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Accounting for tax consolidation under A-IFRS

A drop in the IFRS ocean?

August 2005



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Welcome to our *Discussion Paper* on accounting for tax consolidation under Australian equivalents to International Financial Reporting Standards (A-IFRS).

In this *Discussion Paper*, we focus on recently issued UIG Interpretation 1052 *Tax Consolidation Accounting* (Interpretation 1052). The debate around accounting for tax consolidation has continued unabated since soon after the Federal Government announced the move to allow Australian groups to tax consolidate. The process has been long and arduous and the development of Interpretation 1052 is the latest instalment, this time under A-IFRS.

For all the rigmarole surrounding the development of this latest instalment on the appropriate accounting for tax consolidation, there may seem that there is little to get excited about. After months of debate and consideration, Interpretation 1052 deals only with the separate financial statements of entities within a tax-consolidated group and many of the other issues surrounding the accounting for income tax in the tax consolidation environment remain unresolved.

However, from a commercial perspective, there are three clear messages for Australian entities arising from Interpretation 1052:

1. tax funding arrangements need to be reviewed and if necessary rewritten to avoid superfluous accounting implications
2. the costs and benefits of any systems changes need to be considered
3. care needs to be taken to ensure that the accounting methodology adopted does not result in unfavourable tax consequences.

This paper explores these issues in addition to providing an in-depth analysis of the accounting mechanics of Interpretation 1052.

We trust that our clients will find this *Discussion Paper* a useful tool in applying Interpretation 1052.

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1. Executive summary

1.1. Overview and introduction

This paper is designed to assist Australian entities in the application of Interpretation 1052 under A-IFRS. Accounting for tax consolidation under A-IFRS is a very small piece of the overall transition puzzle, particularly since Interpretation 1052 only deals with accounting within the separate financial statements of each member of the tax-consolidated group. In other words, tax accounting in the consolidated financial statements is not affected by Interpretation 1052.

The basic thrust of Interpretation 1052 is that the transactions of each entity in a tax-consolidated group remain taxable and so consolidated current and deferred taxes are allocated to each entity, although there is considerable flexibility in how this allocation process is undertaken. Because the legal form of tax consolidation in Australia accords the head entity with the primary obligation for tax, adjustments are then required to recognise this 'assumption' of tax. This can result in equity adjustments being recognised unless tax funding arrangements mirror the initial tax accounting in each entity.

In some respects, the requirements of Interpretation 1052 may be nothing more than an inconvenient distraction in the A-IFRS transition process for many entities. However, the method of accounting for tax consolidation under Interpretation 1052 is vastly different from that which applied under UIG Abstract 52 'Income Tax Accounting under the Tax Consolidation System' and there will be some effort required to implement Interpretation 1052.

In addition, there are three key messages that arise from the implementation of Interpretation 1052 which will warrant attention by all affected entities, as follows:

- **accounting** – tax funding arrangements may need to be reviewed and if necessary rewritten to avoid superfluous accounting implications (see section 3.3)
- **systems** – the costs and benefits of any systems changes to implement Interpretation 1052 need to be considered, particularly in light of proposed changes to IAS 12 *Income Taxes* that have the potential to again change tax consolidation accounting (see sections 3.2.7 and 6.3)
- **tax** – care needs to be taken to ensure that the accounting methodology adopted does not have unfavourable tax consequences (see section 5.3).

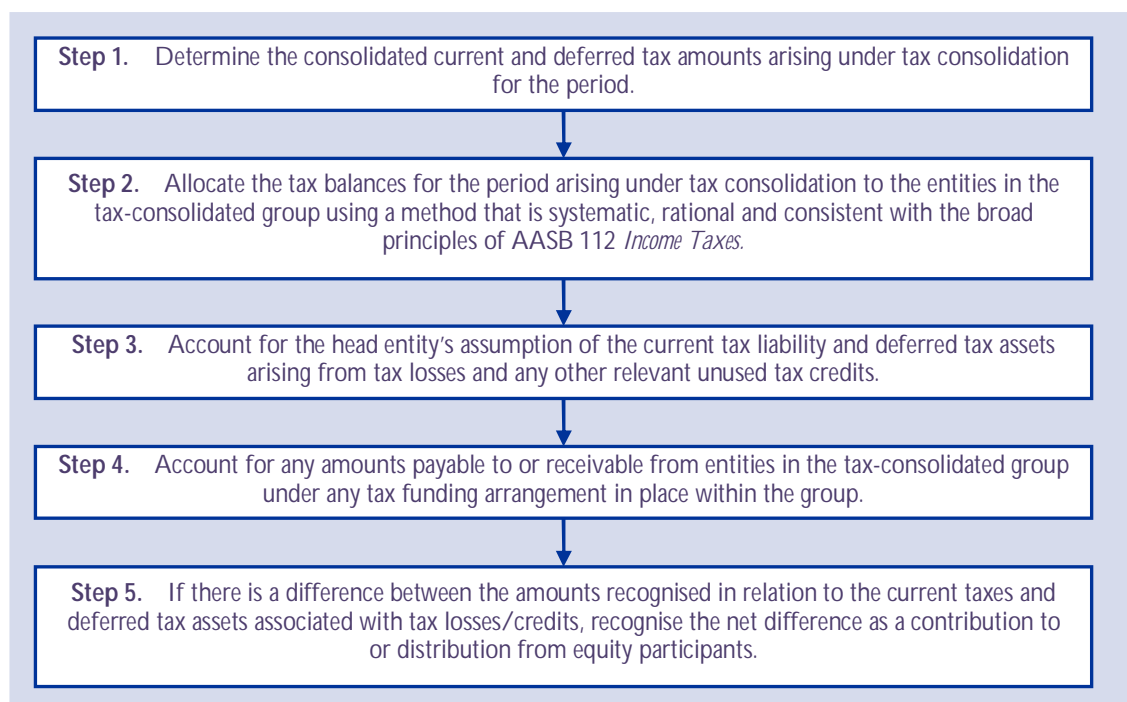
Although there is no impact on consolidation from Interpretation 1052, there remain a number of key issues that all entities should consider – some with potentially real profit and cash flow implications

Finding a way forward on these will require a balance of risks and benefits, as some of the key issues may have contradictory outcomes, e.g. the easiest accounting outcome might have a high systems cost to implement or lead to future unfavourable tax outcomes.

This paper seeks to educate our clients and people on the practical implementation of Interpretation 1052. Due to its nature, it is somewhat technical in focus and includes many examples to highlight the critical concepts, issues and decisions to be made.

1.2. How Interpretation 1052 works

The following table graphically illustrates how Interpretation 1052 accounts for the impact of tax consolidation:



Even with the advent of Interpretation 1052, there remains considerable conjecture as to how any contributions to and distributions from equity participants arising under Step 5 above should be accounted for. Because of this, and in order to avoid unnecessary accounting entries, it is expected that many entities will simply choose to put tax funding arrangements in place that cause equivalent amounts to arise under both Steps 3 and 4, meaning no adjustments arise under Step 5.

1.3. Comparison to the Abstract 52 approach

Interpretation 1052 is substantially different from Abstract 52 that it replaces. The key difference in the approach is due to the conceptual approach of the two pronouncements.

Abstract 52 focussed on the legal form of tax consolidation – because the head entity in the tax-consolidated group has the primary obligation for tax, it was seen to be the ‘taxpayer’ for the purposes of tax accounting. Following this line of argument leads to the conclusion that the head entity should be the only entity to recognise tax balances, with the subsidiaries left to only recognise any amounts that might arise under the tax funding arrangement (if any).

Interpretation 1052 takes a ‘substance over form’ approach – the basic premise is that because the transactions and events that legally occur in each entity are taxable, each entity is seen to have taxable profits and therefore should recognise tax balances. However, because of the head entity has the primary obligation for tax, current tax liabilities are then ‘assumed’ by the head entity.

This change in emphasis has caused much consternation amongst accounting commentators and the business community. The Abstract 52 approach, notwithstanding its numerous problems, was seen as a pragmatic resolution to the issue and provided certainty and ease of implementation – one tax calculation could be prepared and recognised in one entity, maximising the overall benefits of tax consolidation and removing administrative overheads.

Unfortunately, this pragmatic approach has had to be sacrificed in the quest for convergence with International Financial Reporting Standards (IFRS). It is generally held that the Abstract 52 approach could not be continued under A-IFRS as it would be seen to ‘break’ Australian’s compliance with IFRS. The arguments and discussion continued for many months and ultimately resulted in Interpretation 1052 being thrust upon a somewhat unsuspecting business community very late in the transition process.

