TD 2004/62 - Income tax: consolidation tax cost setting rules: how does subsection 701-30(2) of the Income Tax (Transitional Provisions) Act 1997 modify the step 3 amount under section 705-90 of the Income Tax Assessment Act 1997 ?

Taxation Determination

Income tax: consolidation tax cost setting rules: how does subsection 701-30(2) of the *Income Tax (Transitional Provisions) Act 1997* modify the step 3 amount under section 705-90 of the *Income Tax Assessment Act 1997*?

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. The purpose of step 3 is to increase the allocable cost amount (ACA) to reflect the undistributed, (owned) taxed profits and so prevent double taxation (see step 3 in the table to section 705-60). When working out the amount added at step 3 of the 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 under subsection 705-90(6). Once this amount is determined, the excess of undistributed profits should then be considered under the transitional provisions.

2. Section 701-30 of the *Income Tax (Transitional Provisions) Act 1997* [IT(TP)A 1997] is a transitional rule that modifies the operation of step 3 under section 705-90 of the ITAA 1997 for transitional groups formed during the period from 1 July 2002 to the time specified in subsection (1). This transitional rule allows for the step 3 amount under section 705-90 to be increased by so much of the undistributed profits (retained profits) that were limited by the operation of subsections 705-90(3) and (4). These subsections effectively limit the undistributed, owned profits to those that are 'taxed'. The additional amounts (if any) that are added under this transitional rule represent 'untaxed' amounts in the undistributed profits.

3. The additional amounts added at step 3 in the ACA calculation are, however, limited by paragraph 701-30(2)(b) IT(TP)A 1997 to so much of those untaxed profits that, if they were distributed just before the consolidated group formed, the recipient would have been entitled to a rebate of income tax under sections 46 or 46A of the *Income Tax Assessment Act 1936* (ITAA 1936) on the dividends. Subsection 701-30(2)(a) of the IT(TP)A 1997 refers to the additional amount as the '*step 3 untaxed profits increase*'.

Example

4. On 1 July 2001 Beta Co is incorporated as a wholly-owned subsidiary of HCo for $200. During the year ended 30 June 2002 Beta Co acquires two assets for $100 each. Asset 1 is sold during the year for $200, realising a profit of $100. Asset 2 increases in value to $150. Beta Co marks to market and the carrying value of Asset 2 at year end is $150. The accounting standards applicable to Beta Co require that the increase in value of Asset 2 be taken to the Statement of Financial Performance (Profit & Loss Account). After provision for income tax expense of $45, Beta Co's accounting profit is $105. Assessable income for the year is $100, taxable income $100 and tax payable $30. HCo then elects to form a consolidated group as from 1 July 2002. The group is a transitional group and Beta Co is a transitional entity.

5. Beta Co's financial position is as follows:

Table 1: Beta Co – Financial Position at 1 July 2002 ($)

Cash	200	Equity	200
Asset 2	150	Retained earnings	105
Cost $100		Taxed $70	
Market value (MV) $150		Untaxed $35	
		Provision for income tax	30
		PDIT	15
	350		350

6. The ACA would be as follows:

Table 2: ACA calculation for Beta Co

Step 1	Add cost of membership interests		200
Step 2	Add liabilities		
	• subsection 705-70(1) accounting liability: 30 (Provision for income tax)	30	
	• subsection 705-70(1) accounting liability: 15 (Provision for deferred income tax)	15	
	Reduction		
	• section 705-75(1) reduction for future deduction: 0	(0)	45
Step 3	Add undistributed profits		
	• subsection 705-90(2) undistributed profits: 105;		
	• subsection 705-90(3) limit: 70; and		
	• subsection 705-90(6) extent to which subsection 705-90(3) amount includes profits accrued to joined group: 70	70	

	ADD		
	• add undistributed, untaxed/untaxable profits section 701-30 of the IT(TP)A: 0	0	70
Step 8	ACA		315

7. Beta Co has retained profits of $105 for the purposes of subsection 705-90(2). This amount is limited under subsection 705-90(3) to $70 (franking account balance of $30 × 70/30). As all of the profits accrued to the group, this is the basic case step 3 amount under subsection 705-90(6). The remaining profits not counted must be tested under the transitional rule for step 3. In this example it is assumed that these untaxed profits could not be distributed as a rebatable dividend just before the joining time. Accordingly, although the untaxed profits of $35 not included in the basic case step 3 amount would satisfy paragraph 701-30(2)(a) of the IT(TP)A 1997 they would not satisfy paragraph 701-30(2)(b). The step 3 amount in the above table is therefore $70.

8. The ACA of $315 will be reduced by the tax cost setting amount (TCSA) of the retained cost base asset (cash) of $200. The remaining ACA will be allocated to set the TCSA of the reset cost base asset (Asset 2) [paragraph 705-35(1)(c)].

Date of effect

9. 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/D39

Related Rulings/Determinations:

TR 92/20

Subject references:

- ACA
- allocable cost amount
- consolidation
- cost setting
- loss
- profits
- retained profits
- step 3
- tax cost setting amount
- taxed profits
- undistributed profits
- untaxed profits

Legislative references:

- TAA 1953 Pt IVAAA
- ITAA 1936 46
- ITAA 1936 46A
- ITAA 1997 705-35(1)(c)
- ITAA 1997 705-70(1)
- ITAA 1997 705-75(1)
- ITAA 1997 705-90
- ITAA 1997 705-90(2)
- ITAA 1997 705-90(3)
- ITAA 1997 705-90(4)
- ITAA 1997 705-90(6)
- IT(TP)A 1997 701-30
- IT(TP)A 1997 701-30(1)
- IT(TP)A 1997 701-30(2)
- IT(TP)A 1997 701-30(2)(a)
- IT(TP)A 1997 701-30(2)(b)
- IT(TP)A 1997 701-35(1)(c)

ATO references

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