Worked example

Estimating undistributed, frankable profits accruing to group before joining time (ACA step 3)

Description

This example shows acceptable methods for estimating, for the purpose of working out the ACA step 3 amount, profits accruing for all or part of a financial period to a consolidated group's membership interests in an entity before it joins the group. These methods can also be used to estimate accrued losses.

Commentary

At step 3 of the ACA calculation an amount is added for the undistributed, frankable profits of a joining entity that have accrued to membership interests held continuously by the joined group until the joining time. → section 705-90

The purpose of this step is to prevent double taxation by allowing the group a cost for retained taxed or frankable profits that accrued to membership interests when they were continuously held (as can occur where there is an incremental acquisition of an entity).

The amount to be added at step 3 is determined as follows:

Firstly, work out the undistributed profits of the joining entity that are retained profits under the joining entity's accounting principles for tax cost setting. The joining entities accounting principles for tax cost setting are the accounting standards or authoritative pronouncements of the Australian Accounting Standards Board that the entity would use if it were to prepare its financial statements just before the joining time.

→ subsection 705-90(2), subsection 705-70(3), section 995-1, *Income Tax Assessment Act 1997* (ITAA 1997); Taxation Determination TD 2004/55

Secondly, work out the extent to which the undistributed profits are fully frankable. This is done by assuming all income tax liabilities or refunds of income tax have been taken into account for the purposes of determining the joining entity's franking account surplus just before the joining time (but not any period while it was a member of another consolidated group).

→ subsections 705-90 (3) to (5)

A profit is held to have accrued to the joined group before the joining time if, on the assumption that it was distributed by the joining entity (and any entity interposed between the joining entity and the head company successively distributed the profit immediately after receiving it), it would have been received by the head company as it accrued. That is, the amount of undistributed frankable profit included at step 3 is determined by reference to the amount of undistributed profit accruing over a period in which membership interests are continuously held, not just when the profit is realised. → subsections 705-90(6) to (8)

Methods of estimating accrued profits (or losses)

To help reduce the costs of compliance, subsection 705-90(9) allows the amount of profit (or loss) that accrued to the joined group in a particular period to be worked out using the most reliable basis for estimation available. This recognises that detailed records may not always be available to permit a precise calculation of the profits (or losses) that accrued to the group.

Where there is insufficient information to enable a precise calculation, the ATO will accept the methods outlined below as providing a reliable estimate of the accrued profits for the purposes of step 3. These methods can also be used to estimate losses that have accrued to the joined group. Note that:

- The accounting profit for a particular accounting period is used as the starting point for working out profit or loss accruing in that period.
- Where the profit or loss accruing to the group during part of an accounting period must be estimated (e.g. where membership interests were acquired during the period and accounts were not taken at that time), the profit or loss accruing during the part-period may be estimated by apportioning the profit between the part periods on a daily basis (see Method 1 and Example 1 below).
- Profit or loss on disposal of an asset may be accepted as having accrued in the financial period the profit or loss has been recognised for accounting purposes, unless the asset has been held by the joining entity over two or more accounting periods and the realised gain or loss is over $1 million, in which case the gain or loss must be spread over the period in which the asset was held (see Method 2 and Example 2 below).

Method 1 – Estimating profits accruing during part of an accounting period

For example, where membership interests were acquired part way through an accounting period, a reliable estimate of the profits that accrued during each part period can be obtained by apportioning the annual profits of the joining entity on a daily basis. Where accounts are taken on a more frequent basis (e.g. every six months) the profits made in the shorter period could be apportioned on a daily basis.

This method, as it applies to the disposal of an asset, is illustrated in Example 1 below.

Method 2 – Estimating accrued profits where gain/loss on disposal of asset > $1m

Under this method, the profits accruing to the joined group can be estimated on the basis of relevant information such as the asset's market value at the time that the membership interests in the joining entity were acquired by the joined group. If a market value or other more reliable information is not available, an estimate based on an average figure over the period that a membership interest was continuously held may be acceptable. For example, where market values are used for this purpose, it may be assumed that the value of an asset increases or decreases on a straight-line basis between any two reference points where a market valuation is available. Such points of reference might be the time of purchase (using the purchase price), the time of sale (using the sale price), or an appropriate estimate of value at the end of a financial period (e.g. where assets have been revalued for the accounts).