The other surprise for Australian entities will be the outcome of ‘contributions by or distributions to equity participants’ as a result of the application of Interpretation 1052. This change, partly due to subtle differences in the accounting frameworks underlying the ‘old’ Australian Standards and A-IFRS, clearly sees ‘non commercial’ transactions between related parties as equity transactions. The approach is justified on the basis that an entity would only assume another entity’s tax liability due to a related party relationship – therefore these transactions should not impact the reported profits of each entity, but instead give rise to equity transactions.

1.4. Signposts to the key messages and issues

The table below provides a prioritised series of signposts to the remainder of this document. It is designed to allow users of this document to quickly find matters of interest and those issues that are most likely to be of importance.

Key messages and issues	Section	Importance	Occurrence
Commercial considerations <ul style="list-style-type: none"> • There may be inadvertent real tax consequences arising from the tax allocation method adopted. For instance, the use of consolidated carrying amounts in the allocation process may result in a higher level of deferred tax liabilities which may unfavourably impact the 'reverse ACA' calculation in the event a subsidiary leaves the tax-consolidated group. • Tax funding arrangements (TFAs) may need to be revisited and revised. To avoid recording transactions in equity, the provisions of a TFA would need to be revised to align with the method of accounting adopted in each entity. Furthermore, only <i>current tax liabilities</i> are assumed by the head entity and many TFAs currently seek to 'push down' deferred taxes as well – under Interpretation 1052 these will <i>already</i> be in the separate financial statements of each entity. • Systems modifications need to be balanced against other competing considerations. This is particularly important in light of the proposed changes to IAS 12 and the possible resultant changes to Interpretation 1052. 	5.3	High	Always
	3.3.2	High	Always
	3.2.7 6.3	High	Always
Application of Interpretation 1052 <ul style="list-style-type: none"> • Interpretation 1052 only applies to separate financial statements. Other tax consolidation issues that <i>do</i> impact consolidated financial statements have not been dealt with in the Interpretation. • Tax consolidation accounting has changed to achieve IFRS compliance. The Abstract 52 approach was a pragmatic approach under A-GAAP but was seen as inconsistent with IFRS. • Full retrospective application is required. The requirements of Interpretation 1052 will need to be fully retrospectively applied on transition to A-IFRS, with some minor concessional treatments permitted. 	3.1	n/a	n/a
	2.3.1	n/a	n/a
	6	High	Always
Accounting methodology <ul style="list-style-type: none"> • Each entity in a tax-consolidated group recognises tax balances. This is justified on the basis that the transactions of each entity remain <i>taxable</i>, even though the tax is paid through a consolidated tax return. • Entities need to choose a method for tax accounting in each entity. Interpretation 1052 does not specify a method of accounting in each entity, so long as the method chosen is systematic, rational and consistent with the broad principles of AASB 112. • Specific tax consolidation adjustments are required. The assumption of the current tax liability (and any tax losses) by the head entity is treated as a contribution from (or distribution to) equity participants, after netting the impacts of any tax funding arrangement. 	3.1	Medium	Always
	3.2	Medium	Always
	3.4	Medium	Always

Executive summary

Signposts to the key messages and issues

Key messages and issues	Section	Importance	Occurrence
Accounting issues <ul style="list-style-type: none"> • The measurement method chosen may initially result in differences between the consolidated tax position and the current tax liability recognised. Entities will need to be cognisant of the additional adjustments that this can create under some methods. 	3.2.2	Medium	Particularly where the 'stand-alone taxpayer' method is adopted
<ul style="list-style-type: none"> • The tax consequences of business combinations can be problematic. AASB 3 <i>Business Combinations</i> requires the accounting for business combinations when control is obtained, but this may precede the acquiree's entry into the tax-consolidated group. 	3.2.5.3	Medium	Transaction specific
<ul style="list-style-type: none"> • Tax losses incurred by entities in tax-consolidated groups create additional problems. The tax income recognised by entities in the group will ordinarily depend on the entire group's use of the losses, unless the 'stand alone taxpayer' method is used. Care needs to be taken that distributions are appropriately accounted for, and that tax income benefits are appropriately allocated. 	3.4.6	Medium	Regularly
<ul style="list-style-type: none"> • Accounting for the pre-implementation effects of tax consolidation has not been determined. There are differing views and no preferred approach has been currently determined. 	5.1	Low	Sometimes
<ul style="list-style-type: none"> • It is unclear how tax consolidation affects tax accounting for investments. There are many views as to whether, and if so, how, tax consolidation should affect the measurement and recognition of deferred taxes associated with investments in controlled entities. 	5.2	Medium	Always
<ul style="list-style-type: none"> • Multiple entry consolidated (MEC) groups need to carefully consider accounting. The requirements of Interpretation 1052 apply equally to 'normal' tax-consolidated group and MEC groups. However, the equity transaction treatment is more difficult to implement because the 'head entity' is not at the top of the group structure. 	3.4.6.4	Medium	In MEC groups

2. Background

2.1. The key elements of tax consolidation

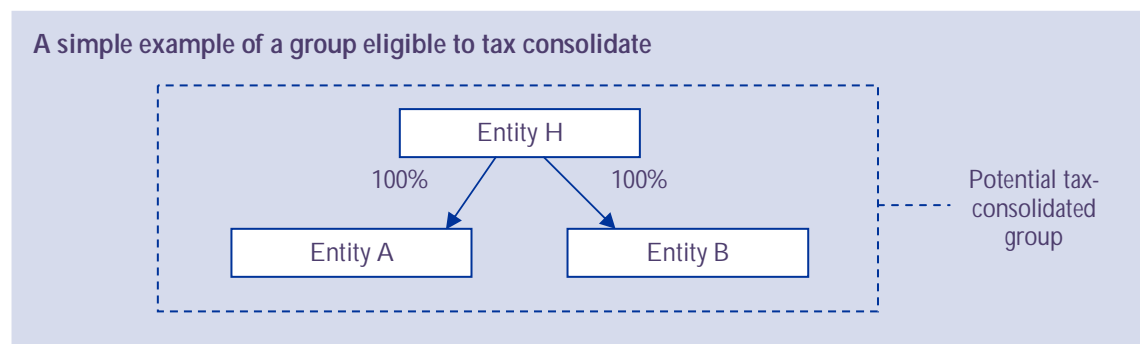
2.1.1. Enabling legislation


The enacting legislation for the tax consolidation regime amended the income tax assessment acts and includes:

- mandatory requirements, which are applicable to all entities (where relevant)
- the tax consolidation provisions, which certain entities can optionally elect to adopt.

The tax consolidation system optionally allows the following groups of entities to elect to tax consolidate and be treated as a single entity for income tax purposes:

- a parent entity (the 'head entity') and its wholly-owned subsidiaries, all being Australian residents for tax purposes – including companies, and, in some cases, trusts and partnerships¹
- Australian-resident wholly-owned subsidiaries of a non-resident company, in various combinations, with an eligible subsidiary being appointed as the 'head entity' of the multiple entry consolidated (MEC) group.



 The examples in this publication use the above simplified structure to illustrate concepts and examples. In practice, eligible groups are more complex than the simple example above. However, by using this simple example the critical concepts can be more easily relayed.

¹ The requirements of the tax law in relation to the identification of the 'head entity' in a tax-consolidated group are that the head entity must be an entity eligible to tax consolidate which is not a subsidiary of another eligible entity. The practical effect of this requirement is that in a 'normal' tax-consolidated group, the head entity will be the ultimate parent entity in the wholly-owned group. This rule does not apply to 'multiple entry consolidated' (MEC) groups, where the requirements are much more flexible (see section 3.4.6.4).

Background

The key elements of tax consolidation

2.1.2. Overview of the impact of electing to tax-consolidate

Under the legislation, if an eligible group elects to be taxed as a consolidated group:

- each of the entities in a tax-consolidated group are taken to be 'part' of the head entity for the purposes of the tax consolidation legislation
- eligible tax losses of members of the tax-consolidated group are transferred to the head entity, and remain with the head entity even if the entity leaves the group
- the assets and liabilities of each member entity are seen to be the assets and liabilities of the head entity for the purpose of the tax consolidation system
- a single consolidated annual tax return is required to be prepared for the entire tax-consolidated group
- transactions between entities in the tax-consolidated group are ignored for tax purposes
- the head entity has the primary legal obligation for the income tax liabilities of the group
- each entity in the group is jointly and severally liable for the income tax liability of the group where the head entity defaults, subject to the terms of any valid tax sharing agreement between the entities in the group
- if a new entity joins the tax-consolidated group, the tax values of assets of the group are 'reset' through the so-called 'allocable cost amount' (ACA) calculation
- if an entity leaves the tax-consolidated group, the tax values of the assets and liabilities whilst part of the group are taken with the leaving entity.

