TD 2004/58 - Income tax: consolidation tax cost setting rules: should distributions of profits accrued to the joined group that recoup losses accrued to the group be counted when determining the step 4 amount of the allocable cost amount on formation of a transitional consolidated group?

Taxation Determination

Income tax: consolidation tax cost setting rules: should distributions of profits accrued to the joined group that recoup losses accrued to the group be counted when determining the step 4 amount of the allocable cost amount on formation of a transitional consolidated group?

Preamble

The number, subject heading, date of effect and paragraph 1 to paragraph 2 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. Yes. Where a joining entity makes a distribution prior to the joining time out of profits that accrued to the joined group, and those profits recouped losses for income tax purposes that accrued to the joined group, the distribution is subtracted at step 4 of the allocable cost amount (ACA) under subparagraph 705-95(b)(ii) of the *Income Tax Assessment Act 1997* (ITAA 1997). This is not changed if the group is a transitional consolidated group.

2. The purpose of step 4 is to prevent the ACA reflecting a return of part of the amount paid to acquire the membership interests in the joining entity (step 4 column 2 in the table in section 705-60). In particular, subparagraph 705-95(b)(ii) prevents the ACA reflecting an amount paid for membership interests in the joining entity that was later (but before it became a member of the joined group) lost and, following the recoupment of the loss, the profit that recouped the loss was distributed.

Example 1

3. On 1 July 2001, 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 tax loss of $50,000. ACo makes an accounting loss of $35,000 (after creation of a deferred tax asset (DTA) of $15,000 in respect of the tax loss). In the second year of operation ACo has an accounting profit of $35,000 (after reversing for the DTA). The assessable income of $50,000 recouped the tax loss carried forward from the first year. The taxable income (loss) is therefore $nil. ACo paid the profits as an unfranked interim dividend on 30 June 2003. On 1 July 2003 HCo and ACo consolidate. At the joining time ACo's market value was $65,000.

4. ACo's financial position at 1 July 2003 is shown in Table 1.

Table 1: ACo – Financial Position at 1 July 2003 ($)

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

5. The ACA would be as follows:

Table 2: ACA calculation for A Co ($)

Step 1	Add cost of membership interests		100,000
Step 3	Add undistributed profits		0
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 the joined group that recouped losses accrued to the group: 35,000	35,000	(35,000)
Step 8	ACA		65,000

6. In the above table, the Step 4 amount is $35,000. 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 at step 4, the ACA does not effectively reinstate the tax loss.

7. The ACA of $65,000 will be allocated to the retained cost base asset (that is, cash). There is no shortfall or excess of ACA.

Example 2

8. Assume the same facts as above, but in this example the retained earnings balance is $nil because there was no distribution by ACo of current year profits.

9. ACo's financial position at 1 July 2003 is shown in Table 3.

Table 3: ACo – Financial Position at 1 July 2003 ($)

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

10. The ACA would be as follows:

Table 4: ACA calculation for A Co ($)

Step 1	Add cost of membership interests	100,000
Step 4	Less Pre-joining time distributions out of certain profits	(0)
Step 8	ACA	100,000

11. The ACA of $100,000 will be allocated to the retained cost base asset (that is, cash). There is no shortfall or excess of ACA.

Date of effect

12. 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/D35

Related Rulings/Determinations:
TR 92/20

Subject references:
- ACA
- acquired profits
- allocable cost amount
- consolidation
- cost setting
- losses
- profits
- recouped losses
- step 4
- tax cost setting amount
- transitional consolidated group

Legislative references:
- TAA 1953 Pt IVAAA
- ITAA 1997 705-60
- ITAA 1997 705-95(b)(i)
- ITAA 1997 705-95(b)(ii)

ATO references
NO: 2004/9704
ISSN: 1038-8982