Worked example

Determining the amount of a deferred tax liability to be used at ACA step 2, including use of administrative short cuts

Description

This example shows how to work out, for the purposes of subsection 705-70(1A), the amount of a deferred tax liability (DTL) to be used at ACA step 2 where the DTL for the joined group can be assumed to be less than it was for the joining entity. Administrative short cuts are available for this purpose in certain circumstances.

Note

Proposed changes to consolidation rules

Proposed changes to the consolidation rules will simplify the cost setting process in relation to deferred tax liabilities for entities that form a consolidated group during the transitional period – see Treasury Position Paper No. 23, *Adjusting for changes in deferred tax liabilities in working out the allocable cost amount* on the Consolidation CD or at **www.treasury.gov.au**

Commentary

Generally the liability to be added at step 2 is the amount that can or must be recognised in the joining entity's notional statement of financial position at the joining time, determined in accordance with accounting standards or statements of accounting concepts made by the Australian Accounting Standards Board → subsection 705-70 (1), ITAA 1997.

However, if, in accordance with the accounting standards or statements, the amount of the accounting liability of the joining entity would be different when it became an accounting liability of the joined group, the latter amount is treated as the amount of the liability → subsection 705-70 (1A), ITAA 1997.

An example of an accounting liability that would be affected by this rule is a deferred tax liability (DTL).

When determining the value of a DTL, the amount recognised in the notional statement of financial position should be the amount that would have been recognised if the deferred tax assets (DTA) and DTL had not been set off in accordance with AASB 1020 (AAS 3) 'Income Taxes'.

The purpose of subsection 705-70(1A) is to ensure that the appropriate amount of ACA is allocated to reset cost base assets. Where a head company of a consolidated group acquires another entity to bring into the group, it is assumed that the head company will pay only the market value for the net assets of the entity. In deciding what it is willing to pay, the head company will factor in the value of DTL in the joining entity that will be recognised by the consolidated group at the joining time. Without an adjustment, the resulting higher acquisition price, together with the existing value of DTL in the joining

entity, would effectively create a double count in the ACA. By replacing the joining entity's value for DTL with the amount that would be the accounting liability of the joined group, this double counting is negated.

Subsection 705-70(1A) therefore requires the value of the joining entity's DTL when it becomes a DTL of the group to be used at step 2 of the ACA calculation, rather than the DTL included in the joining entity's statement of financial position immediately before the joining time.

Determining the most accurate value for what will become the DTL of the group may require several iterations of the ACA calculation. For example, the correct amount for DTL to be used at step 2 can be worked out using a process of trial and error. The ACA is first calculated based on a particular value of DTL. This could be the DTL carried by the joining entity before the joining time, or a considered estimate of what that value might be. This ACA amount is then allocated to the reset cost base assets of the joining entity to determine their tax cost setting amounts (TCSAs). This in turn allows an amount for the DTL to be determined for the head company based on the TCSAs. If this new DTL is different to the DTL used in the first ACA calculation, a second ACA calculation is required using the new DTL. This process is repeated until the DTL determined for the head company is the same as that used in the last iteration; that is, until there is no longer any variation in the value of the DTL between iterations. It is this amount of the DTL in the joining entity that becomes the DTL of the joined group, and the amount that should be used for the purposes of ACA step 2.

In view of the compliance costs of such an iterative process, you have the option of applying one of the three administrative short cut methods outlined below. If these short cut methods are not suitable for your circumstances and you would like to use another administrative approach, contact the Tax Office for guidance.

Administrative short cuts

1. You can perform two or three ACA iterations and then make an informed judgement to estimate the final result, and then redo the calculation using that estimate, so as to shorten the iterative process required to produce a result.

2. You can apply a 'materiality' factor to the change in value at each iteration to limit the number of iterations required – i.e., you do not need to do another iteration provided the change in value of the DTL between iterations is 2% or less and less than $1 million dollars → 'Short cut method 2: applying the materiality factor', p. 8.

3. You can stop the process at any point in the iterative cycle provided the value of the DTL at that point is less than the DTL used in the previous iteration.

The short cut methods are illustrated below in Example 1.

In some cases, applying section 705-70(1A) may not require numerous iterations and thus consideration of the short cut methods is not required. See Example 2, where the correct DTL was determined by the second iteration.

Note: In cases where an existing consolidated group acquires all of the membership interests in a joining entity for a price reflecting the full market value of its assets, and it is expected that no adjustment will be needed for over-depreciation, so that no discount has been allowed in the purchase price for DTL of the joining entity, the starting value for DTL in the iterative process could be zero. This should reduce the number of iterations required.