☞ This document assumes a high-level knowledge of tax consolidation but does not purport to represent a complete or comprehensive summary of how tax consolidation is implemented. Questions regarding the operation of tax consolidation from a taxation perspective should be directed to appropriate tax specialists.

2.2. Recap of the UIG Abstract 52 approach

2.2.1. Conceptual basis for UIG Abstract 52

UIG Abstract 52 was developed by the Urgent Issues Group within the context of Australian pronouncements and other generally-accepted accounting principles (A-GAAP) as they stood at that time, and was initially considered before the move in Australia to convergence with International Financial Reporting Standards was fully underway.

As a result, A-GAAP afforded the UIG considerable flexibility in developing the proposals in UIG 52. In many respects, UIG 52 follows the *legal* form of the operation of tax consolidation, i.e. because under the income tax assessment acts the 'head entity' has the primary obligation for the payment of tax, it was seen as the 'taxpayer' and therefore the entity that should account for tax.

2.2.2. Basic principles of UIG 52

Under UIG 52, the following basic principles must be applied by a tax-consolidatable group in the period *after* the implementation date of the tax consolidation system:

- deferred tax is measured by reference to the carrying amounts of each subsidiary's assets and liabilities at the level of the tax-consolidated group and their tax values applying under tax consolidation
- the head entity in the tax-consolidated group must recognise current and deferred tax amounts in respect of its own transactions, events and balances and those of entities in the tax-consolidated group
- the other members of the tax-consolidated group must not recognise any current or deferred tax balances
- the economic entity must recognise current and deferred tax amounts arising in respect of the transactions, events and balances of the economic entity
- each entity must recognise the assets and liabilities arising under any tax sharing arrangement, with revenue or expense being recognised directly in income tax expense (UIG 52.10–12).

In the amendments made to UIG 52 as part of the revisions to that Abstract in December 2003, the application of these requirements under the superseded AASB 1020 were amended. In particular, where the superseded AASB 1020 was being applied:

- where the tax value of assets had not been reset, and for liabilities, deferred taxes were measured based on the previous timing differences at the level of the tax-consolidated group, i.e. no adjustment is made (UIG 52.10(a)(i))
- deferred taxes were only recognised in relation to *timing differences* in accordance with the entity's accounting policy – noting that most entities may not have previously tax-effected non-tax-depreciable assets, intangibles and fair value adjustments that were not related to tax-depreciable assets (UIG 52.30).

Deferred taxes recognised under Abstract 52 depended on upon the entity's accounting policies in relation to intangibles, business combinations and other areas.

Background

Why was Interpretation 1052 developed?

2.3. Why was Interpretation 1052 developed?

The primary reason that Interpretation 1052 is considered necessary in the Australian context is a lack of guidance under AASB 112 on how tax consolidation should be treated in the separate financial statements of the members of a tax-consolidated group.

Tax accounting methodology in the *consolidated* financial statements of entities is quite clear under AASB 112. AASB 112 requires that in consolidated financial statements, temporary differences are determined by comparing the carrying amounts of assets and liabilities in the consolidated financial statements with the appropriate tax base, determined by reference to the consolidated tax return (see AASB 112.11).

However, AASB 112 provides no guidance on if, and if so how, tax accounting should be undertaken in the separate financial statements of the various members of a tax consolidated group.

Because in Australia a large number of separate financial statements are prepared, the need for guidance in the separate financial statements of members of the tax-consolidated group is much more important than in other countries where a tax consolidation regime exists.

☞ Interpretation 1052 currently deals only with tax accounting in the separate financial statements of members of the tax-consolidated group. For more information about other related issues affecting the consolidated financial statements, refer to section 5.

2.3.1. What is wrong with the UIG 52 approach under A-IFRS?

At the AASB meeting held on 12-13 May 2004, the AASB requested the UIG, when reconsidering the application of UIG 52 under A-IFRS, to consider treating tax funding obligations as an income tax only where the agreement levied on the subsidiary member of a tax-consolidated group amounts that would be recognised as income tax items by the subsidiary were it still a separate taxable entity.

In addition, accounting commentators expressed concern that the requirements of UIG 52 were inconsistent in some respects with AASB 112, in areas such as:

- requiring the head entity to recognise deferred taxes in relation to temporary differences arising from assets and liabilities not recognised in its separate financial statements
- treating all payments under tax funding arrangements as part of income tax expense (as noted above)
- unusual outcomes such as the head entity recognising a tax expense (income) when a new entity joined a tax-consolidated group, even though this would normally give rise to an adjustment to goodwill on consolidation under AASB 3 *Business Combinations*.
- not reflecting a 'true' cost of doing business in each entity in the tax-consolidated group in accordance with the *Framework for the Preparation and Presentation of Financial Statements*.

As a result, the UIG reconsidered the approach in UIG 52 and brought Interpretation 1052 more into line with other pronouncements dealing with tax consolidation, principally the United States' Statement of Financial Accounting Standards No. 109 *Accounting for Income Taxes* (SFAS 109).

3. The Interpretation 1052 approach

3.1. What is the basic approach of Interpretation 1052?

The view adopted by Interpretation 1052 is that each member of a tax-consolidated group is subject to the broad requirements of AASB 112 because it has taxable profits as defined in that standard (UIG 1052.29).

Taxable profits are defined as “the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable)” (AASB 112.5)

The transactions and events of each entity remain taxable under tax consolidation, so each entity recognises taxes.

From the perspective of a tax-consolidated group, the transactions undertaken by each member of a tax-consolidated group *are* taxable, albeit through a consolidated tax return process (UIG 1052.25). This is akin to transactions recognised in ‘divisions’ of a stand alone entity being subject to tax as part of the tax return for the entity as a whole.

Therefore, the head entity and each subsidiary in a tax-consolidated group is required by AASB 112 to account for the current and future tax consequences of its assets and liabilities and transactions and other events of the current period (UIG 1052.7)².

The consolidated current and deferred tax amounts for a tax-consolidated group are required to be allocated among the entities in the group when they issue separate financial statements (UIG 1052.8).

² This wording (used in UIG 1052.7) has been loosely based on the first part of the ‘Objective’ paragraph of AASB 112. The full Objective of AASB 112 is not reproduced in the Interpretation because it refers to the carrying amounts of assets and liabilities in an *entity’s* balance sheet, whereas Interpretation 1052 permits the use of *consolidated* carrying amount in some cases (see sections 3.2.3, 3.2.4 and 3.2.7.3).

The Interpretation 1052 approach

How is tax recognised and measured in each entity?

3.2. How is tax recognised and measured in each entity?

3.2.1. Basic principles

Interpretation 1052 does not specify a single method for allocating current and deferred tax amounts for a tax-consolidated group when those entities issue separate financial statements. However, Interpretation 1052 does require the method adopted to be systematic, rational and consistent with the broad principles established in AASB 112 (UIG 1052.8).

No one allocation method is prescribed by Interpretation 1052

The following methods are provided as examples of acceptable allocation methods (UIG 1052.9):

- a 'stand alone taxpayer' basis for each entity as if it continued to be a taxable entity in its own right
- a 'separate taxpayer within group' approach for each entity, on the basis that the entity is subject to tax as part of the tax-consolidated group. This method requires adjustments for transactions and events occurring within the tax-consolidated group that do not give rise to a tax consequence for the group or that have a different tax consequence at the level of the group
- a 'group allocation' approach, under which the income tax amounts for the tax-consolidated group are allocated among each entity in the group.

Because the above methods are provided as 'examples' there may be other methods that satisfy the general principles in paragraph 8 of Interpretation 1052. However, in practice it would appear that entities will adopt one of the above methods, particularly given the substantial flexibility already afforded through these methods.

Background to the 'methods' approach

The change to tax accounting in each entity is significantly different to the approach used under UIG Abstract 52, which required tax accounting only in the head entity. Furthermore, Interpretation 1052 is only being finalised very late in the A-IFRS transition process and will need to be applied by some entities only a few weeks after it was approved by the AASB.

