Worked example

Adjustment at ACA step 2 to allow for timing differences between accounting and tax recognition of liabilities

Description

The ACA step 2 amount for an accounting liability is reduced or adjusted in some circumstances → sections 705-70, 705-75, 705-80 and 705-85, *Income Tax Assessment Act 1997* (ITAA 1997). This example shows how:

- section 705-80 works in conjunction with sections 705-70 and 705-75, using liabilities raised by accrued employee leave entitlements to demonstrate the principle
- an administrative shortcut can be used to determine the amount and timing of notional deductions in situations where insufficient information is available for an accurate reconstruction, and
- administrative guidelines can be used in reconstructing the accounts as required by section 705-80.

Commentary

The second step in determining a joining entity's ACA involves adding all of its accounting liabilities, in accordance with its accounting principles for tax cost setting. 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. → subsection 705-70(1), subsection 705-70(3), section 995-1, ITAA 1997

If any parts of an accounting liability will give rise to a deduction to the head company when discharged, the liability amount is reduced by the deduction amount multiplied by the general company tax rate (except to the extent that the liability amount has already been reduced because of the future tax benefit). → subsection 705-75(1)

Where there is a timing difference between income tax provisions and accounting standards in recognising a liability, a notional ACA calculation is required → section 705-80. The notional ACA is calculated by assuming the liability had been discharged for income tax purposes at the same time as it is taken into account for accounting purposes. This may in turn require a notional reconstruction of the joining entity's accounting and tax positions for the years in which the liability arose in order to align them. Under the reconstruction there may be adjustments to the amounts at step 3 (undistributed profits), step 5 (unused losses that have accrued to the group) and step 6 (unused losses that have not accrued to the group). Note that these adjustments are only relevant for the purposes of this calculation.

The notional ACA is then compared with the first ACA which is calculated without applying section 705-80. If:

notional ACA < first ACA:	reduce the step 2 amount by the difference
notional ACA > first ACA:	increase the step 2 amount by the difference
notional ACA = first ACA:	no adjustment to step 2 amount is required

→ section 705-80

The amounts calculated at each step of the first ACA calculation, other than the step 2 amount, will remain as the relevant amounts for the final ACA calculation. → Taxation Determination TD 2004/70; Taxation Determination TD 2004/71

Accrued employee leave entitlements

An accrued employee entitlement such as long service leave is a liability of the joining entity according to the accounting standards. For tax purposes, an accrued employee leave entitlement is not deductible in the year it accrues. It will be deductible by the head company when the liability is discharged. Consequently, an adjustment under section 705-80 may be required where the liabilities of a joining entity include such a provision.

Disaggregation of liabilities

The accounting liabilities to which section 705-80 applies need to be disaggregated into each liability type. For example, where the joining entity's provision for employee benefits is an aggregate of long service leave and annual leave entitlements, the provisions for long service leave and annual leave must be disaggregated and recognised.

Is a notional reconstruction required?

A notional reconstruction is required of the joining entity's accounting and tax positions for the years in which the liability arose in order to align them → section 705-80. Note that there are circumstances where the notional reconstruction will not change the position and therefore effectively does not have to be undertaken.

Short cut method for recognising amount and timing of notional deduction

In many cases taxpayers may not have sufficient information available to accurately reconstruct the tax position as required by section 705-80. Where the historical information needed to establish the amount and timing of any notional deduction is not available, the most reliable basis of estimation may be used. → section 705-80

To assist taxpayers to determine the amount of a notional deduction, and the time or period to which it relates, the short cut method illustrated in the decision flow chart in figure 1 provides a reasonable approximation of the deduction allocation required by section 705-80.

However, you can only use the shortcut method in situations where you do not have sufficient information on which to base a reliable estimate. If the short cut method is not suitable for your circumstances and you would like to use another approach you should contact the ATO for guidance.

The administrative short cut method is based on a concept of materiality under which an immaterial amount is deemed to relate to the immediate prior year.

Materiality thresholds

An amount for the total of the section 705-80 affected liabilities is material if it exceeds the greater of $5 million or 5% of the ACA as initially calculated. An amount for an individual liability is material if it exceeds the greater of $1 million or 1% of the initial ACA.

Guidelines for notional reconstruction to align accounting and tax positions

The notional reconstruction that may be required to align the tax and accounting positions should be undertaken in line with the following guidelines. (Note that the notional reconstruction is limited to the 'tax accounts' – deferred tax assets, deferred tax liabilities and the provision for taxation. The other accounts remain unchanged.)

- There must be consistency in the treatment of the financial accounts and the notionally reconstructed accounts.
  - For example, if a deferred tax asset reflecting the future benefit arising from an unused tax loss is not normally recorded in the financial accounts it should not be recorded in the notionally reconstructed accounts.
- If a notional reconstruction is required it must be undertaken for each year to which the liability relates.
- The notional reconstruction should be confined to the income tax accounts – i.e. the deferred tax assets, deferred tax liabilities and provision for income tax.
- Deferred tax assets and deferred tax liabilities in respect of liabilities to which section 705-80 applies will cease to exist for the purposes of the notional reconstruction.
- Deferred tax assets may need to be created for unused notional tax losses, but only if the deferred tax asset was previously recorded in the financial accounts or where the taxpayer applies the accounting standards in such a way that it would have been recorded had it existed.
- The notional reconstruction of the provision for tax must take into account 'real world' payments and refunds.
- The tax provision must always be treated as a liability regardless of the balance in the hypothetical account.
  - There will be instances where the notional reconstruction results in the entity moving from a real world taxable income to a notional tax loss, resulting in the provision for tax moving into a debit balance. In these circumstances the provision for tax will reduce the amount available to be included at step 2 of the notional ACA calculation.
- Notional journal entries reflecting the aligned taxation and accounting position should be completed where appropriate.
- A notional franking account must be prepared and it must take into account real world dividend payments.
- If there is any difference between the notional ACA and the first ACA the difference is set off against the total of the first ACA step 2 amount.

