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. The example also shows how a reconstruction of the accounts required by section 705-80 may be undertaken using an administrative shortcut where insufficient information is available for an accurate reconstruction.

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. → subsection 705-70(1)

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 variations 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 the variations to these amounts are only 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.

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.

The following table provides a guide as to the situations in which a notional reconstruction of the joining entity's tax position is required by section 705-80.

Table 1: Is a notional reconstruction of the tax position required?

Situation	Reconstruction required?
On formation, non-chosen subsidiary member where: • there are *no* unrecouped accounting losses at the joining time (i.e. retained profits are nil or above), and • there are *no* unutilised tax losses at the joining time, and either: • there are *no* notional unutilised tax losses* at the joining time arising from the alignment of the accounting and tax positions required by section 705-80,	No
or • there *are* unutilised notional tax losses* arising from the alignment of the accounting and tax positions required by section 705-80.	Yes
Unrecouped accounting losses or unutilised tax losses exist at the joining time	Yes
Single entity joining a consolidated group (basic case)	Yes

* Notional tax losses: In situations where a taxpayer is in accounting profit, notional tax losses arising from the alignment of the accounting and tax positions will only occur where:

– there is a timing difference between income tax provisions and accounting standards in recognising income, or

– the tax law allows deductions to be claimed at a greater rate than would be the case for the same class of accounting expense (such as where accelerated depreciation or concessions such as R&D have been claimed for tax purposes).

A comparison of the tax position disclosed in the income tax returns and the liabilities to which section 705-80 applies will give an indication as to whether any notional tax deductions for the liability would give rise to a notional tax loss.

Short cut method for notional reconstruction

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 Tax Office 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.

Examples

Examples 1 to 3 demonstrate how section 705-80 applies to the ACA calculation, while examples 4 and 5 demonstrate 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.

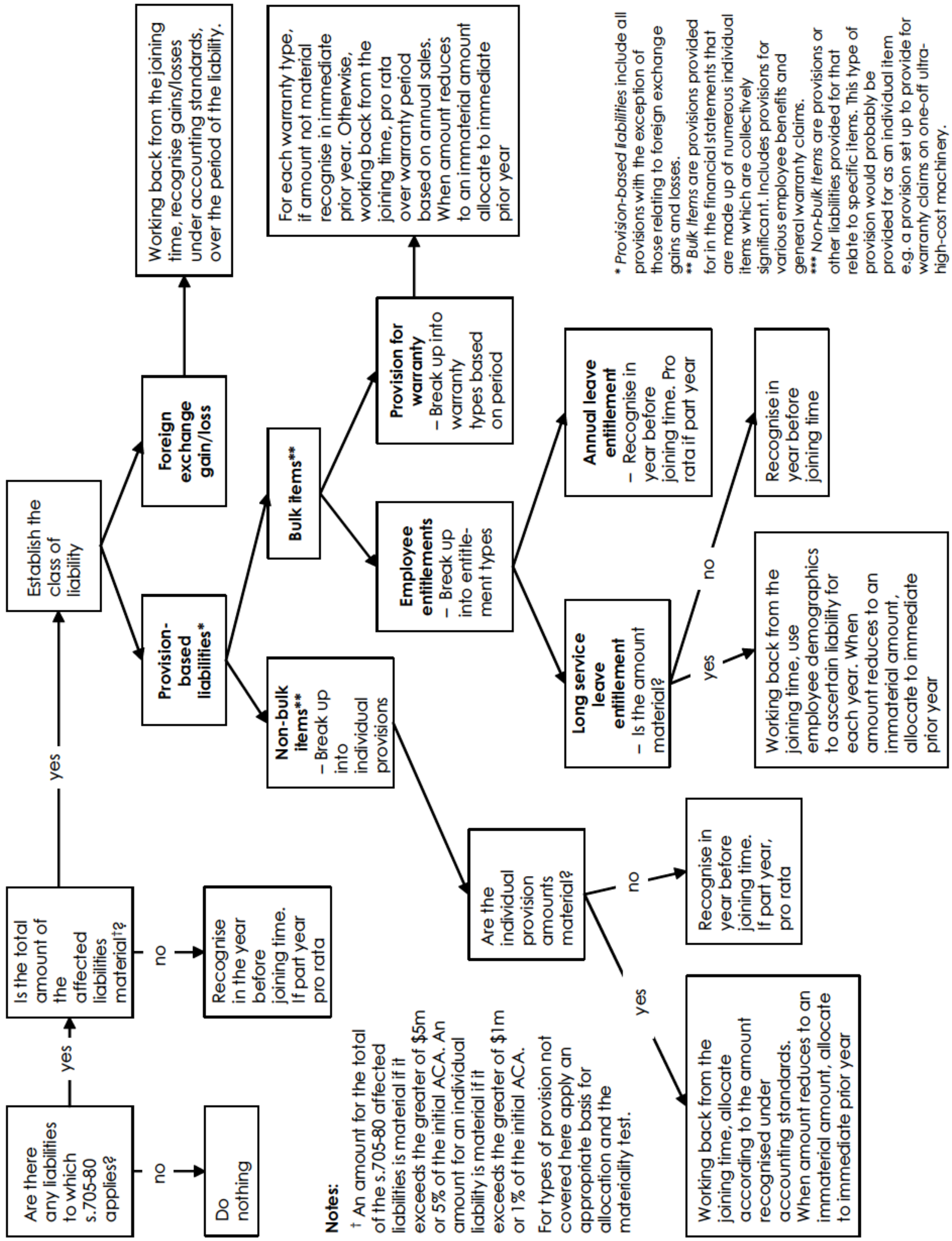
Example 2 shows how section 705-80 applies to the ACA calculation for a joining entity that has accounting profits. A reconstruction is not necessary because the joining entity is in an accounting and tax profit situation at the joining time and on the application of section 705-80 the notional tax deductions 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 the notional reconstruction where only limited information is available and the notional deductions are determined using the administrative short cut method described in figure 1.

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.

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

Cash	100	Capital	200
Deferred tax asset	60	Retained earnings	(140)
		Provision	
		– Annual leave	100
	160		160

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 a liability according to the accounting standards and it 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
Deferred tax asset	30	Retained earnings	70
		Provisions	
		– Income tax	60
		– Annual leave	100
	430		430

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

First ACA calculation

The provision for annual 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 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
Deferred tax asset	60	Retained earnings	(140)
		Provisions	
		– 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
Deferred tax asset	120	Retained earnings	(280)
		Provisions	
		– Annual leave	100
		– Long service leave	100
	220		220

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

First ACA calculation

The provisions for annual leave and long service leave are liabilities according to the accounting standards 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 require 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

Facts

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
Deferred tax asset	15	Provisions	
		– Long service leave	50
		– 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
Deferred tax asset	21	Provisions	
		– Long service leave	70
		– 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
Deferred tax asset	36	Provisions	
		– long service leave	120
		– 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
Deferred tax asset	66	Provisions	
		– long service leave	170
		– Tax	30
		– 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

Facts

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	<u>$105m</u>
ACA	<u>$389m</u>

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.

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.

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