It is understood that the UIG (and its tax consolidation subcommittee) received many unofficial submissions and representations from corporate entities objecting to the proposals in initial drafts of Interpretation 1052, particularly the requirement for each entity in the group to conduct its own tax accounting. Many entities noted that this change could undermine the efficiencies available to entities where a so-called 'top-down' approach to calculating tax liabilities under tax consolidation was being utilised.

In what might be considered partly a response to the concerns raised by constituents, and partly due to the uncertainties surrounding accounting for tax consolidation at the global level, the UIG appears to have adopted a pragmatic approach to the question of which methods could be used by entities to measure current and deferred taxes in tax-consolidated groups. The examples cited in Interpretation 1052 appear to be designed to accommodate the various calculation methodologies that corporate groups may utilise and therefore limit the implementation costs associated with the Interpretation.

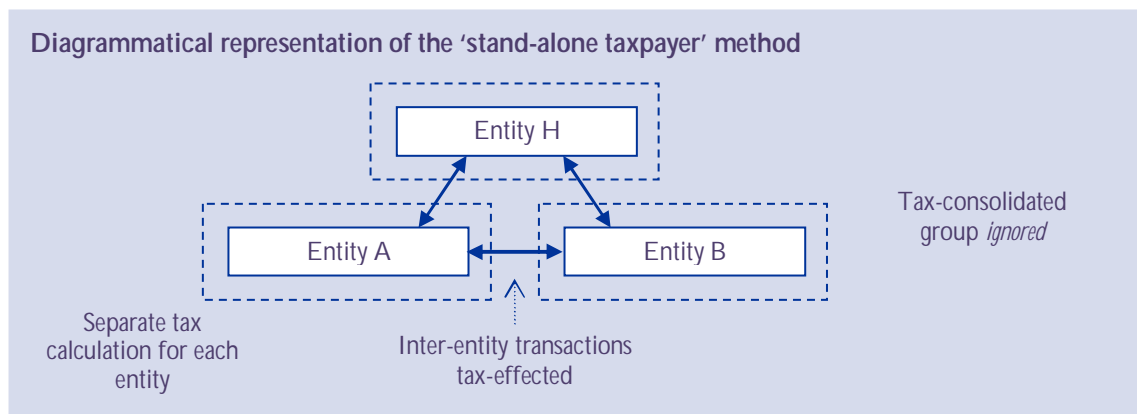
3.2.2. 'Stand-alone taxpayer method'

Under the 'stand-alone' taxpayer method, the consolidated current and deferred taxes are allocated to members of the tax-consolidated group *as if* each entity in the group were a taxpayer in its own right. The basic premise of this method is that the allocation is made by performing a notional tax calculation for each entity in the tax-consolidated group by applying the concepts of AASB 112 reflecting the outcome if the entity were not part of the tax-consolidated group, but instead were a taxpayer itself.

This means that transactions between members of the tax-consolidated group are accounted for as subject to tax even if the transaction occurred with an entity inside the tax-consolidated group, e.g. sales of inventory, management fees and so on. Although these types of transactions are ignored when preparing the consolidated tax return, this method will tax-effect the transactions to be consistent with the basic premise of the method.

When calculating deferred taxes under the stand-alone taxpayer method, temporary differences are measured by reference to the carrying amounts of assets and liabilities in the entity's balance sheet. In other words, consistent with the premise behind the method, if the entity is considered to be a taxpayer in its own right, then it must apply the requirements of AASB 112 in a manner consistent with this method, i.e. a full separate calculation based on the carrying amounts in the entity itself. However, the tax bases of assets and liabilities are determined by reference to the tax values applying under tax consolidation (UIG 1052.32).

☞ Some commentators argue that a 'pure' implementation of the stand-alone taxpayer method would involve the determination of the tax base by reference to the pre-consolidation tax values of an entity. Under this view, the *entire* impact of tax consolidation is ignored, including the effects of joining a tax-consolidated group. However, this view is difficult to support under the broad principles of AASB 112 and would result in current and deferred taxes being recognised in the entity that potentially bore no relationship to the tax consolidated position.



3.2.2.1. Arguments in favour and against the method

Proponents of the 'stand-alone taxpayer' method argue that it more correctly shows the 'true cost' of doing business in each entity as similar transactions are tax-effected in the same way regardless of whether they are with entities within or outside the tax-consolidated group. It produces an outcome that is not distorted by any transactions between members of the tax-consolidated group that occur prior to a transaction that is external to the tax-consolidated group.

Opponents of this method argue that the method is inconsistent with 'the broad principles' of AASB 112 because it is tantamount to 'what if' accounting. However, we understand that it is commonly adopted from a practical perspective under SFAS 109 and since it is expressly permitted by Interpretation 1052, must be acceptable.

The Interpretation 1052 approach

How is tax recognised and measured in each entity?

3.2.3. 'Separate taxpayer within group' method

The 'separate taxpayer within group' method is in practical terms quite similar to the 'stand-alone taxpayer' method insofar as the allocation is performed by means of a separate tax calculation for each entity in the tax-consolidated group.

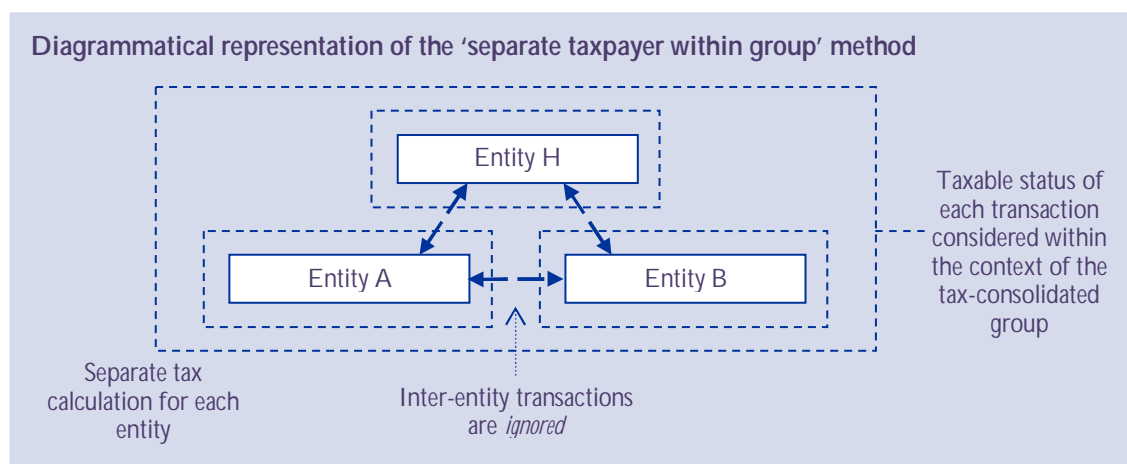
However, the conceptual basis for the method is more closely aligned with the definition of "taxable income" in AASB 112 in that the method ignores transactions that occur within the tax-consolidated group and which are therefore not taxable when the consolidated tax return is prepared.

Where the separate taxpayer within group method is used, entities effectively have a choice as to whether deferred taxes are calculated by reference to the carrying amounts of the assets within the separate financial statements of each entity, or those arising on consolidation (UIG 1052.37).

☞ The use of consolidated carrying amounts in the calculation of deferred taxes in separate financial statements is contentious. Entities that adopt this approach need to be aware of the potential pitfalls of the approach. See section 3.2.7.3 for more information about this topic.

Proponents of the 'separate taxpayer within group' method argue that it is more conceptually correct than the other methods because it requires a separate current and deferred tax calculation that is consistent with more of the principles of AASB 112.

Opponents of the method argue that by ignoring intercompany transactions, the income tax expense reported in the separate financial statements can be distorted and undermine comparability of financial statements between entities.



Example comparing the 'stand-alone taxpayer' and 'separate taxpayer within group' methods

Entities H, A and B are members of a tax-consolidated group. H is the head entity in the tax-consolidated group. The tax rate is 30% and the calculation of the taxable income for the tax-consolidated group is summarised as follows:

	A	B	H	Elims	Group
Accounting profit	700 ⁽¹⁾	(400) ⁽¹⁾	300 ⁽¹⁾	(100) ⁽²⁾	500
Non-deductible expenses	70	-	-	-	70
Share issue expenses ⁽³⁾	-	-	(10)	-	(10)
Other tax adjustments ⁽⁴⁾	(60)	(10)	-	-	(70)
Movements in temporary differences ⁽⁵⁾	200	(100)	(40)	-	60
Taxable income	910	(510)	250	(100)	550

- (1) Included in the accounting profit of H is a \$50 management fee charged to A and a \$40 management fee charged to B during the year for various services.
- (2) Represents the unrealised profit on the intercompany sale of inventory from A to B during the year (such inventory remaining on hand at year end). From the consolidated perspective, the tax value of the inventory is equal to the carrying amount in A's books before the transaction.
- (3) During the year, H incurred share issue expenses of \$50, which are permitted to be deducted over a five year period under current tax law.
- (4) Other tax adjustments represent current year items permitted under the tax law, e.g. additional research and development deductions and other items which have no impact on deferred taxes.
- (5) Represents the net movement in other temporary differences for the period that coincide with a current tax movement, e.g. tax and book depreciation of property, plant and equipment during the period.