Examples

Examples 1 to 3 demonstrate how section 705-80 applies to the ACA calculation, examples 4 and 5 demonstrate use of the short cut method for the notional deduction, and example 6 demonstrates the notional reconstruction.

Example 1 shows how section 705-80 applies to the ACA calculation for a joining entity that has a tax loss. A notional reconstruction for the year immediately before consolidation is required because the joining entity has unutilised tax losses at the joining time.

Example 2 shows how section 705-80 applies to the ACA calculation for a joining entity that has accounting profits. A reconstruction is not necessary because the joining entity is in an accounting and tax profit situation at the joining time and on the application of section 705-80 the notional tax deductions for the provisions would not give rise to a notional tax loss.

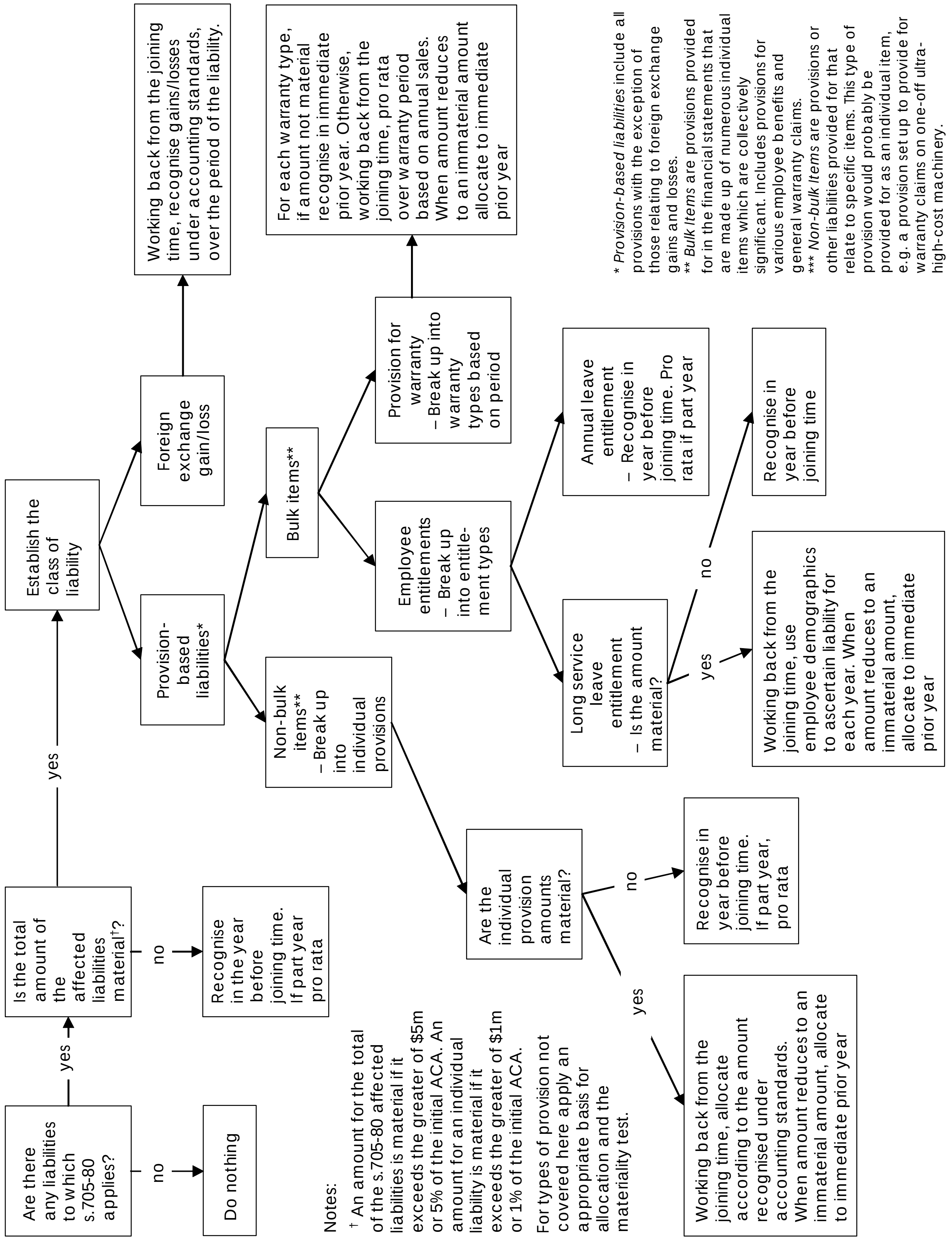
Example 3 shows how section 705-80 applies to the ACA calculation for a joining entity that has been incrementally acquired and has tax losses. In this example, a notional reconstruction is required for more than one year before consolidation occurs, as the joining entity has unutilised tax losses at the joining time.

