Worked example

Determining undistributed, taxed (frankable) profits accrued to group before joining time (ACA step 3)

Description

The entry ACA step 3 adds the amount of undistributed, taxed (frankable) profits that accrued to the joined group before the joining time. This example shows how to determine the amount of profits that are accrued to the joined group at step 3 of the ACA calculation in accordance with section 705-90 of the *Income Tax Assessment Act 1997* (ITAA 1997).

Commentary

Where a joining entity is a corporate tax entity, step 3 of the ACA calculation starts with working out the undistributed profits of the joining entity at the joining time. These are the amounts that, in accordance with the joining entity's accounting principles for tax cost setting, are retained profits of the joining entity. The joining entity's 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.→ subsections 705-90(1) and (2), subsection 705-70(3), section 995-1, ITAA 1997

The exception to subsection 705-90(2) is provided by subsection 705-90(2A). If a loss that did not accrue to the joined group before the joining time would be taken into account in working out the undistributed profits, the loss is not so taken into account in working out the subsection 705-90(2) amount.
→ subsection 705-90(2A)

Once the undistributed profits of the joining entity are ascertained, the extent to which the undistributed profits would be fully frankable is calculated. In calculating the amount the joining entity would be able to frank, it is assumed that the joining entity's income tax liabilities or refunds of income tax as at the joining time (but not any period before leaving another consolidated group) have been taken into account for the purpose of determining the franking account balance. → subsections 705-90(3) to (5)

Next, the extent to which the undistributed frankable profits accrued to the joined group before the joining time is calculated → subsection 705-90(6). A profit accrued to the joined group before the joining time if, on the assumptions that:

- it was distributed to holders of membership interests as it accrued, and
- entities interposed between the head company and the joining entity successively distributed it immediately after receiving it,

it would have been received by the head company in respect of membership interests that it held continuously until that time either directly or indirectly through interposed entities. → subsection 705-90(7)

Where membership interests in the joining entity have been progressively acquired and continuously held until the joining time, each period in which the membership interests have been acquired is required to be tested against subsection 705-90(7). When testing for a particular period, the starting point is the profits derived in that particular period to the extent the amount satisfied subsection 705-90(3). Any profits derived other than during the testing period are excluded from the test of that period.

The examples

Example 1 and 2 demonstrate how to ascertain the step 3 amount of the entry ACA calculation where:

- the joining entity had undistributed profits before the head company acquired some or all of the membership interests
- the entity then incurred losses, and
- the entity followed this by deriving profits again,

during different financial years before the head company acquires the remaining membership interests (if any) and forms a consolidated group.

In example 1, the head company acquires all the membership interests in a company and forms a consolidated group two years later with the subsidiary company.

Example 2 shows how to determine the step 3 amount where there have been progressive acquisitions of membership interests in the joining entity.

Example 3 demonstrates how to ascertain the amount of profits accrued to the joined group before the joining time where there are different classes of shares with different entitlements to profits in the joining entity.

Although examples 2 and 3 illustrate the step 3 amount calculation for an entity that is joining on a group's formation, the methodology in determining the amount of profits accrued to the joined group before the joining time also applies to a joining entity that joins a consolidated group where the membership interests of that joining entity were acquired progressively before the joining time.

Example 1

On 1 July 2001, X Co is incorporated with $1,000 contributed capital in cash by Mr F. During the first year of trading, X Co purchases a non-depreciating asset for $1,000 and derives a taxed profit of $350 after providing for income tax of $150. The financial position at 1 July 2002 is shown in table 1:

Table 1: X Co – financial position at 1 July 2002 ($)

Cash	500	Equity	1,000
Non-depreciating asset	1,000	Retained profits	350
		Provision for tax	150
	1,500		1,500

On 1 July 2002, M Co acquires all the membership interests of X Co for $1,350 from Mr F. During the financial year ending 30 June 2003, X Co incurs a tax loss of $300. The financial position at 1 July 2003 is shown in table 2:

Table 2: X Co – financial position at 1 July 2003 ($)

Cash	50	Equity	1,000
Deferred tax asset (DTA)	90	Retained profits	140
Non-depreciating asset	1,000		
	1,140		1,140

X Co derives a profit before tax of $500 during the financial year ending 30 June 2004. After deducting the previous year's tax loss of $300, X Co has a taxable income of $200 and makes a provision for tax of $60. The financial position at 1 July 2004 is shown in table 3:

Table 3: X Co – financial position at 1 July 2004 ($)

Cash	550	Equity	1,000
Non-depreciating asset	1,000	Retained profits	490
		Provision for tax	60
	1,550		1,550

On 1 July 2004, M Co forms a consolidated group with X Co as its subsidiary member.