Consolidated financial statements

The following entry would be recognised in the consolidated financial statements in relation to current tax for the period

CR	Current tax liability (\$550 x 30%)	165
DR	Equity (\$10 share issue costs x 30%) ⁽¹⁾	3
DR	Current tax expense ((\$550 + \$10) x 30%)	168

- (1) A deferred tax asset of \$15 (\$50 x 30%) would be recognised directly in equity when the expenditure is incurred. The current tax and reversal of the DTA would either both be recognised directly in equity (following AASB 112.61) or in tax expense (a 'short-cut' method).

Separate financial statements

The basis for the determination of taxable profits in each entity using the 'stand alone taxpayer' method would be the 'taxable income' line in the table above. The following table reconciles between 'taxable profits' under the 'stand alone taxpayer' and 'separate taxpayer within group' methods:

	A	B	H	TOTAL
Taxable profits on a 'stand alone taxpayer' basis	910	(510)	250	650
Adjustments:				
Management fees	50	40	(90)	-
Unrealised profits in inventory	(100)			(100)
Taxable profits on a 'separate taxpayer within group' basis	860	(470)	160	550

The current tax amount under each approach would be as follows:

	A	B	H	TOTAL
Using the 'stand alone taxpayer' method	273	(153)	75	195
Using the 'separate taxpayer within group' method	258	(141)	48	165

The difference in the total current tax amount between the two methods is due to the unrealised profit in inventory being treated as a taxable transaction under the 'stand alone taxpayer' method.

The Interpretation 1052 approach

How is tax recognised and measured in each entity?

3.2.4. 'Group allocation' method

The 'group allocation' method is very different to the 'stand-alone taxpayer' and 'separate taxpayer within group' methods. This method considers that the allocation of current and deferred taxes to entities in the tax-consolidated group should be a 'pure' allocation. Separate or notional tax calculations are effectively ignored in favour of a *direct* allocation to entities in the group.

Interpretation 1052 provides little guidance on how the 'group allocation' method should be implemented. But Interpretation 1052 does specifically note that the following 'group allocation' methods would not be considered 'acceptable methods' for the calculation of current and deferred taxes by members of the tax-consolidated group (UIG 1052.10, 39):

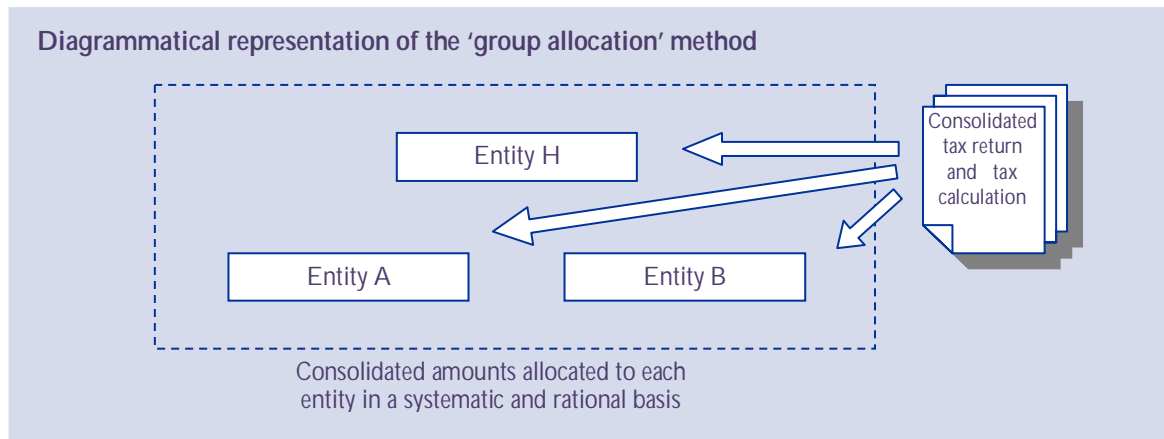
- a method that allocates only current tax liabilities to an entity in the group that has taxable temporary differences
- a method that allocated deferred taxes to an entity in the group using a method that is fundamentally different from the temporary difference approach required by AASB 112
- a method that allocates no current or deferred tax expense to an entity in the group that has taxable income because the tax-consolidated group has no current or deferred income tax expense
- a method that only allocates current taxes to entities in the group that have accounting profits, with no allocation to entities that have accounting losses
- a method that allocated current taxes to entities in the group on an arbitrary basis, for example on the basis of sales revenue, total assets, net assets or operating profits without adjustment for material items that are not assessable or deductible for tax purposes.

In many respects, it might be considered that the UIG was faced with a dilemma of how to provide guidance or examples of acceptable group allocation methods, because any such guidance would effectively become the *de facto* standard that might be routinely applied by entities, without necessarily considering the overriding principles of an allocation method.

However, the consequence of only providing broad guidelines as to what is *unacceptable* when using the group allocation method is that entities are afforded a substantial amount of flexibility in its use. This flexibility therefore presents opportunities particularly in relation to cost savings for reworking tax-consolidation systems. However, some caution is also warranted because it is unknown what approaches may ultimately be found to be acceptable under this method.

The group allocation method provides substantial flexibility but with some risk

When the group allocation method is used, entities effectively have a wide choice as to how deferred taxes are allocated to the individual members of the tax-consolidated group and this may or may not result in consolidated carrying amounts being used, as they will effectively be dependent upon the allocation process utilised.



Possible group allocation methods

The following are some examples of allocation methods that *might* be acceptable when using the 'group allocation' method of allocating current and deferred income taxes to members of a tax-consolidated group. As the use of this method can be contentious and accepted practice has not yet developed, none of these examples should be considered to be 'acceptable' merely by being listed. Entities considering using this method should carefully assess the merits of these and other options.

- allocating deferred tax balances on the basis of the underlying item giving rise to the deferred taxes, e.g. deferred tax assets associated with employee benefits on the basis of the level of employee benefit liability, deferred tax liabilities associated with property, plant and equipment on the basis of the relative book value of the items held, etc
- allocating total income tax expense (current and deferred) to entities on the basis of effective tax rates (after adjustment for 'permanent' items) and making adjustments for material deferred tax items that are related to specific entities
- specific identification of deferred tax balances by the entities to which they relate and allocating deferred taxes on that basis
- allocating current taxes on the basis of operating profits in each entity, after adjustment for 'permanent' items and/or material deferred tax movements
- allocation based on a tax funding arrangement in place within the tax-consolidated group (see section 3.3.2).
- variants of the 'stand-alone taxpayer' or 'separate taxpayer within group' methods, e.g. recognising deferred tax assets by reference to the tax-consolidated group or measuring deferred taxes on the basis of consolidated carrying amounts under the 'stand-alone taxpayer' method, treating some transactions such as management fees as taxable and deductible under the 'separate taxpayer within group' method

It should be noted that Interpretation 1052 requires the disclosure of the method used (see section 4) – where a group allocation method is used it might be reasonable to expect that some detail of the actual workings of the method might be disclosed.

The Interpretation 1052 approach

How is tax recognised and measured in each entity?

3.2.5. Issues common to all methods

Although Interpretation 1052 permits a number of different methods to allocate the consolidated current and deferred tax balances to the entities in the tax-consolidated group, there are a number of common issues that arise no matter which method is utilised. Some of these issues are discussed briefly below.

3.2.5.1. Recognising changes in tax bases when entities join a tax-consolidated group

When a subsidiary joins a tax-consolidated group, the tax bases of its assets and liabilities are determined by reference to the tax values applying under tax consolidation, with the effects of any changes being recognised in accordance with AASB 112.65 (UIG 1052.32).

This means that no matter which method is chosen for allocating current and deferred taxes to members of the tax-consolidated group, the tax values arising under tax-consolidation must be used, reset or otherwise. It also means that the use of pre-consolidation tax values would not be permitted under any method.