Example 4 demonstrates the notional reconstruction process where reasonably accurate information is available.

Example 5 demonstrates how the amount and timing of a notional deduction is determined where only limited information is available, using the administrative shortcut method described in figure 1.

Example 6 demonstrates the notional reconstruction necessary to align the accounting and tax positions using the guidelines set out earlier in this section.

Figure 1: Decision flow chart for section 705-80 deduction allocation short cut



Example 1

Facts

ACo is incorporated on 1 July 2004 with $200 cash by HCo.

Table 1: Financial position at 1 July 2004 ($)

Cash	200	Capital	200
	200		200

During the financial year ending 30 June 2005, ACo makes a tax loss of $100 and a provision for annual leave of $100. The deferred tax asset includes $30 from the tax loss as well as $30 from the provision for annual leave. The provision for annual leave is a liability of ACo in accordance with its accounting principles for tax cost setting.

Table 2: Financial position at 30 June 2005 ($)

Cash	100	Capital	200
DTA	60	Retained earnings	(140)
		Provision for annual leave	100
	160		160

DTA: deferred tax asset

On 1 July 2005, HCo forms a consolidated group with ACo as a subsidiary member.

Calculation

First ACA calculation

The provision for annual leave is an accounting liability, and is not deductible for income tax purposes in the year it accrues. Therefore, as a subsection 705-70(1) liability, only its net cost to the group is recognised at step 2 of the ACA calculation → subsection 705-75(1):

Step 1	Add amount paid by HCo to incorporate ACo	$200
Step 2	Add amount accrued for annual leave ($100) – subsection 705-70(1), *less* $30, the future tax deductible amount – subsection 705-75(1)	$70
Steps 3 & 4		Nil
Step 5	Subtract unused tax losses	($100)
Steps 6 & 7		Nil
First ACA		$170

Notional ACA calculation (section 705-80)

Section 705-80 requires a notional ACA calculation based on the assumption that the employment leave entitlement is tax deductible in the same financial year as it is accrued. Accordingly, ACo is taken to have made a tax loss of $200 and the notional ACA calculation is as follows:

Step 1	Add amount paid by HCo to incorporate ACo	$200
Step 2	Add amount accrued for annual leave – subsection 705-70(1)	$100
Steps 3 & 4		Nil
Step 5	Subtract unused tax losses *plus* $100 for the accrued employee leave entitlement (as if it were deductible for income tax purposes)	($200)
Steps 6 & 7		Nil
Notional ACA		$100

Final ACA calculation

As the notional ACA is less than the first ACA, the difference of $70 is subtracted from the step 2 amount of the first ACA calculation ($70) → section 705-80. The step 2 amount after this adjustment is therefore nil, with the final ACA calculated as follows:

Step 1	Add amount paid by HCo to incorporate ACo	$200
Step 2	Add amount accrued for annual leave ($100) – subsection 705-70(1), *less* $30 for future tax deductible amount – subsection 705-75(1). Then subtract $70 (section 705-80 adjustment)	Nil
Steps 3 & 4		Nil
Step 5	Subtract unused tax losses	($100)
Steps 6 & 7		Nil
Final ACA		$100

Allocation of the final ACA

The final ACA is allocated to the retained cost base assets (cash of $100). The deferred tax asset for the provision for annual leave ($30) is an excluded asset under subsection 705-35(2). There is no excess or shortfall in the ACA.

Example 2

Facts

BCo is incorporated by HCo on 1 July 2004 with $200 cash.

Table 3: Financial position at 1 July 2004 ($)

Cash	200	Capital	200
	200		200

During the financial year ending 30 June 2005, BCo's taxable income is $200 and it makes a provision for annual leave of $100.

Table 4: Financial position at 30 June 2005 ($)

Cash	400	Capital	200
DTA	30	Retained earnings	70
		Provision for income tax	60
		Provision for annual leave	100
	430		430

On 1 July 2005, HCo forms a consolidated group with BCo as a subsidiary member.

The provision for annual leave is a liability of BCo in accordance with its accounting principles for tax cost setting.

Calculation

First ACA calculation

The provision for annual leave is an accounting liability, and is not deductible for income tax purposes in the year it accrues. Therefore, as a subsection 705-70(1) liability, only its net cost to the group is recognised at step 2 of the ACA calculation → section 705-75(1):

Step 1	Add amount paid by HCo to incorporate BCo	$200
Step 2	Add amount accrued for annual leave ($100) – subsection 705-70(1), *less* $30 for future tax deductible amount – subsection 705-75(1). Then add amount for provision for income tax ($60) – subsection 705-70(1)	$130
Step 3	Add amount of undistributed frankable profits	$70
Steps 3A to 7		Nil
First ACA		$400

Notional ACA calculation

Section 705-80 requires a notional ACA calculation based on the assumption that the accrued employment leave entitlements are tax deductible in the same financial year as they are accrued. Accordingly, BCo's taxable income would be $100 and therefore the provision for income tax would be $30. The amounts for the other liability (provision for annual leave) and profit would remain unchanged. The notional ACA calculation is as follows:

Step 1	Add amount paid by HCo to incorporate BCo	$200
Step 2	Add amount accrued for annual leave ($100) and the provision for income tax ($30) – subsection 705-70(1)	$130
Step 3	Add amount of undistributed frankable profits	$70
Steps 3A to 7		Nil
Notional ACA		$400

Final ACA and its allocation

The first ACA and the notional ACA are both $400. In this situation, no adjustment to the step 2 amount is required under section 705-80, and therefore the final ACA amount is also $400.