This method is illustrated in Example 2.

Distribution of profits – in order from the most recent income year to the earliest

Changes to the consolidation rules permit profits to be allocated between income years using a last-in-first-out (LIFO) approach. Under this method the amount of profit that accrued to the joined group during a particular period is worked out by assuming that profits were distributed in order from the most recent income year to the earliest.

Once profits are allocated between years for which distributions were made, it is further assumed that unfranked distributions were paid out of profits of the relevant year that were not subject to income tax before they were paid out of profits that were subject to income tax.

Where it is necessary to identify the source of profits within a year, a proportional approach may be applied.

Note that although use of this method is specifically provided for in the legislation, it does not limit the use of other means of arriving at a reliable estimate for the amount of profit that accrued to the group during a particular period. → subsection 705-90(10), ITAA 1997; paragraphs 1.135 – 1.143 of the Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004

Example 1 – gain or loss from disposal **of asset ≤ $1m**

Facts

This example demonstrates how to use a daily apportionment of annual profits to determine the profit accruing to a joined group from the disposal of an asset (where gain or loss ≤ $1m), for the purposes of step 3.

HCo is the head company of a consolidated group. On 1 November 2004, HCo acquires 20% of ACo for $70,000. ACo prepares its accounts at the end of each financial year. ACo's financial position at 30 June 2004 is shown in table 1.

Table 1: ACo – financial position at 30 June 2004 ($'000s)

Cash	200	Equity (10,000 ordinary shares)	350
Investments 1 (MV 100)	100		
Land 1 (MV 50)	50		
	350		350

MV: market value

ACo disposes of Investment 1 on 30 April 2005 for $107,143, realising an after tax profit of $5,000. It then acquires another asset, Land 2, on 1 May 2005 for $105,000. ACo's financial position at 30 June 2005 is shown in table 2.

Table 2: ACo – financial position at 30 June 2005 ($'000s)

Cash	200	Equity	350
Land 1 (MV 60)	50	Profit (after tax)	5
Land 2 (MV 125)	105		
	355		355

HCo acquires a further 40% of membership interests in ACo on 1 September 2005 for $154,000. ACo disposes of Land 1 on 31 March 2006 for $64,286, realising an after tax profit of $10,000. It acquires Investment 2 on the same day for $60,000. ACo's financial position at 30 June 2006 is shown in table 3.

Table 3: ACo – balance sheet at 30 June 2006 ($'000s)

Cash	200	Equity	350
Land 2 (MV 120)	105	Profit (after tax)	15
Investment 2 (MV 60)	60		
	365		365

On 1 July 2006, HCo acquires the remaining 40% of membership interests in ACo for $152,000 and ACo joins the group.

Calculation

A: Calculate the ACA

The ACA is calculated as follows:

Step 1

Membership interest

Purchased 1/11/2004 (20%)	$70,000
Purchased 1/9/2005 (40%)	$154,000
Purchased 1/7/2006 (40%)	$152,000
TOTAL	$376,000

Note: As the market value of each share exceeded or equalled its cost base the cost base is used → section 705-65.

Step 2

There are no liabilities. The result after step 2 is $376,000.

Step 3: Add undistributed frankable profits accrued to the joined group

As the gains from the disposal of Investment 1 and Land 1 were each less than $1 million, method 1 can be used to estimate the profit that accrued to HCo from the disposal of these assets.

Accounting year ending	Annual profit	Percentage MI* held	Period MI held in year	No. days MI held	Accrued profit
30/6/2005	$5,000	20%	1/11/04 to 30/6/05	242	$663 i.e. 20% x $5,000 x 242/365
Subtotal					$663
30/6/2006	$10,000	20%	1/7/05 to 31/8/05	62	$340 i.e. 20% x $10,000 x 62/365
		60%	1/9/05 to 30/6/06	303	$4,981 i.e. 60% x $10,000 x 303/365
Subtotal					$5,321
Total accrued profits to be added at step 3					$5,984

* MI: membership interests

The result after step 3 is $381,984.