Paragraph 65 of AASB 112 states the following:

“When an asset is revalued for tax purposes and that revaluation is related to an accounting revaluation of an earlier period, or to one that is expected to be carried out in a future period, the tax effects of both the asset revaluation and the adjustment to the tax base are credited or charged to equity in periods in which they occur. However, if the revaluation for tax purposes is not related to an accounting revaluation of an earlier period, or to one that is expected to be carried out in a future period, the tax effects of the adjustment of the tax base are recognised in the income statement.”

Paragraph 65 of AASB 112 is providing further guidance on the application of the general requirement under AASB 112 to charge or credit current and deferred tax directly to equity if the tax relates to items that are credited or charged, in the same or a different period, directly to equity (AASB 112.61).

Applying these requirements in the context of tax consolidation will often be difficult and involve judgement.

Differing views on applying paragraph 65 of AASB 112

If an item of property, plant and equipment is measured on the revaluation basis under AASB 116 *Property, Plant and Equipment*, the reset of its tax value under tax consolidation might be considered:

- always ‘related to an accounting revaluation’ as both seek to provide some measure of the asset’s fair value, albeit at potentially different points in time
- never ‘related to an accounting revaluation’ because the resetting of tax values under tax consolidation is driven by the specific tax laws surrounding the reset which may not bear any direct resemblance to the fair value of the asset as recognised for the asset
- dependent upon the individual circumstances of each situation giving due regard the valuation methodology, similarities between the book and tax values assigned and other factors.

☞ The above analysis applies in relation to the separate financial statements of a joining entity. See sections 3.2.5.3 and 3.4.6.4 for discussion of the impacts of tax consolidation on accounting for business combinations.

3.2.5.2. Intra-group sales of assets

When entities within a tax-consolidated group sell assets between themselves, these transactions are ignored for the purposes of the consolidated tax return. This has the following effects:

- any profits and losses realised by the selling entity are ignored in the preparation of the consolidated tax return
- the amount paid by the buying entity will not affect the tax value of the item, as the tax value will remain the same as before the intra-group transaction.

Tax accounting from the seller's perspective will depend on the method used. As noted in section 3.2.2 above, if the 'stand alone taxpayer' method is used then the intra-group sales transaction can be tax effected if it would have a tax consequence if the transaction occurred outside the group. The transaction would be effectively ignored under the 'separate taxpayer within group' and 'group allocation methods'.

When tax accounting from the buyer's perspective, the asset acquired may have a different tax value from the accounting carrying amount, giving rise to a temporary difference in the buying company. However, as intra-group transactions do not generally impact taxable income or accounting profits at the time of initial recognition and unless the transaction is a business combination, the so-called 'initial recognition exception' in paragraphs 15(c) and 24 of AASB 112 would operate to prohibit the recognition of a deferred tax liability or asset. Therefore, the buying entity would *not* be able to recognise any deferred tax consequences arising.

The buying company will generally be unable to recognise deferred taxes due to the operation of the 'initial recognition exception'

Where consolidated carrying amounts are utilised in the computation of deferred taxes in the members of the tax-consolidated group, the carrying amount will generally be that of the selling company, i.e. the intra-group transaction would be eliminated. However, where a temporary difference existed in the selling company immediately before the transfer of the asset, this temporary difference would still fall into the 'initial recognition exception' in the buying company.

- ☞ The Illustrative Examples accompanying Interpretation 1052 provide examples of the treatment of intra-group sales transactions under various methods.

The Interpretation 1052 approach

How is tax recognised and measured in each entity?

3.2.5.3. Business combinations where control is obtained before 100% ownership

Under Australian taxation law, it is generally only 100% owned subsidiaries that are permitted to join a tax-consolidated group. Furthermore, it is only when such entities join the group that tax values are reset under the 'ACA' calculation (subject to the transitional provisions) and the entity's transactions become taxable within the context of the group.

This tax treatment creates an unusual issue where business combinations occur in stages or over a period of time such that control over an acquiree is obtained before 100% ownership is obtained and the entity joins the tax-consolidated group, e.g. a hostile takeover of an acquiree where control is obtained a number of months before full ownership is achieved through compulsory acquisition.

The fundamental question in these situations is how the impact of tax consolidation on temporary differences should be taken into account in the consolidated financial statements under the initial accounting for the business combination under AASB 3 *Business Combinations*, if at all. The two main views include:

- the expected reset of tax values should be anticipated and taken into account in measuring the deferred tax balances arising from the business combination so long as it is probable that full control of the acquiree is anticipated³
- the reset of tax values under tax consolidation should only be reflected when the entity achieves 100% ownership and either:
 - taken into account in any equity transaction recognised in accordance with the Australian Guidance to AASB 127 *Consolidated and Separate Financial Statements*⁴, or
 - recognised in the same way as any other tax revaluation, which will lead to the amounts being recognised in tax expense or income or directly in equity depending on the assets and liabilities to which the deferred taxes relate⁵.

The two views will produce differing amounts of goodwill which has flow on impacts to other areas such as impairment testing.

☞ Because the determination of tax values for entities entering the group can be a long and complex process, it is strongly recommended that entities consider identifying deferred tax balances as an item that is provisionally accounted for under paragraphs 61 and 62 of AASB 3. This will require disclosure in accordance with paragraph 69 of AASB 3 but will allow the initial accounting for the business combination to be adjusted until that accounting is finalised (within a 12 month period).

³ This view is supported by reference to paragraph 51 of AASB 112, which requires the measurement of deferred tax liabilities and deferred tax assets to reflect the tax consequence that would follow from the manner in which the entity expected to recover or settle the carrying amount of its assets and liabilities. In this situation, management would effectively be arguing that the assets and liabilities would be expected to be recovered as part of the tax-consolidated group and so the reset of tax values would be taken into account when initially accounting for the business combination.

⁴ This view is supported by reference to the Australian material accompanying AASB 127 and the proposals in ED 141 'Proposed Amendments to AASB 127 *Consolidated and Separate Financial Statements*'. Because the acquisition of a non-controlling interest shares is not a business combination but is seen as a transaction between equity participants in the economic entity, the net difference between the consideration paid and the non-controlling interest balance acquired (after adjusting the carrying amount of goodwill) is recognised directly in equity (noting that the 'full goodwill' method is also proposed under ED 139 *Proposed Amendments to AASB 3 'Business Combinations*'). This transaction is what gives rise to the 'reset' under tax consolidation and so it is argued that it is appropriate to recognise the deferred tax consequences directly in equity as well in complying with paragraph 61 of AASB 112.

⁵ This treatment would be adopted in the separate financial statements of the acquiree – refer to section 3.2.5.1 for more information on this topic. This view is supported on the basis that the effects of entering the tax-consolidation group do not relate to the original business combination (when control was obtained) and represent a post-acquisition 'tax revaluation' which should be recognised in accordance with paragraph 65 of AASB 112.

Example

Entity X makes a hostile takeover offer for Entity Y in April 20X5. Both entities are listed on the ASX and have a June year end. At 30 June 20X5, X holds 51% of Y and obtains control. By the end of August 20X5, X has reached over 90% in Y and compulsorily acquires the remaining shares in Y that it does not own. At this point, Y joins X's existing tax-consolidated group and the tax values of Y's assets are reset, resulting in a favourable uplift of \$900,000 (at 30%). The total cost of the acquisition is \$10 million, the fair value of X's assets is \$9.5 million and a deferred tax liability of \$2.0 million exists prior to the effects of the tax-consolidation reset.

The business combination is accounted for as follows:

(\$000s)	<u>Reset values not included</u>	<u>Reset values included</u>
Fair values of net assets acquired (before deferred taxes)	9,500	9,500
Deferred tax liability	(2,000)	(1,100)
Total net fair value	<u>7,500</u>	<u>8,400</u>
Less: non-controlling interest (49%)	(3,675)	(4,116)
Controlling interest share	<u>3,825</u>	<u>4,284</u>
Goodwill arising	1,275	816
Total cost of the combination (51% x \$10 million)	<u>5,100</u>	<u>5,100</u>

When the additional 49% of X is purchased, this is then not treated as a business combination, but is instead considered a transaction between equity holders.