The final ACA is allocated to the retained cost base asset (cash of $400). The deferred tax asset is an excluded asset under subsection 705-35(2). There is no excess or shortfall in the ACA.

Example 3

Facts On 1 July 2004, CCo is incorporated with $300 cash. On the same day, HCo purchases 60% of CCo for $180.

Table 5: Financial position at 1 July 2004 ($)

Cash	300	Capital	300
	300		300

During the financial year ending 30 June 2005, CCo incurs a tax loss of $100 and makes a provision of $100 for annual leave. The deferred tax asset includes $30 from the tax loss and $30 from the provision for annual leave.

Table 6: Financial position at 30 June 2005 ($)

Cash	200	Capital	300
DTA	60	Retained earnings	(140)
		Provision for annual leave	100
	260		260

On 1 July 2005, HCo purchases the remaining 40% of CCo for $64.

During the financial year ending 30 June 2006, CCo again incurs a tax loss of $100 and makes a provision for long service leave of $100. The deferred tax asset again includes $30 from the tax loss and $30 from the provision for long service leave.

Table 7: Financial position at 30 June 2006 ($)

Cash	100	Capital	300
DTA	120	Retained earnings	(280)
		Provision for annual leave	100
		Provision for long service leave	100
	220		220

On 1 July 2006, HCo forms a consolidated group with CCo as a subsidiary member.

The provisions for annual leave and long service leave are liabilities of CCo in accordance with its accounting principles for tax cost setting.

Calculation

First ACA calculation

The provisions for annual leave and long service leave are accounting liabilities, and they are not deductible for income tax purposes in the year they accrue. Therefore, as subsection 705-70(1) liabilities, only their net cost to the group is recognised at step 2 of the ACA calculation → subsection 705-75(1):

Step 1	Add amount paid by HCo for membership interests in CCo ($180 for 60% and $64 for 40%)	$244
Step 2	Add the provision for annual leave ($100) and long service leave ($100), *less* the future tax deductible amount of $60	$140
Steps 3 & 4		Nil
Step 5	Subtract unused owned tax losses: i.e., 60% of the $100 tax loss in the first year *plus* 100% of the $100 tax loss in the second year	($160)
Step 6	Subtract acquired tax losses multiplied by the company tax rate: i.e., 40% of the $100 tax loss from the first year *multiplied* by 30%	($12)
Step 7		Nil
First ACA		$212

Notional ACA calculation

Section 705-80 requires a notional ACA calculation based on the assumption that the accrued employment leave entitlements are tax deductible in the same financial year as they accrue. In HCo's situation, its financial position for both years requires a notional reconstruction so that a notional ACA can be calculated. Accordingly, the $100 annual leave accrued in the first year would be taken to be tax deductible in that year. This is added to the actual tax loss of $100 to give a notional tax loss for the first year of $200. Similarly, the $100 long service leave that accrued in the second year would be taken to be tax deductible in the second year resulting in a notional tax loss for the second year of $200.

The notional ACA calculation is as follows:

Step 1	Add amount paid by HCo for membership interests in CCo ($180 for 60% and $64 for 40%)	$244
Step 2	Add amount accrued for annual leave ($100) and long service leave ($100) – subsection 705-70(1)	$200
Steps 3 & 4		Nil
Step 5	Subtract the notional unused owned tax losses: i.e., 60% of the $200 tax loss in the first year *plus* 100% of the $200 tax loss in the second year	$320
Step 6	Subtract notional acquired tax losses multiplied by the company tax rate: i.e., 40% of the $200 tax losses from the first year *multiplied* by 30%	$24
Step 7		Nil
Notional ACA		$100

Final ACA calculation

As the notional ACA is less than the first ACA, the difference of $112 is subtracted from the step 2 amount of the first ACA calculation ($140) → section 705-80. The step 2 amount after this adjustment is therefore $28, and the final ACA calculation is as follows:

Step 1	Add amount paid by HCo to incorporate CCo	$244
Step 2	Add amount accrued for annual leave ($100) and long service leave ($100) – subsection 705-70(1), *less* $60, the future tax deductible amount – subsection 705-75(1), and $112, the section 705-80 reduction	$28
Steps 3 to 4		Nil
Step 5	Subtract unused owned tax losses: i.e., 60% of the $100 tax loss in the first year *plus* 100% of the $100 tax loss in the second year	($160)
Step 6	Subtract acquired tax losses multiplied by the company tax rate: i.e., 40% of the $100 tax loss from the first year *multiplied* by 30%	$12
Step 7		Nil
Final ACA		$100

Allocation of the final ACA

The final ACA is allocated to the retained cost base asset (cash of $100). The deferred tax assets for the annual leave ($30), the long service leave ($30) and for the unused tax losses ($60) are excluded assets under subsection 705-35(2). There is no excess or shortfall in the ACA.

Example 4 Company A is incorporated on 1 July 2000 with capital of $100 million. During the year it acquires land for $100 million, receives income of $100 million (taxable income $100 million) and makes provision for long service leave of $50 million and tax of $30 million.