Example 1

Facts

Sub Co is incorporated by head company HCo for $200,000 on 1 July 2004. At that time Sub Co acquires property for $100,000 and a depreciating asset for $100,000. For the year ending 30 June 2005, Sub Co derives accounting income (also assessable income) of $100,000. No dividends were paid. The asset is depreciated 20% for accounting purposes and 50% for tax purposes.

HCo forms a consolidated group with Sub Co on 1 July 2005. Its financial performance and financial position at the joining time is as follows:

Table 1: Sub Co – financial performance for year ending 30 June 2005 ($)

	A/Cs	Tax
Sales	100,000	100,000
Depreciation	20,000	50,000
Profit	80,000	50,000
Tax at 30%	24,000	15,000
Tax Expense	24,000	
Provision for Tax	15,000	
DTL	9,000	

Table 2: Sub Co – financial position at 30 June 2005 ($)

Cash	100,000	Equity	200,000
Property	100,000	Profit	56,000
Asset	80,000	Provision for Tax	15,000
		DTL	9,000
	280,000		280,000

Sub Co's franking account has a credit balance on 30 June 2005 of $15,000 (on a tax paid basis, under the Simplified Imputation System). The converted balance is then grossed-up under subsection 705-90(3) to $35,000. After adjusting for hypothetical payments etc. under subsection 705-90(4), the step 3 amount is limited to $35,000.

Sub Co's book value for the depreciating assets is $80,000 and adjustable value is $50,000. In this case the market value of the depreciating asset is equal to its book value at the joining time.

Calculation

The following calculation shows how the value of the DTL to be used at step 2 of the ACA calculation is determined, starting, for convenience, with the joining entity's DTL amount.

Table 3: ACA calculation – 1st iteration ($)

Step 1	Add cost of membership interests		200,000
Step 2	Add Liabilities		
	– Provision for Tax	15,000	
	– DTL to be carried by HCo	9,000	24,000
Step 3	Add undistributed taxed profits		35,000
Step 8	Total ACA		259,000

Table 4: Tax cost setting amounts (TCSA) after 1st iteration ($)

Step A	ACA	259,000
Step B	*Less* retained cost base assets	
	–- Cash	(100,000)
Step C	Allocate balance of ACA to reset cost base assets	159,000
	Market value	**TCSA**
Property	100,000	88,333
Asset	80,000	70,667
	180,000	159,000

Table 5: Value of DTL to head company after 1st ACA iteration ($)

	Book value	**TCSA**	**Diff @30%**
Asset	80,000	70,667	(9,333 x 30%) = 2,800
DTL in head coy			2,800

This does not match the DTL used in ACA step 2. This amount is used in the next iteration.

Table 6: ACA calculation – 2nd iteration ($)

Step 1	Add cost of membership interests		200,000
Step 2	Add Liabilities		
	– Provision for Tax	15,000	
	– DTL to be carried by HCo	2,800	17,800
Step 3	Add undistributed taxed profits		35,000
Step 8	Total ACA		252,800

Table 7: TCSAs after 2nd iteration ($)

Step A	ACA	252,800
Step B	*Less* retained cost base assets	
	– Cash	(100,000)
Step C	Allocate balance of ACA to reset cost base assets	152,800
	Market value	**TCSA**
Property	100,000	84,889
Asset	80,000	67,911
	180,000	152,800

Table 8: Value of DTL to head company after 2nd ACA iteration ($)

	Book value	**TCSA**	**Diff @30%**
Asset	80,000	67,911	(12,089 x 30%) = 3,627
DTL in head coy			3,627

After the second iteration the DTL is $3,627. This does not match the DTL used in step 2 in the second ACA iteration. This amount is used in the next ACA iteration.

Table 9: ACA calculation – 3rd iteration ($)

Step 1	Add cost of membership interests		200,000
Step 2	Add Liabilities		
	– Provision for Tax	15,000	
	– DTL to be carried by HCo	3,627	18,627
Step 3	Add undistributed taxed profits		35,000
Step 8	Total ACA		253,627

Table 10: TCSAs after 3rd iteration ($)

Step A	ACA	253,627
Step B	*Less* retained cost base assets	
	– Cash	(100,000)
Step C	Allocate balance of ACA to reset cost base assets	153,627
	Market value	**TCSA**
Property	100,000	85,348
Asset	80,000	68,279
	180,000	153,627

Table 11: Value of DTL to head company after 3rd ACA iteration ($)

	Book value	**TCSA**	**Diff @30%**
Asset	80,000	68,279	(11,721x 30%) = 3,516
DTL in head coy			3,516

After the third iteration the DTL is $3,516. This is different to the amount used in ACA step 2 for this iteration, although the difference is gradually reducing. The process is continued until the number does not change.