The step 3 calculation

The tax position and retained profit account balance at the end of each income year is summarised in table 4:

Table 4: Summary of X Co's tax position and retained profit balance

Year	Tax position	Retained profit balance
2001-02	Taxed profit $350	$350
2002-03	Tax loss $300	$140
2003-04	Taxed profit $140 (after utilising $300 previous year loss)	$490

At the joining time, as X Co is a corporate tax entity, the ACA step 3 amount is calculated according to section 705-90, which determines how much of X Co's undistributed, taxed profits that accrued to the joined group are added at step 3 of the ACA calculation.

Applying section 705-90

At the joining time, X Co has retained profits of $490. That amount satisfies subsection 705-90(3) because X Co's franking account balance would be $210. Of this, $150 is the franking account balance from tax paid. This amount is increased by the provision for tax of $60, a result of the modification in subsection 705-90(4). The exclusion under subsection 705-90(5) does not apply as X Co has not been a member of another consolidated group before joining the M Co group. Therefore, undistributed profits of $490 worked out under subsection 705-90(2) would be fully frankable.

Subsection 705-90(6) allows only the amount of undistributed, fully frankable profits that accrued to the joined group to be added. To work out whether any of the $490 accrued to the joined group before the joining time, subsection 705-90(7) needs to be considered.

In this example, the profits of $490 were derived during the financial years ending 30 June 2002, 2003 and 2004. Because there has been a change in the holder of the membership interests in X Co, the test under subsection 705-90(7) is required for each period (1 July 2001 to 30 June 2002 and 1 July 2002 to 30 June 2004) to ascertain whether any profits accrued to the M Co group.

For the financial year ending 30 June 2002, X Co derived a retained profit of $350. Had it been distributed on 30 June 2002 to the holder of membership interests, it would have been distributed to Mr F, with M Co not receiving any of the distribution. Therefore, none of the $350 accrued to the joined group.

During the financial years ending 30 June 2003 and 2004, while M Co holds 100% of the membership interests in X Co, X Co derives retained profits totalling $140. Had this been distributed on 30 June 2004 to the holder of membership interests, M Co would have received $140. This means $140 accrued to the joined group.

Therefore, the amount to be added at step 3 under section 705-90 is $140.

ACA calculation ($):

Step 1	100% membership interest acquired – 1/7/2003	1,350	1,350
Step 2	Add liability: provision for tax	60	1,410
Step 3	Add accrued profits:		
	1/7/2001 to 30/6/2002	nil	
	1/7/2002 to 30/6/2004	140	
		140	1,550
Steps 3A to 7		Nil	1,550
ACA			1,550

Allocating the ACA

$550 of the ACA is allocated to cash. This leaves $1,000 to be allocated to the non-depreciating asset. There is no shortfall or surplus in the ACA.

Example 2

On 1 July 2004, B Co is incorporated with $1,000 contributed capital in cash by C Co. During the first year of trading, B Co purchases a non-depreciating asset for $1,000 and derives a taxed profit of $280 after providing for income tax of $120. The financial position at 1 July 2005 is shown in table 5:

Table 5: B Co – financial position at 1 July 2005 ($)

Cash	400	Equity	1,000
Non-depreciating asset	1,000	Retained profits	280
		Provision for tax	120
	1,400		1,400

On 1 July 2005, A Co acquires 50% of B Co for $640 from C Co. During the financial year ending 30 June 2006, B Co incurs a tax loss of $200. The financial position at 1 July 2006 is shown in table 6:

Table 6: B Co – financial position at 1 July 2006 ($)