Table 8: Financial position at 30 June 2001 ($m)

Cash	100	Capital	100
Land	100	Retained earnings	35
DTA	15	Provision for long service leave	50
		Provision for income tax	30
	215		215

During the year ending 30 June 2002, company A pays the 2001 income year tax of $30 million, receives income of $100 million, incurs costs of $30 million for long service leave (taxable income $70 million) and makes provision for long service leave of $50 million and tax of $21 million.

Table 9: Financial position at 30 June 2002 ($m)

Cash	140	Capital	100
Land	100	Retained earnings	70
DTA	21	Provision for long service leave	70
		Provision for tax	21
	261		261

During the year ending 30 June 2003, company A pays the 2002 income year tax of $21 million, receives income of $100 million (taxable income $100 million) and makes provision for long service leave of $50 million and tax of $30 million.

Table 10: Financial position at 30 June 2003 ($m)

Cash	219	Capital	100
Land	100	Retained earnings	105
DTA	36	Provision for long service leave	120
		Provision for tax	30
	355		355

During the year ending 30 June 2004, company A pays the 2003 income year tax of $30 million, receives income of $100 million (taxable income $100 million) and makes provision for long service leave of $50 million, tax of $30 million and annual leave of $50 million.

Table 11: Financial position at 30 June 2004 ($m)

Cash	289	Capital	100
Land	100	Retained earnings	105
DTA	66	Provision for long service leave	170
		Provision for tax	30
		Provision for annual leave	50
	455		455

Company A joins a consolidated group on 1 July 2004. Its section 705-80 affected liabilities can be allocated as follows:

Provision for annual leave

The liability arising from the provision for annual leave relates to the year ending 30 June 2004. While this is clearly the case in this example, it may also be reasonable to assume that the vast majority of employees would take their annual leave on an annual basis. Therefore, such an allocation provides a reasonable approximation of the deduction allocation. However, if information is available that can provide a more reliable basis of allocation that basis must be used.

Provision for long service leave

Company A has in its accounts made provision for an amount of $50 million per year for long service leave. In this instance, a first in, first out approach would be an appropriate basis of allocation as it would result in a reasonable approximation of the deduction allocation. The provision balance of $170 million for long service leave at 30 June 2004 would therefore be allocated as follows:

Year ending 30 June 2004	$50m
Year ending 30 June 2003	$50m
Year ending 30 June 2002	$50m
Year ending 30 June 2001	$20m

Again, if information is available that can provide a more reliable basis of allocation, that basis must be used.

Example 5

Using the same financial data as in example 4, assume that the only records that company A had, or could obtain, are its statement of financial position for the year ending 30 June 2004 and income tax data obtained from the ATO. This example shows how in these circumstances company A might reconstruct its tax position for the purposes of section 705-80 using the administrative shortcut.

The initial ACA is calculated as follows:

Step 1	$100m
Step 2	$184m
Step 3	$105m
ACA	$389m

For the purposes of the administrative shortcut, an amount for the total of the section 705-80 liabilities is material if it exceeds the greater of $5 million or 5% of the ACA as initially calculated.

As the total of company A's section 705-80 affected liabilities ($220 million) exceeds $19.45 million (5% of the ACA), it is a material amount and it is necessary to establish the class of the liability.

The liabilities in this instance fall into the bulk items category and need to be broken up into the entitlement types, i.e. annual leave entitlements of $50 million and long service leave entitlements of $170 million.

The annual leave entitlements can be reasonably allocated to the year ending 2004.

As the total of the individual liability for long service leave ($170 million) is a material amount (it exceeds the greater of $1 million or 1% of the initial ACA), it is necessary to allocate the amount on an annual basis. The long service leave can be allocated on the basis of employee demographics at each year end, unless a more reliable basis is available, and the alignment of the accounting and taxation positions required by section 705-80 should proceed on that basis.

Example 6

Note that this example presumes a constant rate of tax in each of the four years but the guidelines are equally applicable where there have been changes in the tax rates.

Year 1

ACo, a wholly owned subsidiary of HC, was incorporated at the start of the Y1 financial year with contributed capital of $100. During the Y1 financial year it acquired land for $100, borrowed the equivalent of A$2000 in US$, purchased shares in BCo for $2000, received income of $100 and made provision for long service leave of $50 and tax of $30. At the end of Y1 the A$ value of the US$ debt was $1950.

Table 12

Item description	Tax outcome ($)	Accounting outcome ($)
Income	100	100
Forex gain		50
Gross income/loss	100	150
Expenses – long service leave		50
Income/loss	100	100

Table 13: Financial position at end of Y1 ($)

Cash	100	Capital	100
Land	100	Retained earnings	70
DTA	15	Provision for long service leave	50
Shares in BCo	2000	Provision for tax	30
		US$ debt	1950
		DTL	15
	2215		2215

DTL: deferred tax liability

Table 14: Journal entries for Y1 ($)

Dr Tax expense	30		
Dr DTA – long service leave	15		
		Cr Provision for tax	30
		Cr DTL – forex	15

Table 15: Financial position reflecting the alignment of tax and accounting positions at end Y1 for section 705-80 purposes ($)

Cash	100	Capital	100
Land	100	Retained earnings	70
Shares in BCo	2000	Provision for long service leave	50
		Provision for tax	30
		US$ debt	1950
	2200		2200

Note: The alignment of the Y1 accounting and tax positions has not resulted in a change in the amount of taxable income (though the component parts are different). The notional journal entries to reflect the alignment are:

Dr Tax expense	$30		
		Cr Provision for tax	$30

Year 2

During the Y2 financial year, ACo paid the Y1 tax of $30, received income of $100, paid expenses of $60 and made provision for long service leave of $50 and tax of $12. At end of Y2 the A$ value of the US$ debt is $2050.