Steps 4 to 7

These steps are not applicable as there are no distributions, no losses, and no inherited deductions. Therefore, the result after step 7 is $381,984.

Step 8

The final ACA amount is $381,984.

B: Allocate ACA to retained cost base assets

Cash $200,000

Remaining ACA $181,984

C: Apportion remaining ACA over reset cost base assets

The tax cost setting amounts for the reset cost base assets are:

Asset	Market value	Apportionment	Tax cost setting amount
Land 2	$120,000	$181,984 x 120/180	$121,323
Investments 2	$60,000	$181,984 x 60/180	$60,661
Totals	$180,000		$181,984

Example 2 – gain or loss > $1m

Facts

This example demonstrates how to use available information to determine a profit accruing to a joined group from the disposal of an asset (where gain or loss > $1m) for the purposes of step 3.

HCo acquires 10% of the membership interests in ACo for $20 million on 1 July 1999. On the same day ACo purchases Asset 1.

ACo's financial position at 1 July 1999 is shown in table 4.

Table 4: ACo – financial position at 1 July 1999 ($m)

Cash	100	Capital	200
Asset 1	100		
	200		200

On 1 July 2000, HCo acquires a further 15% of ACo for $38 million. No market value of the asset is obtained.

On 31 December 2001, HCo acquires a further 75% of ACo for $262 million. The market value of the asset is $250 million.

On 1 June 2002, Asset 1 is disposed for $300 million.

On 1 July 2002, HCo forms a consolidated group with ACo. Its financial position at 1 July 2002 is shown in table 5.

Table 5: ACo – financial position at 1 July 2002 ($m)

Cash	400	Capital	200
		Retained earnings	140
		Provision for tax	60
	400		400

Calculation

The sale of Asset 1 has realised an after tax profit $140 million which is recorded as retained earnings. When the $60 million provision for tax is paid, the undistributed profits of $140 million will be fully frankable. The profit has accrued over a period in which HCo has incrementally acquired membership interests in ACo. The gain from the sale of the asset exceeds $1 million. Therefore, for the purpose of step 3, the profit that accrued to the membership interests in ACo is determined using available information on the market values of the asset (method 2).

Figure 1 shows how the profit is estimated as having accrued to the group over the period in which HCo has incrementally acquired membership interests in ACo and up to the formation of the consolidated group.

1 July 1999 to 31 December 2001

HCo acquires 10% of the membership interests in ACo on 1 July 1999, when the market value of Asset 1 is $100 million. An additional 15% is acquired on 1 July 2000, when no market value or other reliable information on the asset is available. As the market values of the asset at 1 July 1999 and 31 December 2001 are available, an estimate based on average market values over this period is acceptable. If more reliable information existed as at 1 July 2000, a separate calculation of the profit that accrued to HCo would be required.

Based on the change in market values of the asset, a $150 million pre-tax profit has accrued between 1 July 1999 and 31 December 2001. The after tax profit on the asset that has accrued to HCo's membership interest in ACo is $105 million. HCo held 10% of the membership interests in ACo for 366 days (from 1 July 1999 to 30 June 2000) and 25% for 548 days (from 1 July 2000 to 30 December 2001).

