTA) of $15,000.00 in respect of the tax loss). In the year ended 30 June 2007 Beta Co made an accounting profit of $35,000.00 (after reversing the DTA). Assessable income was $50,000.00 and, after recouping the tax loss, the taxable income was $nil. Beta Co

paid the 2006-2007 profits as an unfranked interim dividend on 30 June 2007. HCo then elects to form a consolidated group.

3. Beta Co's statement of financial position is as follows:

Table 1: Beta Co – Financial Position at 1 July 2007 ($)

Cash	65,000	Equity	100,000
		Retained earnings (Loss)	(35,000)
	65,000		65,000

4. Beta Co's ACA would be as follows:

Table 2: ACA calculation for Beta Co ($)

Step 1	Add cost of membership interests			100,000
Step 4	Less Pre-joining time distributions out of certain profits			
	• Subparagraph 705-95(b)(i) distributions of acquired profits: 0;	0		
	and			
	• subparagraph 705-95(b)(ii) distributions of profits accrued to joined group that recouped losses accrued to the group: 35,000		35,000	(35,000)
Step 8	ACA			65,000

5. In the above table the step 4 amount is $35,000.00. All of the profits were untaxed as they recouped the prior year tax loss. By subtracting the distribution of profits that accrued to the joined group of $35,000.00 at step 4, the ACA does not effectively reinstate the tax loss.

6. The tax cost setting amount for the retained cost base assets (that is, cash) is $65,000.00.

7. There is no shortfall or excess of ACA.

Example 2 – payment of a fully franked interim dividend

8. Gamma Co is incorporated on 1 July 2006 as a wholly-owned subsidiary of HCo for $100,000.00. In the year ended 30 June 2007 Gamma Co made an after tax profit of $70,000.00. In the year ended 30 June 2008 Gamma Co made a tax loss of $100,000.00. Gamma made an accounting loss of $70,000.00 (after creation of a DTA of $30,000.00 in respect of the tax loss). The balance of retained earnings at 30 June 2008 was $0. During the year ended 30 June 2009 Gamma Co made an accounting profit of $70,000.00 (after reversing for the DTA). Gamma Co's assessable income was $100,000.00 and, after recouping the tax loss, the taxable income was $nil. Gamma Co paid the 2008-2009 profits as a fully franked interim dividend on 30 June 2009. HCo then elects to form a consolidated group.

9. Gamma Co's statement of financial position is as follows:

Table 3: Gamma Co – Financial Position at 1 July 2009 ($)

Cash	100,000	Equity	100,000
		Retained earnings	0
	100,000		100,000

10. Gamma Co's ACA would be as follows:

Table 4: ACA calculation for Gamma Co

Step 1	Add cost of membership interests		100,000
Step 4	Less Pre-joining time distributions out of certain profits • Subparagraph 705-95(b)(i) distributions of acquired profits: 0; and • subparagraph 705-95(b)(ii) distributions of profits accrued to joined group that recouped losses accrued to the group: 70,000	70,000	(70,000)
Step 8	ACA		30,000

11. In Table 4 above the step 4 amount is $70,000.00. All of the profits were untaxed as they recouped prior year tax losses. The retained cost base assets (that is, cash) exceed the ACA by $70,000.00. The shortfall in ACA will be taxed as a capital gain under section 104-510 (CGT event L3) of the ITAA 1997.

Example 3

12. The facts are the same as in example two with the exception that the dividend had not been paid.

13. Gamma Co's statement of financial position is as follows:

Table 5: Gamma Co – Financial Position at 1 July 2009 (no dividend)($)

Cash	170,000	Equity	100,000
		Retained earnings	70,000
	170,000		170,000

14. Gamma Co's ACA is as follows:

Table 6: ACA calculation for Gamma Co ($)

Step 1	Add cost of membership interests		100,000
Step 3	Add undistributed profits		
	• subsection 705-90(2) undistributed profits: 70,000;		
	• subsection 705-90(3) limit, representing taxed undistributed profits: 70,000; and		
	• paragraph 705-90(6)(a) extent to which the subsection 705-90(3) amount includes profits accrued to joined group: 70,000	70,000	
	LESS		
	• paragraph 705-90(6)(b) extent to which subsection 705-90(6)(a) amount includes profits that accrued to joined group that recouped losses that accrued to group: (70,000)	(70,000)	0
Step 8	ACA		100,000

15. In Table 6 above the step 3 amount is $nil. All of the profits were untaxed as they recouped prior year tax losses.

16. The following summary illustrates the relevant amounts:

	30/6/07	**30/6/08**	**30/6/09**	**Tax paid**	**totals**
Retained profits balance at 30 June	70,000	0	70,000		
Accounting profit (loss)					
• taxed	70,000		0	30,000	
• untaxed	0		70,000		
	70,000	(70,000)	70,000		
Less: Amount absorbed by subsequent year loss	(70,000)				
Balance					
• taxed	0		0		0
• untaxed	0		70,000		70,000
	0		70,000		70,000
Covered by s.705-90(3) limit					
• taxed	0		0		
• untaxed	0		70,000		70,000
	0		70,000		70,000

17. The retained cost base assets (that is, cash) exceed the ACA by $70,000.00. The shortfall in ACA will be taxed as a capital gain under section 104-510 (CGT event L3) of the ITAA1997. This is the same outcome as in example 2 above.

Date of Effect

18. 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

19. 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:

- ACA
- acquired profits
- allocable cost amount
- consolidation
- cost setting
- losses
- recouped losses
- step 4
- tax cost setting amount

Legislative references:

- TAA 1953 Pt IVAAA
- ITAA 1997 104-510
- 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(b)(i)
- ITAA 1997 705-95(b)(ii)

Other references:

- Explanatory Memorandum to the New Business Tax System (Consolidation) Act 2002

ATO references
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