Table 16

Item description		Tax outcome ($)		Accounting outcome ($)
Income		100		100
Gross income		100		100
Expenses	60		60	
Long service leave			50	
Forex loss			100	
Total deductions/expenses		60		210
Income/loss		40		(110)

Table 17: Financial position at end Y2 ($)

Cash	110	Capital	100
Land	100	Retained earnings	(7)
Shares in BCo	2000	Provision for long service leave	100
DTA – long service leave	30	Provision for tax	12
DTA – forex	15	US$ debt	2050
	2255		2255

Table 18: Journal entries for Y2 ($)

Dr DTA – long service leave	15		
Dr DTA – forex	15		
Dr DTL – forex	15		
		Cr Tax expense	33
		Cr Provision for tax	12

Table 19: Financial position reflecting the alignment of tax and accounting positions at end Y2 for section 705-80 purposes ($)

Cash	110	Capital	100
Land	100	Retained earnings	(7)
Shares in BCo	2000	Provision for long service leave	100
DTA – loss	33	US$ debt	2050
	2243		2243

Note: As a consequence of the alignment of the Y2 accounting and tax positions, a notional loss of $110 is available to be offset against the Y3 profits. The notional journal entries reflecting the carry forward tax loss of $110 are:

Dr Deferred tax asset – Tax loss	$33		
		Cr Tax expense	$33

Year 3

During the Y3 financial year, ACo paid the Y2 tax of $12, received income of $100, paid a $70 fully franked dividend ($100 – $30 franking credits) and made provision for long service leave of $50 and tax of $30. At end Y3 the A$ value of the US$ debt is $1300.

Table 20

Item description	Tax outcome ($)	Accounting outcome ($)
Income	100	100
Forex gain		750
Gross income	100	850
Expenses – long service leave		50
Income/loss	100	800

Table 21: Financial position at end Y3 ($)

Cash	128	Capital	100
Land	100	Retained earnings	483
DTA – long service leave	45	Provision for long service leave	150
Shares in BCo	2000	Provision for tax	30
		US$ debt	1300
		DTL	210
	2273		2273

Table 22: Journal entries for Y3 ($)

Dr DTA – long service leave	15		
Dr Tax expense	240		
		Cr Provision for tax	30
		Cr DTL – forex	210
		Cr DTA – forex	15

Table 23: Financial position reflecting the alignment of tax and accounting positions at end Y3 for section 705-80 purposes ($)

Cash	128	Capital	100
Land	100	Retained earnings	483
DTA – long service leave	NIL	Provision for long service leave	150
Shares in BCo	2000	Provision for tax	195
		US$ debt	1300
	2228		2228

Note: As a consequence of the alignment of the Y3 accounting and tax positions, the Y3 notional taxable income is $690 (accounting profit of $800 less the notional carry forward loss from Y2 of $110). The notional journal entries reflecting the alignment are:

Dr Tax expense	$240		
		Cr Provision for tax	$207
		Cr Deferred tax asset – Tax loss	$33

The balance in the tax provision of $195 reflects the journal entry credit of $207 less the real world payment of $12 – there was no notional tax provision in the Y2 alignment accounts.

Year 4

During theY4 financial year, A Co paid the Y3 tax of $30, received income of $100, paid expenses of $150, made provision for long service leave of $50 and annual leave of $50. At the end of Y4 the A$ value of the US$ debt is $1600.

HC forms a consolidated group at the commencement of the Y5 financial year.

Table 24

Item description		Tax outcome ($)		Accounting outcome ($)
Income		100		100
Gross income		100		100
Expenses	150		150	
Long service leave			50	
Annual leave			50	
Forex loss			300	
Total deductions/expenses		150		550
Income/loss		(50)		(450)

Table 25: Financial position at end Y4 ($)

Cash	48	Capital	100
Land	100	Retained earnings	168
Shares in BCo	2000	Provision for long service leave	200
		Provision for annual leave	50
DTA – long service leave	60	US$ debt	1600
DTA – annual leave	15	DTL	120
DTA – tax loss	15		
	2238		2238

Table 26: Journal entries for Y4 ($)

Dr DTA – long service leave	15		
Dr DTA – annual leave	15		
Dr DTA – tax loss	15		
Dr DTL	90		
		Cr Tax expense	$135

Table 27: Financial position reflecting the alignment of tax and accounting positions at end Y4 for section 705-80 purposes ($)

Cash	48	Capital	100
Land	100	Retained earnings	168
Shares in BCo	2000	Provision for long service leave	200
DTA – long service leave	NIL	Provision for annual leave	50
DTA – annual leave	NIL	Tax	165
DTA – tax loss	135	US$ debt	1600
	2283		2283

Note: The Y4 alignment of accounting and taxation positions has resulted in a notional tax loss of $450. The notional journal entries reflecting the alignment outcome are:

Dr Deferred tax asset – tax loss	$135		
		Cr Tax expense	$135

Franking accounts for multi year example

Table 28: Franking account

Financial year	Description	Dr ($)	Cr ($)	Balance ($)
Y2	Paid Y1 tax		30	30
Y3	Paid Y2 tax		12	42
	Franked div.	30		12
Y4	Paid Y3 tax		30	42

Note: ACo's franking account balance at the joining time is $42. Because Y4 results in a tax loss, the assumptions in subsection 705-90(4) have no application.