Cash	80	Equity	1,000
DTA	60	Retained profits	140
Non-depreciating asset	1,000		
	1,140		1,140

B Co derives a profit before tax of $300 from trading during the financial year ending 30 June 2007. After deducting the previous year's tax loss of $200, B Co has a taxable income of $100 and makes a provision for tax of $30. The financial position at 1 July 2007 is shown in table 7:

Table 7: B Co – financial position at 1 July 2007 ($)

Cash	380	Equity	1,000
Non-depreciating asset	1,000	Retained profits	350
		Provision for tax	30
	1,380		1,380

On 1 July 2007, A Co acquires the remaining 50% of the membership interests in B Co for $675 and forms a consolidated group with B Co as its subsidiary member.

The step 3 calculation

The tax position and retained profit account balance as at the end of each income year is summarised in table 8:

Table 8: Summary of B Co's tax position and retained profit balance

Year	Tax position	Retained profit balance
2004-05	Taxed profit $280	$280
2005-06	Tax loss $200	$140
2006-07	Taxed profit $70 (after utilising $200 previous year loss)	$350

At the joining time, as B Co is a corporate tax entity, the ACA step 3 amount is calculated according to section 705-90, which determines how much of B Co's undistributed, taxed profits that accrued to the joined group are added at step 3 of the ACA calculation.

Applying section 705-90

At the joining time, B Co has retained profits of $350. That amount satisfies subsection 705-90(3) because B Co's franking account balance would be $150. Of this, $120 is the franking account balance from tax paid. This amount is increased by the provision for tax of $30, a result of the modification in subsection 705-90(4). The exclusion under subsection 705-90(5) does not apply as B Co has not been a member of another consolidated group before joining the A Co group. Therefore, undistributed profits of $350 worked out under subsection 705-90(2) would be fully frankable.

Subsection 705-90(6) allows only the amount of undistributed, fully frankable profits that accrued to the joined group to be added. To work out whether any of the $350 accrued to the joined group before the joining time, subsection 705-90(7) needs to be considered.

In this example, the profits of $350 were derived during the financial years ending 30 June 2005, 2006 and 2007. Because there have been changes in the holders of the membership interests in B Co, the test under subsection 705-90(7) is required for each period (1 July 2004 to 30 June 2005 and 1 July 2005 to 30 June 2007) to ascertain whether any profits accrued to the A Co group.

For the financial year ending 30 June 2005, B Co derived a retained profit of $280. Had it been distributed on 30 June 2005 to the holder of membership interests, it would have been distributed to C Co, with A Co not receiving any of the distribution. Therefore, none of the $280 accrued to the joined group.

> **Note**
>
> Had A Co's acquisition of the first 50% (on 1 July 2005) been on 1 June 2005, there would be two testing periods for the financial year ending 30 June 2005 – 1 July 2004 to 31 May 2005 and 1 to 30 June 2005. In that case, the estimating methods set out in section C2-4-260 of this manual could be used to estimate the amount of profits accrued to the joined group.

During the financial years ending 30 June 2006 and 2007, while A Co holds 50% of the membership interests in B Co, B Co derives retained profits totalling $70. Had this profit been distributed on 30 June 2007 to the holders of membership interests, A Co would have only received $35. This means $35 accrued to the joined group.

Therefore, the amount to be added at step 3 under section 705-90 is $35.

> **Note**
>
> Had A Co acquired the second 50% of membership interests on 1 July 2006 (instead of 1 July 2007) while still forming the group on 1 July 2007, a test to ascertain how much of the loss did not accrue to the joined group would be required. The test is provided by subsection 705-90(8) in conjunction with subsection 705-90(7) to test whether any amount of loss would not be accrued to the group. If any loss that did not accrue to the joined group reduces the amount of retained profits, subsection 705-90(2A) permits the non-accrued loss not to be taken into account from the retained profits.

ACA calculation ($):

Step 1	50% membership interest acquired – 1/7/2005	640	
	50% membership interest acquired – 1/7/2007	675	
		1,315	1,315
Step 2	Add liability: provision for tax	30	1,345
Step 3	Add accrued profits:		
	1/7/2005 to 30/6/2006	nil	
	1/7/2005 to 30/6/2007	35	
		35	1,380
Steps 3A to 7		Nil	1,380
ACA			1,380

Allocating the ACA

$380 of the ACA is allocated to cash. This leaves $1,000 to be allocated to the non-depreciating asset. There is no shortfall or surplus in the ACA.