Table 12: Apply 705-70(1A) ($)

		4th calc	**5th calc**	**6th calc (final)**
ACA Step 1		200,000	200,000	200,000
Step 2	Provision for Tax	15,000	15,000	15,000
	DTL	**3,516**	**3,531**	**3,529**
Step 3		35,000	35,000	35,000
Total ACA		253,516	253,531	253,529
Apply to Cash		100,000	100,000	100,000
Available to reset cost base assets	Market value			
Property	100,000	85,287	85,295	85,294
Asset	80,000	68,229	68,236	68,235
Total	180,000	153,516	153,531	153,529
DTL in head entity				
Asset		3,531	3,529	3,529
Total DTL		3,531	3,529	3,529

To the nearest dollar the amount used for DTL at step 2 of the ACA calculation in the 6th iteration is the same as the DTL calculated for the group at the end of the 6th iteration. The correct amount of DTL to be counted at step 2 of the ACA under subsection 705-70(1A) is therefore $3,529. The step 2 amount will be $18,529 ($15 000 + 3,529) and not $24,000 (as in the first iteration).

Table 13: Final ACA calculation ($)

Step 1	Add cost of membership interests		200,000
Step 2	Add Liabilities		
	– Provision for Tax	15,000	
	– DTL to be carried by HCo	3,529	18,529
Step 3	Add undistributed taxed profits		35,000
Step 8	Total ACA		253,529

Table 14: Final TCSAs ($)

Step A	ACA	253,529
Step B	*Less* retained cost base assets	
	– Cash	(100,000)
Step C	Allocate balance of ACA to reset cost base assets	153,529
	Market value	**TCSA**
Property	100,000	85,294
Asset	80,000	68,235
	180,000	153,529

Applying the short cut methods to Example 1

Short cut method 1: shortening the process by informed judgement

Example 1 demonstrates that the result for the DTL at each iteration will lie between its original value in the joining entity and the first value calculated in the head company. The difference in value between iterations gradually declines until the DTL used in step 2 is the same as the DTL determined for the group. The use of an informed judgement after, say, two or three iterations may reduce the number of iterations required to reach the final result.

In Example 1, after the third iteration you could make the judgement that in the next iteration you will insert a value for the DTL of, say, $3,520. After two more iterations you may want to make another informed judgement of the DTL value to be inserted in the next iteration.

Short cut method 2: applying the materiality factor

The number of iterations can be reduced by applying a materiality factor to the percentage change in DTL between iterations – i.e., you do not need to do another iteration provided the change in value of the DTL between iterations is 2% or less and less than $1 million dollars.

This short cut method is demonstrated using Example 1 in table 15. By iteration 4, the change in the DTL value (i.e., $3,531-$3516 = $15 or 0.43%) is 2% or less and less than $1 million. Therefore, using this short cut, the number of iterations required in this example is limited to four.

Table 15: Applying the materiality factor short cut

Iteration	DTL used in step 2 ($)	DTL in head entity after calculation ($)	Difference ($)	Calculation	Percentage change (%)
1	9000	2,800	6,200	6,200/9,000 x 100/1	68.89
2	2,800	3,627	827	827/2,800 x 100/1	29.54
3	3,627	3,516	111	111/3,627 x 100/1	3.06
4	3,516	3,531	15	15/3,516 x 100/1	0.43
5	3,531	3,529	2	2/3,531 x 100/1	0.06
6	3,529	3,529	0		n/a

Short cut method 3: stopping the process when the DTL is less than the previous iteration

Example 1 demonstrates how the DTL value 'zig zags' between the original value in the joined entity and the first value calculated in the head entity. The change in the value of the DTL becomes smaller with each iteration.

The Tax Office will accept a value determined by you where you choose to stop at any point in the iterative process, provided the value of the DTL at that point is less than the DTL used in the previous iteration.

For instance, in Example 1, you may choose to halt the process after iterations 1 or 3. If you choose to stop at these iterations the DTL value that you would use at step 2 of the final ACA calculation would be $2,800 or $3,516 respectively.

Example 2

Facts

Head company HCo is the head company of an existing consolidated group. It acquires 100% of the membership interests in Sub Co for $245,500 on 1 July 2003. As a result Sub Co joins the consolidated group. Sub Co's statement of financial position is shown in table 16.

