TD 2004/D39 - Income tax: consolidation tax cost setting rules: are taxed profits considered before untaxed profits when determining which profits are included in the step 3 (subsection 705-90(3)) amount?

Australian Government
Australian Taxation Office

Draft Taxation Determination
TD 2004/D39

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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. When working out the amount added at step 3 of the allocable cost amount (ACA) we 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). This subsection 70-90(3) amount consists of taxed profits first and then untaxed profits where the retained profit amount is made up of both. You then work out the extent to which the profits are profits that accrued to the group (paragraph 705-90(6)(a)). This amount is reduced to the extent that it recouped a loss for income tax purposes that accrued to the group (paragraph 705-90(6)(b)). 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 before 2 July 2003. The transitional rule allows for the step 3 amount under subsection 705-90 to be increased by so much of the undistributed profits (retained profits) that were limited by the operation of subsection 705 -90(3), subsection 705-90(4) and paragraph 705-90(6)(b). Subsections 705-90(3) and 705-90 (4) limit the undistributed profits to those that are taxed. The notional franking account is grossed-up using the formula in subsection 705-90(3) in order to isolate that portion of the undistributed profits of the joining entity that represents taxed profits. (See paragraph 5.115 of the Explanatory Memorandum to the *New Business Tax System (Consolidation and Other Measures) Bill (No 2) 2002*. Therefore, the additional amount (if any) under the transitional rule represents the “untaxed” amounts in the undistributed profits.

3. The additional amount added at step 3 in the ACA calculation is, 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 $200.00. During the year ended 30 June 2002 Beta Co acquires two assets for $100.00 each. Asset 1 is sold during the year for $200.00, realising a profit of $100.00. Asset 2 increases in value to $150.00. Beta Co marks to market and the carrying value of Asset 2 at year end is $150.00. 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 payable, Beta Co's accounting profit is $120.00. Assessable income for the year is $100.00, taxable income $100.00 and tax payable $30.00. HCo then elects to form a consolidated group effective 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	120
Cost $100		Taxed $70	
Market value (MV) $150		Untaxed $50	
		Provision for income tax	30
	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	
	Reduction		
	• Section 705-75(1) reduction for future deduction: 0	(0)	30
Step 3	Add undistributed profits		
	• Subsection 705-90(2) undistributed profits: 120;		
	• subsection 705-90(3) limit, representing taxed undistributed profits: 70; and		
	• paragraph 705-90(6)(a) extent to which subsection 705-90(3) amount includes profits accrued to joined group: 70	70	

	LESS		
	• paragraph 705-90(6)(b) extent to which subsection 705-90(6)(a) amount includes profits accrued to joined group that recouped losses accrued to the group: (0)	(0)	
	ADD		
	• add undistributed, untaxed /untaxable profits section 701-30 of the IT(TP)A: 0	0	70
Step 8	ACA		300

7. Beta Co has retained profits of $120.00 for the purposes of subsection 705-90(2). This amount is limited under subsection 705-90(3) to $70.00 (franking account balance of $30.00 x 70/30). As all of the profits accrued to the group, this is the basic case step 3 amount under paragraph 705-90(6)(a). 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 $50.00 would satisfy paragraph 701-30(2)(a) of the IT(TP)A 1997 they would not satisfy paragraph 705-30(2)(b). The step 3 amount in the above table is therefore $70.00.

8. The ACA of $300.00 will be reduced by the tax cost setting amount (TCSA) of the retained cost base asset (cash) of $200.00. The remaining ACA will be allocated to set the TCSA of the reset cost base asset (Asset 2) of $100.00 [subsection 705-35(1)(c)].

Date of Effect

9. 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

10. 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**

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Commissioner of Taxation
21 July 2004

Previous draft:

Not previously issued in draft form

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 46A
- 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)(a)
- ITAA 1997 705-90(6)(b)
- IT(TP)A 1997 701-30
- IT(TP)A 1997 701-30(2)(a)
- IT(TP)A 1997 701-30(2)(b)
- IT(TP)A 1997 701-35(1)(c)

Other references:

- Explanatory Memorandum of the New Business Tax System (Consolidation and Other Measures) Bill (No 2) 2002

ATO references

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