(\$000s)	<u>Reset values not included</u>	<u>Reset values included</u>
Goodwill recognised at the time of the business combination	1,275	816
Notional goodwill at 100% (calculated by ÷ 51%)	2,500	1,600
Goodwill acquired from non-controlling interests (49%)	1,225	784
Non-controlling interest acquired	3,675	4,116
Total assets acquired	<u>4,900</u>	<u>4,900</u>
Cost of the additional ownership interest	4,900	4,900
Balancing adjustment recognised directly in equity	<u>-</u>	<u>-</u>

There is no balancing adjustment recognised directly in equity because the per-share purchase price is the same for both transactions, meaning that the non-controlling interests are paid an amount exactly equal to their interest in the net assets of X including the 'grossed up' goodwill.

X will recognise a gain of \$900,000 from the impacts of its tax bases being reset. Where this has not been taken into account in the initial accounting for the business combination, a consolidation adjustment might be made to recognise the impacts directly in equity. Even though the amount recognised as an equity transaction in the example above is nil in all cases, the deferred tax consequences of the equity transaction might still be arguably recognised directly in equity. In this case, the following consolidation entry would be made:

DR	Deferred tax income	900,000	
	CR	Equity reserve	900,000

The effect of this entry is to eliminate the gain made by X from the tax consolidation reset and link it to the equity transaction, being the purchase of the non-controlling interest.

If the effects are not recognised directly in equity, the effects of entering tax-consolidation would effectively be considered a post-acquisition event and no entry would be made on consolidation. As a result, the gain of \$900,000 made by the subsidiary on reset would flow through to the consolidated financial statements.

The Interpretation 1052 approach

How is tax recognised and measured in each entity?

3.2.5.4. Different types of taxpayer joining tax-consolidated groups

The legislation governing tax consolidation permits numerous types of entities to join a tax-consolidated group, including companies, trusts and partnerships. Sometimes, certain members of a tax-consolidated group would be taxed differently if they were outside the group, e.g. the taxable income arising in relation to certain types of partnerships and trusts are taxed in the hands of the partners/beneficiaries, rather than in the entity itself.

Once these entities join a tax-consolidated group they are treated as being 'part' of the head entity for tax purposes and their transactions, events and balances are taxed in the same manner as other members of the group.

The question then arises as to whether the entity's pre-consolidation tax status should be taken into account when applying Interpretation 1052, and whether the allocation method chosen has an impact on the accounting outcome.

It would seem logical to treat all entities in the tax-consolidated group in the same manner and allocate current and deferred taxes to all entities without regard to their pre-consolidation tax status. This pragmatic view could also reasonably be adopted even if the 'stand alone taxpayer' method is used, because it is 'systematic, rational and consistent with the broad principles established in AASB 112'.

☞ Affected tax-consolidated groups should carefully consider the wording of any tax funding arrangements to ensure that the payment obligation is determined on the basis of each entity being a 'corporate' taxpayer

3.2.5.5. Can different entities in a tax-consolidated group use different tax accounting methods?

Interpretation 1052 is silent as to whether each entity in a tax-consolidated group must use the same method of accounting for income taxes in its separate financial statements. Preliminary drafts of the Interpretation included an explicit requirement that the method adopted must be applied by each entity in a tax-consolidated group. However, this requirement was deleted in the final version of the Interpretation.

Because Interpretation 1052 is silent on this issue, it may be possible for various entities in the group to use different methods. However, due to the 'systematic and rational' requirement remaining in paragraph 8 of Interpretation 1052, this might be expected to be an extremely rare occurrence.

3.2.6. Summary of the methods

The following summarises in overview terms the various methods available for accounting for income taxes in the separate financial statements of each subsidiary in a tax-consolidated group.

Area	Stand-alone taxpayer method	Separate taxpayer within group method	Group allocation method
Current tax allocation	Separate calculation	Separate calculation	Allocation of consolidated current tax payable
Deferred tax allocation	Separate calculation	Separate calculation	Allocation of consolidated deferred tax amounts
Treatment of transactions within the group	Considered a transaction with an external party and tax accounted in the same manner as if the transaction were with a party external to the group	Adjusted for when tax accounting so that no tax consequences from the transaction are recognised, i.e. treated as non-taxable	Effectively the same as the separate taxpayer within group method because these transactions have already been eliminated in the consolidated tax calculation
Carrying amounts used in the measurement of deferred taxes	Carrying amounts in the separate financial statements of each entity	Carrying amounts in the separate financial statements of each entity or the consolidated carrying amounts if considered more appropriate	Deferred taxes are measured in the consolidated financial statements by reference to the consolidated carrying amounts and tax values applying under tax consolidation and then allocated to each entity in a rational and systematic manner. Therefore, the outcome in each entity will depend on the allocation method adopted
Tax bases used in the measurement of deferred taxes	By reference to the tax values applying under tax consolidation (reset or otherwise)	By reference to the tax values applying under tax consolidation (reset or otherwise)	
Recognition of deferred tax assets (see section 3.4.6.1)	Consider the ability of the entity itself to meet the recognition requirements, based on its own expected future tax position	Consider within the context of the entire tax-consolidated group	Consider within the context of the entire tax-consolidated group

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How is tax recognised and measured in each entity?

3.2.7. A few words of caution on choosing and applying a method

Interpretation 1052 is very permissive and therefore affords entities substantial flexibility when accounting for taxes in the separate financial statements of entities in the tax-consolidated group.

There are however some pitfalls that entities should be aware of in planning their implementation of Interpretation 1052. Many of these pitfalls result from the forthcoming amendments to IAS 12 emanating from the IASB/FASB convergence project on income taxes. Because Interpretation 1052 is partly based on the requirements of SFAS 109 *Accounting for Income Taxes*, developments in this convergence project are of some import to applying the Interpretation in the Australian context.

As part of the convergence project, the IASB has recently decided to incorporate the tax consolidation requirements from SFAS 109 into a revised IAS 12⁶. It is therefore likely that Interpretation 1052 will require revision or be withdrawn when the revised AASB 112 is applicable.

Forthcoming changes to IAS 12 may change tax consolidation accounting and also provides some additional guidance on the implementation of Interpretation 1052.

Paragraph 40 of SFAS 109 (on which Interpretation 1052 is based) reads as follows:

40. The consolidated amount of current and deferred tax expense for a group that files a consolidated tax return shall be allocated among the members of the group when those members issue separate financial statements. This Statement does not require a single allocation method. The method adopted, however, shall be systematic, rational, and consistent with the broad principles established by this Statement. A method that allocates current and deferred taxes to members of the group by applying this Statement to each member as if it were a separate taxpayer meets those criteria. Examples of methods that are not consistent with the broad principles established by this Statement include:

- a. A method that allocates only current taxes payable to a member of the group that has taxable temporary differences*
- b. A method that allocates deferred taxes to a member of the group using a method fundamentally different from the asset and liability method described in this Statement (for example, the Opinion 11 deferred method)*
- c. A method that allocates no current or deferred tax expense to a member of the group that has taxable income because the consolidated group has no current or deferred tax expense.*

Some of key matters to note are briefly discussed in the sections that follow.

⁶ For more information, refer to the *IASB Update* issued by the IASB as a result of its meeting held in London on 15 and 17 March 2005.

3.2.7.1. A change in method might be considered a change in accounting policy

From time to time entities may wish to change their allocation method from that which has been applied in the past. The question then becomes whether the effects of the change in method should be considered:

- a 'change in accounting estimate', on the basis that the methods are an allocation process that estimates the current and deferred tax applicable to each entity, or
- a 'change in accounting policy', on the basis that the methods are 'specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial reports' (see AASB 108.5).

Interpretation 1052 does not directly deal with this issue and there are arguments supporting both views. However, the distinction is very important because under AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*, changes in accounting estimates are adjusted prospectively (AASB 108.36), whereas a change in accounting policy is adjusted retrospectively (with some exceptions) (AASB 108.22).

Where the 'change in accounting policy' is adopted, this may require a substantial re-working of prior tax calculations using the new method chosen unless it is impracticable to do so. AASB 108 provides strict guidance on when full retrospective application would be considered 'impracticable' and it might ordinarily be expected that adjustments for a number of prior years would be able to be performed.

☞ The issue of whether a change between methods is a change in accounting policy remains unresolved, although it would appear that a change in method under US GAAP is treated as a change in accounting policy. Treating a change in method as a change in accounting policy under A-IFRS would require retrospective application of the method under paragraph 22 of AASB 108 – this may potentially be onerous and means that entities need to be careful in their initial choice of method adopted.