Before the joining time, Sub Co paid an unfranked dividend of $15,000 to its holding company. The holding company was entitled to an inter-corporate dividend rebate in respect of the dividend.

Table 16: Sub Co – Statement of financial position at joining time ($)

Cash	85,000	Capital	200,000
Depreciating Asset	80,000	Retained earnings	41,000
Non-depreciating Asset	100,000	Provision for Tax	15,000
		Deferred tax liability	9,000
	265,000		265,000

Sub Co's book value for the Depreciating Asset is $80,000 and adjustable value is $50,000. In this case the market value of the Depreciating Asset is equal to its book value at the joining time.

Calculation

The following example shows how to work out the value of the DTL to be used at step 2 of the ACA calculation, starting, for convenience, with the joining entity's DTL amount.

Table 17: ACA calculation – 1st iteration ($)

Step 1	Add cost of membership interests		245,500
Step 2	Add Liabilities		
	– Provision for Tax	15,000	
	– DTL to be carried by HCo	9,000	24,000
Step 8	ACA		269,500

Table 18: TCSAs after 1st iteration ($)

Step A	ACA	$269,500
Step B	*Less* retained cost base assets	
	– Cash	($85,000)
Step C	Allocate balance of ACA to reset cost base assets and adjust for revenue like assets	$184, 500
	Market value	**TCSA**
Depreciating Asset	$80, 000	$80,000*
Non-depreciating Asset	$100,000	$104,500*
	$180,000	$184, 500
Step D	Adjust TCSA of over-depreciated asset	
Depreciating Asset		$65,000**
Non-depreciating Asset		$104,500

* Tax cost setting amount for reset cost base assets held on revenue account adjustment (section 705-40). The TCSA amount for a depreciating asset must not exceed the greater of the asset's market value and the joining entity's terminating value. In the above case the TCSA of the Depreciating Asset was $82,000, i.e. $2,000 greater than its market value. This excess is allocated to other reset cost base asset (i.e. Non-depreciating Asset increased from $102,500 to $104,500).

** The Depreciating Asset is over-depreciated by $30,000. The tax deferral amount for the Depreciating Asset is $15,000. The lesser of these two amounts (i.e., $15,000) is the over-depreciation reduction amount under section 705-50. Therefore the TCSA for the Depreciating Asset is further reduced from $80,000 to $65,000. The excess of this amount is not reallocated to other reset cost base assets.

Table 19: Value of DTL to head company after 1st ACA iteration ($)

	Book value	TCSA	Diff @30%
Depreciating Asset	80,000	65,000	($15,000 x 30%) = 4,500
DTL in head coy			4,500

This does not match the DTL used in ACA step 2. This amount is used in the next iteration.

Table 20: ACA calculation – 2nd iteration ($)

Step 1	Add cost of membership interests		245,500
Step 2	Add Liabilities		
	– Provision for Tax	15,000	
	– DTL to be carried by HCo	4,500	19,500
Step 8	ACA		265,000

Table 21: TCSAs after 2nd iteration ($)

Step A	ACA	$265,000
Step B	*Less* retained cost base assets	
	– Cash	($85,000)
Step C	Allocate balance of ACA to reset cost base assets and adjust for revenue like assets	$180,000
	Market value	**TCSA**
Depreciating Asset	$80,000	$80,000*
Non-depreciating Asset	$100,000	$100,000
	$180,000	$180,000
Step D	Adjust TCSA of over-depreciated assets	
Depreciating Asset		$65,000**
Non-depreciating Asset		$100,000

* No revenue-like asset adjustment required. The TCSA amount for the depreciating asset does not exceed the greater of the asset's market value and the joining entity's terminating value (section 705-40).

** As previously determined, the over-depreciation reduction amount under section 705-50 is $15,000. Therefore the TCSA for the Depreciating Asset is further reduced from $80,000 to $65,000. The excess of this amount is not reallocated to other reset cost base assets.

Table 22: Value of DTL to head company after 2nd ACA iteration ($)

	Book value	TCSA	Diff @30%
Depreciating Asset	80,000	65,000	($15,000 x 30%) = 4,500
DTL in head coy			4,500

This matches the DTL used in ACA step 2. Therefore, in this example, further iterations are not required and the short cuts do not need to be considered.

The final tax cost setting amounts for the reset cost base assets are the amounts as in table 21 – the amounts at the second iteration.

References

Income Tax Assessment Act 1997, subsections 705-70(1) and 705-70(1A); as amended by the *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002)

Revision history

Section C2-4-242 first published 3 December 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on proposed changes to consolidation rules, p. 1.	Proposed legislative amendments.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).