The amount of undistributed profits for section 705-90 purposes (ACA step 3) is $98 ($42 x 70/30).

Table 29: Hypothetical franking account (reflecting the alignment of the taxation and accounting positions for section 705-80 purposes)

Financial year	Description	Dr ($)	Cr ($)	Balance ($)
Y2	Hypothetical payment of Y1 tax		30	30
Y3	Franked div.	30		NIL
Y4	Hypothetical payment of Y3 tax		207	207

Note: The amount of undistributed profits for hypothetical section 705-90 purposes (ACA step 3) is $483 ($207 x 70/30).

Table 30: ACA calculation ($)

ACA step	Initial ACA	Hypothetical ACA	Final ACA
Step 1	$100	$100	$100
Step 2 (Less 705-70 adjustment – Initial $75)	$1895	$2015	$2000
Step 3	$98	$168	$98
	$2093	$2283	$2198
Step 5 (Less 705-100(2) adjustment – Initial nil, Hypothetical $450 – $315)	$50	$135	$50
ACA	$2043	$2148	$2148

ACA is allocated to Cash $48, Land $100 and Shares $2000.

Accounts for multi-year example

Table 31: Capital ($)

Balance cfwd	100	Y1 Cash	100
	100		100
		Balance bfwd	100

Table 32: Cash ($)

Y1 Capital	100	Y1 Land	100
Y1 Loan	2000	Y1 Shares	2000
Y1 Income	100	Balance cfwd	100
	2200		2200
Balance bfwd	100	Y2 Tax	30
Y2 Income	100	Y2 Expenses	60
		Balance cfwd	110
	200		200
Balance bfwd	110	Y3 Tax	12
Y3 Income	100	Y3 Dividend	70
		Balance cfwd	128
	210		210
Balance bfwd	128	Y4 Tax	30
Y4 Income	100	Y4 Expenses	150
		Balance cfwd	48
	237		237
Balance cfwd	48		

Table 33: Land ($)

Y1 Cash	100	Balance cfwd	100
	100		100
Balance cfwd	100		

Table 34: Shares ($)

Y1 Cash	2000	Balance cfwd	2000
	2000		2000
Balance cfwd	2000		

Table 35: US$ debt ($)

Y1 Profit & loss	50	Y1 Cash	2000
Balance cfwd	1950		
	2000		2000
		Balance bfwd	1950
Balance cfwd	2050	Y2 Profit & loss	100
	2050		2050
Y3 Profit & loss	750	Balance bfwd	2050
Balance cfwd	1300		
	2050		2050
		Balance bfwd	1300
Balance cfwd	1600	Y4 Profit & loss	300
	1600		1600
		Balance bfwd	1600

Table 36: Income ($)

Y1 Profit & loss	100	Y1 Cash	100
	100		100
Y2 Profit & loss	100	Y2 Cash	100
	100		100
Y3 Profit & loss	100	Y3 Cash	100
	100		100
Y4 Profit & loss	100	Y4 Cash	100
	100		100

Table 37: Provision for long service leave ($)

Balance cfwd	50	Y1 Profit & loss	50
	50		50
		Balance bfwd	50
Balance cfwd	100	Y2 Profit & loss	50
	100		100
		Balance bfwd	100
Balance cfwd	150	Y3 Profit & loss	50
	120		150
		Balance bfwd	150
Balance cfwd	200	Y4 Profit & loss	50
	200		200
		Balance bfwd	200

Table 38: Provision for annual leave ($)

Balance cfwd	50	Y4 Profit & loss	50
	50		50
		Balance bfwd	50

Table 39: Provision for tax ($)

Balance cfwd	30	Y1 Journal	30
	30		30
Y2 Cash	30	Balance bfwd	30
Balance cfwd	12	Y2 Journal	12
	42		42
Y3 Cash	12	Balance bfwd	12
Balance cfwd	30	Y3 Journal	30
	42		42
Y4 Cash	30	Balance bfwd	30
	30		30

Table 40: Tax expense ($)

Y1 Journal	30	Y1 Profit & loss	30
	30		30
Y2 Profit & loss	33	Y2 Journal	33
	33		33
Y3 Journal	240	Y3 Profit & loss	240
	240		240
Y4 Profit & loss	135	Y4 Journal	135
	135		135

Table 41: DTA – Long service leave ($)

Y1 Journal	15	Balance cfwd	15
	15		15
Balance bfwd	15		
Y2 Journal	15	Balance cfwd	30
	30		30
Balance bfwd	30		
Y3 Journal	15	Balance cfwd	45
	45		45
Balance bfwd	45		
Y4 Journal	15	Balance cfwd	60
	60		60
Balance bfwd	60		

Table 42: DTA – Annual leave ($)

Y4 Journal	15	Balance cfwd	15
	15		15
Balance bfwd	15		

Table 43: DTA – tax loss ($)

Y4 Journal	15	Balance cfwd	15
	15		15
Balance bfwd	15		

Table 44: DTA – forex ($)

