

Worked example

Adjustment to accounting liabilities for employee entitlements in ACA step 2

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 section 705-75 on a liability raised by accrued employee leave entitlements.

Commentary The second step in determining a joining entity's ACA involves adding all of its accounting liabilities, in accordance with accounting standards, or statements of accounting concepts made by the Australian Accounting Standards Board, at the joining time. → section 705-70

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) → section 705-75. Accrued employee leave such as long service leave is a liability of the accruing entity according to the accounting standards. Such an accrued employee leave entitlement is not deductible in the year it accrues, but will be deductible by the head company when taken. Therefore the cost of the liability to the group is the liability less the benefit from the future tax deduction.

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. This 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. That may result in a variation to the 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) amounts.

The notional ACA is then compared with the first ACA (an ACA 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.

Example

Facts ACo is incorporated on 1 July 2001 with \$200 cash by HCo.

Table 1: Financial position at 1 July 2001

| | | | |
|------|-------|---------|-------|
| Cash | \$200 | Capital | \$200 |
| | \$200 | | \$200 |

During the financial year ending 30 June 2002, ACo makes tax losses of \$100 and a provision for long service leave of \$100.

Table 2: Financial position at 30 June 2002

| | | | |
|----------------------------|-------|----------------------|---------|
| Cash | \$100 | Capital | \$200 |
| Future income tax benefits | \$30 | Retained earnings | (\$170) |
| | | Provision | |
| | | - Long service leave | \$100 |
| | \$130 | | \$130 |

On 1 July 2002, HCo forms a consolidated group with ACo as a subsidiary member.

Calculation **The first ACA calculation**

The provision for employee long service leave is a liability according to the accounting standards and it is not deductible for income tax purposes in the year it accrues. Therefore, as a section 705-70 liability, only its net cost to the group is recognised at step 2 of the ACA calculation → section 705-75:

| | | |
|-------------|--|---------|
| Step 1 | Add amount paid by HCo to incorporate ACo | \$200 |
| Step 2 | Add amount accrued for long service leave, \$100 (section 705-70), minus \$30, the future tax deductible amount (section 705-75) | \$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)

For the notional ACA calculation, assume that the accrued employment leave entitlement is tax deductible in the financial year ending 30 June 2002. The notional financial position in this situation is shown in table 4.

Table 4: Notional statement of financial position at 1 July 2002

| | | | |
|------|--------------|----------------------|--------------|
| Cash | \$100 | Capital | \$200 |
| | | Retained earnings | (\$200) |
| | | Provision | |
| | | - Long service leave | \$100 |
| | <u>\$100</u> | | <u>\$100</u> |

The notional ACA calculation is as follows:

| | | |
|--------------|---|--------------|
| Step 1 | Add amount paid by HCo to incorporate ACo | \$200 |
| Step 2 | Add amount accrued for long service leave (section 705-70) | \$100 |
| Steps 3 & 4 | | Nil |
| Step 5 | Subtract unused tax losses <i>plus</i> \$100, the accrued employee leave entitlement (as if it were deductible for income tax purposes) | (\$200) |
| Steps 6 & 7 | | Nil |
| Notional ACA | | <u>\$100</u> |

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 | | Nil |
| Steps 3 & 4 | | Nil |
| Step 5 | Subtract unused tax losses | (\$100) |
| Steps 6 & 7 | | Nil |
| Final ACA | | <u>\$100</u> |

Allocation of the final ACA

The ACA is \$100. The tax cost setting amount for retained cost base assets (cash) is \$100. The future tax asset is an excluded asset under subsection 705-35(2). There is no excess or shortfall in the ACA.

References

Income Tax Assessment Act 1997, sections 705-35, 705-70, 705-75 and 705-80; as amended 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

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 5.65 to 5.74.