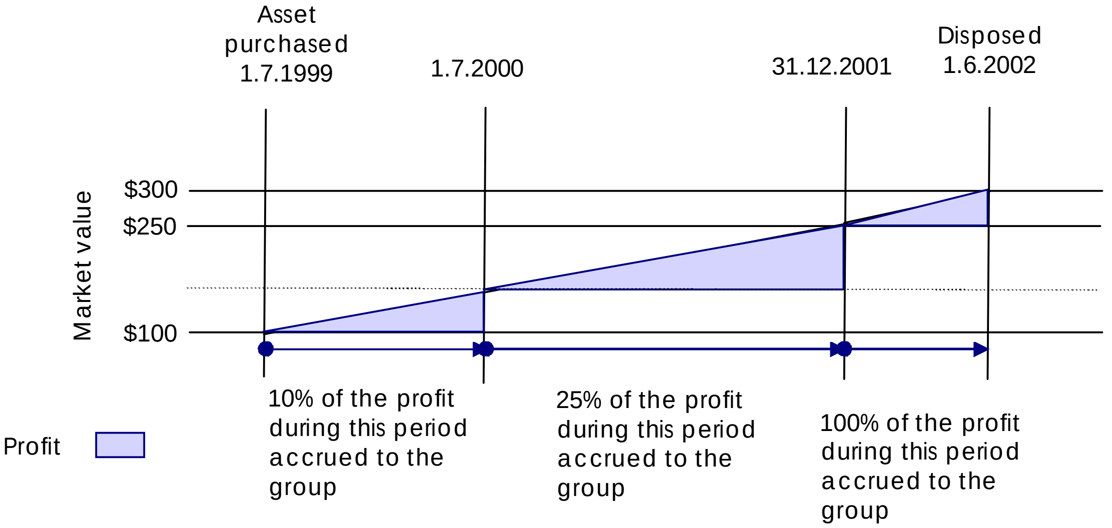
The after tax profit that has accrued to HCo during the period 1 July 1999 to 30 June 2000 is therefore $4.205 million – i.e. $105m x 366/(366 + 548) x 10%.

The after tax profit that has accrued to HCo during the period 1 July 2000 to 30 December 2001 is therefore $15.739 million – i.e. $105m x 548/(366 + 548) x 25%.

31 December 2001 to 30 June 2002

During the period in which HCo holds 100% of the membership interests in ACo, $50 million of pre-tax profit accrued to the asset. The after-tax profit on the asset that has accrued to HCo's membership interests in ACo is therefore $35 million.

Figure 1: How the profit from the disposal of Asset 1 is estimated as having accrued to the group



ACA calculation ($m):

Step 1	10% membership interest acquired – 1/7/1999	20	
	15% membership interest acquired – 1/7/2000	38	
	75% membership interest acquired – 31/12/2002	262	
			320
Step 2	Add liability: provision for tax		60
Step 3	Add accrued profits:		
	1/7/1999 to 30/6/2000	4	
	1/7/2000 to 30/12/2001	16	
	31/12/2001 to 1/6/2002	35	
			55
Steps 3A to 7			Nil
ACA			435

Allocating the ACA

The ACA is $435 million. The tax cost setting amount for the retained cost base asset of Cash is $400 million. There are no reset cost base assets to which the excess ACA can be allocated. Therefore HCo incurs a capital loss of $35 million by virtue of CGT event L4.

References

Income Tax Assessment Act 1997, section 705-90; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002)
- *New Business Tax system (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2

Income Tax Assessment Act 1997, subsections 705-90(2); as amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 8

Income Tax Assessment Act 1997, subsections 705-70(3) and 995-1(1); as inserted by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 8

Explanatory Memorandum to the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, paragraph 1.43 to 1.46

Income Tax Assessment Act 1997, subsection 705-90(10); as inserted by *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1, Part 7

Income Tax Assessment Act 1997, subsection 705-90(2A); as inserted by *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1, Part 8

Income Tax Assessment Act 1997, subsection 705-90(6); as substituted by *Tax Laws Amendment (2004 Measures No. 7) Act 2005* (No. 41 of 2005), Schedule 6, Part 3

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004, paragraphs 1.135 –1.155

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 7) Bill 2004, paragraphs 6.24 – 6.29

Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5 [amending subsection 705-90(2)]

Taxation Determination TD 2004/53 – 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 of the higher-tier entity?

Taxation Determination TD 2004/55 – Income tax: consolidation tax cost setting rules: step 3 of the allocable cost amount: is the 'retained profits' amount referred to in subsection 705-90(2) of the *Income Tax Assessment Act 1997* a cumulative retained profits balance?

Revision history

Section C2-4-260 first published 23 December 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on proposed changes to consolidation rules.	Proposed legislative amendments.
26.10.05	Changes to Commentary.	Legislative amendments.
26.6.07	Note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used.	Reflect announcement on 8 May 2007 by Assistant Treasurer in media release no. 50.
6.5.11	Reference to 'accounting standards for tax cost setting' and definition of that term included on p. 1. Removal of note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used.	Legislative amendments.