Y2 Journal	15	Balance cfwd	15
	15		15
Balance bfwd	15	Y3 Journal	15
	15		15

Table 45: DTL – forex ($)

Balance cfwd	15	Y1 Journal	15
	15		15
Y2 Journal	15	Balance bfwd	15
	15		15
Balance cfwd	210	Y3 Journal	210
	210		210
Y4 Journal	90	Balance bfwd	210
Balance cfwd	120		
	210		210
		Balance bfwd	120

Table 46: Expenses ($)

Y2 Cash	60	Y2 Profit & loss	60
	60		60
Y4 Cash	150	Y4 Profit & loss	150
	150		150

Table 47: Profit & loss ($)

Y1 Long service leave	50	Y1 Income	100
Y1 Tax expense	30	Y1 Forex gain	50
Y1 Retained earnings	70		
	150		150
Y2 Long service leave	50	Y2 Income	100
Y2 Expense	60	Y2 Tax expense	33
Y2 Forex loss	100	Y2 Retained earnings	77
	210		210
Y3 Long service leave	50	Y3 Income	100
Y3 Tax expense	240	Y3 Forex gain	750
Y3 Retained earnings	560		
	850		850
Y4 Long service leave	50	Y4 Income	100
Y4 Annual leave	50	Y4 Tax expense	135
Y4 Expense	150	Y4 Retained earnings	315
Y4 Forex loss	300		
	550		550

Table 48: Retained earnings ($)

Balance cfwd	70	Y1 Profit & loss	70
	70		70
Y2 Profit & loss	77	Balance bfwd	70
		Balance cfwd	7
	77		77
Balance bfwd	7		
Y3 Dividend	70		
Balance cfwd	483	Y3 Profit & loss	560
	560		560
Y4 Profit & loss	315	Balance bfwd	483
Balance cfwd	168		
	483		483
		Balance bfwd	168

Table 49: Trial balance

Account	Dr ($)	Cr ($)
Capital		100
Cash	48	
Land	100	
Shares	2000	
US$ debt		1600
Provision – Long service leave		200
Provision – Annual leave		50
DTA – Long service leave	60	
DTA – Annual leave	15	
DTA – Tax loss	15	
DTL – Forex		120
Retained earnings		168
Total	2238	2238

Hypothetical accounts for multi-year example

(Reflecting the alignment of the taxation and accounting positions for s705-80 purposes)

Table 50: Hypothetical provision – tax ($)

Balance cfwd	30	Y1 Journal	30
	30		30
Y2 Cash	30	Balance bfwd	30
	30		30
Y3 Cash	12	Y3 Journal	207
Balance cfwd	195		
	207		207
Y4 Cash	30	Balance bfwd	195
Balance cfwd	165		
	195		195
		Balance bfwd	165

Table 51: Hypothetical DTA – tax loss ($)

Y2 Journal	33	Balance cfwd	33
	33		33
Balance bfwd	33	Y3 Journal	33
	33		33
Y4 Journal	135	Balance cfwd	135
	135		135
Balance bfwd	135		

Table 52: Hypothetical trial balance

Account	Dr ($)	Cr ($)
Capital		100
Cash	48	
Land	100	
Shares	2000	
US$ debt		1600
Provision – Long service leave		200
Provision – Annual leave		50
Provision – Tax		165*
DTA – Long service leave	NIL*	
DTA – Annual leave	NIL*	
DTA – Tax loss	135*	
DTL – Forex		NIL*
Retained earnings		168
Total	2283	2283

* These entries differ from those in the actual trial balance (table 49).

References

Income Tax Assessment Act 1997, sections 705-35, 705-70, 705-75, 705-80 and 995-1; as amended and inserted by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax system (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2
- *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) Bill (No. 1) 2002, paragraphs 5.65 to 5.74.

Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5

Taxation Determination TD 2004/70 – Income tax: consolidation: does the phrase 'is taken into account at a later time' in paragraph 705-80(1)(a) of the *Income Tax Assessment Act 1997* require that an accounting liability, or a change in the amount of an accounting liability, of a joining entity that is first recognised after the joining time be examined when determining whether or not section 705-80 of that Act applies?

Taxation Determination TD 2004/71 – Income tax: consolidation: can section 705-80 of the *Income Tax Assessment Act 1997* apply to a liability (or a change in a liability) that is recognised for accounting purposes because of an event that occurred after the joining time that provides new evidence of conditions that existed at the joining time?

Revision history

Section C2-4-245 first published 28 May 2003.

Revisions are described below.

Date	Amendment	Reason
3.12.03	Extra examples included to clarify the operation of section 705-80 using liabilities raised by accrued employee leave entitlements to demonstrate the principle.	Clarification.
	Administrative short cut provided for notional reconstruction where limited information is available.	Provided under Commissioner's administrative powers.
27.1.05	Guidelines provided for notional reconstruction to align accounting and tax positions, illustrated with an example.	Provided under Commissioner's administrative powers.
26.10.05	References to two new tax determinations.	
	Deletion of table on notional reconstruction, p. 2.	To correct misleading information.
26.6.07	Changes to tables 26 and 30.	To correct errors.
	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, consequential minor changes to examples 1, 2 and 3.	Legislative amendments.
	Removal of note on proposed changes to clarify both the valuation of liabilities and the accounting principles to be used.	