Example 3

D Co is incorporated on 1 July 2005 with 1,000 Class A ordinary shares at $8 each and 1,000 Class B ordinary shares at $2 each, raising capital of $10,000 in cash. Pursuant to D Co's constitution and the terms of issue, the Class A ordinary shareholders are entitled to 80% of D Co's profits and the Class B ordinary shareholders are entitled to the remaining 20% of D Co's profits. The Class A and Class B ordinary shares represent all the membership interests in D Co.

E Co acquires 900 (90% of) Class A ordinary shares for $7,200 on 1 July 2005.

During the year ending 30 June 2006, D Co purchases a non-depreciating asset for $10,000 and derives an after tax profit of $2,100. D Co's financial position is shown in table 9.

Table 9: D Co – financial position at 1 July 2006 ($)

Cash	3,000	Equity	10,000
Non-depreciating asset	10,000	Retained profits	2,100
		Provision for tax	900
	13,000		13,000

On 1 July 2006, E Co acquires the remaining 100 Class A ordinary shares at $9.68 each and all the 1,000 Class B ordinary shares at $2.42 each, for a total of $3,388. E Co forms a consolidated group with D Co on 1 July 2006.

The step 3 calculation

At joining time, as D Co is a corporate tax entity, the ACA step 3 amount is determined according to section 705-90.

At the joining time, D Co has undistributed profits of $2,100. That amount satisfies subsection 705-90(3) because D Co's franking account balance would be $900. D Co's franking account balance is nil, but it is increased by the provision for tax of $900, a result of the modification in subsection 705-90(4). The exclusion under subsection 705-90(5) does not apply as D Co has not been a member of another consolidated group before joining the E Co group. Therefore, undistributed profits of $2,100 worked out under subsection 705-90(2) would be fully frankable.

Subsection 705-90(6) allows only the amount of undistributed, fully frankable profits that accrued to the joined group to be added. To work out whether any of the $2,100 accrued to the joined group before the joining time, subsection 705-90(7) needs to be considered.

In this example, the profits of $2,100 were derived during the financial year ending 30 June 2006. During that period, E Co holds 90% of the Class A shares and none of the Class B shares. Had the profits been distributed on 30 June 2006 to the holders of the membership interests, E Co would have received $1,512 (i.e. $2,100 x 80% x 900/1,000). Therefore, only $1,512 of the retained and fully frankable profits accrued to the E Co group and is added at step 3 of the ACA calculation.

ACA calculation ($):

Step 1	90% A class membership interest acquired – 1/7/2005	7,200	
	10% A class membership interest acquired – 1/7/2006, and 100% B class membership interest acquired – 1/7/2006	3,388	
		10,588	10,588
Step 2	Add liability: provision for tax	900	11,488
Step 3	Add accrued profits:		
	1/7/2005 to 30/6/2006	1,512	13,000
Steps 3A to 7		Nil	13,000
ACA			13,000

Allocating the ACA

$3,000 of the ACA is allocated to cash. This leaves $10,000 to be allocated to the non-depreciating asset. There is no shortfall or surplus in the ACA.

References

Income Tax Assessment Act 1997, section 705-90

Income Tax Assessment Act 1997, subsection 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

Income Tax Assessment Act 1997, subsections 705-90(1) to 705-90(8)

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

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004, paragraphs 1.135 – 1.148 [inserting (2A)]

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 7) Bill 2004, paragraphs 6.24 – 6.29 [amending (6)(b)]

Explanatory Memorandum to 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 C2-4-261 first published 15 November 2006.

Further revisions are described below.

Date	Amendment	Reason
26.6.07	Note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used, p. 9.	Reflect announcement on 8 May 2007 by Assistant Treasurer in media release no. 50.
6.5.11	Removal of note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used. Reference to 'accounting standards for tax cost setting' and definition of that term included on p. 1.	Legislative amendments.