3.2.7.2. The US SEC has a preferred approach

The Securities and Exchange Commission (SEC) of the United States has indicated a preferred view under SFAS 109 as to how income taxes are to be accounted for in the separate financial statements of subsidiaries in tax consolidated group.

In SEC Staff have made the following observations⁷:

"Some of these subsidiaries have calculated their tax provision on the separate return basis, which the staff believes is the preferable method. . . . When the historical income statements in the filing do not reflect the tax provision on the separate return basis, the staff has required a pro forma income statement for the most recent year and interim period reflecting a tax provision calculated on the separate return basis."

Accordingly, US public enterprises use the separate return method when allocating taxes to the separate financial statements of affected entities.

There remains some uncertainty as to whether the 'separate return approach' under SFAS 109 is equivalent to the 'stand-alone taxpayer' or 'separate taxpayer within group' methods under Interpretation 1052, with the key difference being the treatment of intra-group transactions.

The 'separate return' method is generally used under US GAAP, and is always used by public companies.

⁷ See SEC Staff Accounting Bulletin Topic 1-B.1 (SAB 55), Question 3.

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The footnote to the 'separate return approach' in SFAS 109 notes the following:

... the sum of amounts allocated to individual members of the group may not equal the consolidated amount. That may also be the result when there are intercompany transactions between members of the group. The criteria are satisfied, nevertheless, after giving effect to the type of adjustments (including eliminations) normally present in preparing consolidated financial statements.

Some commentators argue that this is implying that the 'stand alone taxpayer' method is the equivalent treatment under Interpretation 1052, because of the footnote indicating that the income tax amounts of subsidiaries would not equate to the consolidated income tax amounts. Other commentators argue that the wording regarding eliminations in consolidated financial statements indicates that the 'separate taxpayer within group' approach is more appropriate.

In practice, we believe that there may be differing views on how the 'separate return approach' is applied under SFAS 109. The SEC view is only universally applied by US public enterprises and is not necessarily followed by other entities. Furthermore, the SEC staff response is in relation to partially owned subsidiaries that remain eligible to tax consolidate under US tax law, a situation which is not permitted under Australian tax law.

☞ Whilst the exact nature of the 'separate return approach' is unclear, the SEC position may indicate that the 'group allocation' method may not be a favoured approach under SFAS 109. This may be of importance to Australian entities with US reporting requirements, or those that might contemplate US listings or spin off in the future. Also, the SEC view might be considered non-authoritative guidance on applying any revised IAS 12 in the future.

3.2.7.3. Use of consolidated amounts to determine deferred taxes

When accounting for deferred taxes under the 'separate taxpayer within group' and 'group allocation' methods, entities effectively have the choice of using the carrying amounts on consolidation or in the separate financial statements of each entity.

Whilst expressly permitted by Interpretation 1052, there are some commentators that do not support the use of consolidated carrying amounts in the calculation of deferred taxes in separate financial statements. They argue that one of the 'broad principles' of AASB 112 is that deferred taxes are determined by reference to the difference between carrying amounts and tax bases, and that to allow the consolidated carrying amounts to be used is contrary to this principle.

Practical experience with the equivalent requirements under US-GAAP would be that the use of consolidated carrying amounts is generally not used, particularly by public companies⁸.

☞ Entities that choose to use consolidated carrying amounts when accounting for deferred taxes will need to be aware of the possibility of transitional adjustments on any move to a revised AASB 112 (based on the forthcoming revised IAS 12). Affected entities should closely monitor developments on the revisions to IAS 12 emanating from on the IASB/FASB convergence project (noted above).

Tax-consolidated groups that decide to use consolidated carrying amounts in the determination of deferred taxes in the separate financial statements of members of the group must also consider the additional adjustments that may be required. The deferred tax balances of an entity that joins a tax-consolidated group that is determining tax bases on this basis will need to determine how the effects of using consolidated carrying amount should be recognised.

⁸ US public companies would use the 'separate return approach' under SFAS 109 due to the SEC staff views noted in section 3.2.7.2 above. However, it should be noted that in some circumstances, US-GAAP requires the use of 'push-down accounting' in the separate financial statements of subsidiaries which has the impact of aligning the carrying amounts for assets and liabilities in the separate and consolidated financial statements, thereby avoiding this issue.

Interpretation 1052 itself notes that the impact of changes in *tax bases* arising from tax consolidation resets is recognised in accordance with paragraph 65 of AASB 112 (UIG 1052.32, see section 3.2.5.1). However, where consolidated carrying amounts are used, the *carrying amounts* are also notionally changed in the deferred tax calculation.

Because Interpretation 1052 requires compliance with the broad principles of AASB 112, the recognition of deferred taxes in this situation can therefore only be in the profit or loss, directly in equity or as part of the initial accounting for a business combination (AASB 112.58).

There is no amount directly arising in equity from joining a tax-consolidated group, the initial accounting for the business combination is accounted for outside the separate financial statements of the entity, and so this leaves the impact to be recognised in the profit and loss.

Additional adjustments will also be required where an entity leaves a tax-consolidated group that uses consolidated carrying amounts in the determination of deferred taxes. Temporary differences arising are likely to change because under the allocation method previously adopted, they were not determined by reference to the carrying amounts of the subsidiary's assets and liabilities in its balance sheet (UIG 1052.57). This will give rise to a further adjustment to deferred taxes of an entity exiting the tax-consolidated group.

Example comparing the use of consolidated and separate entity carrying amounts

Entity C joins a tax-consolidated group of which H is the head entity. When initially accounting for the business combination, H recognises fair value increases in the carrying amount of property, plant and equipment of \$10,000 (recognised at \$20,000 in C's books) and also recognises intangible assets to the value of \$100,000 (not previously recognised by C). The tax bases assigned under tax consolidation are \$27,000 in respect of the property, plant and equipment and \$25,000 in respect of the intangible assets. For simplicity, assume that there were no temporary differences arising in the separate financial statements of C prior to joining the tax-consolidated group and that no other adjustments are required from the initial accounting for the business combination.

The following table compares the outcome if deferred taxes are determined for the entity using the carrying amounts in the separate financial statements or on consolidation.

	Using carrying amounts in the entity			Using consolidated carrying amounts		
	Carrying amount	Tax base	Temporary difference	Carrying amount	Tax base	Temporary difference
Property, plant and equipment	20,000	27,000	(7,000)	30,000	27,000	3,000
Intangible assets	-	25,000 ⁽¹⁾	(25,000)	100,000	25,000	75,000
Total temporary differences			(32,000)			78,000
At 30%			(9,600)			23,400

(1) Although the intangible asset is not recognised in the separate financial statements of C, the tax base of the intangible is still obtained on entering the tax-consolidated group. In accordance with AASB 112.9, a deferred tax asset still arises and is recognised by C even though the intangible itself is not recognised.

If the carrying amounts within the entity are used to measure deferred taxes, C recognises a deferred tax asset of \$9,600, whereas if consolidated carrying amounts are used, a deferred tax liability of \$23,400 would be recognised. (In either case, the deferred tax liability of \$23,400 would be taken into account in the initial accounting for the business combination and indirectly affect the amount of goodwill or excess arising.)

From the perspective of C, the effect is that available tax values have increased by \$32,000, giving rise to a gain (deferred tax income) of \$9,600. This is the result if the carrying amounts in C's books are used to measure deferred taxes in C's books.

If on the other hand, consolidated carrying amounts are used, C will recognise a loss (deferred tax expense) of \$23,400, representing the additional tax that the consolidated group as a whole will pay from recovering the C's assets at their consolidated carrying amounts. In this situation, if C subsequently left the group and became a separate taxpayer, it would recognise a gain (deferred tax income) of \$33,000 (derecognition of DTL of \$23,400 and recognition of a DTA of \$9,600).

3.3. Tax funding arrangements

3.3.1. What are 'tax funding arrangements'?

A 'tax funding arrangement' ('TFA', sometimes called a 'tax contribution arrangement') is a mechanism by which entities in a tax-consolidated group agree to share responsibility for the amount of tax payable on an on-going basis.

TFAs are different from 'tax sharing agreements' ('TSA') which generally determine the allocation of tax liabilities between entities in a tax-consolidated group should the head entity default on its payment obligations, or deal with adjustments where an entity joins or leaves the tax-consolidated group. TSAs are generally driven by the specific tax law requirements surrounding these agreements⁹.

TFAs are often separately negotiated and documented within tax-consolidated groups and may be less legalistic and formal than TSAs.

Some common examples of tax funding arrangements include allocating taxes on the basis of:

- accounting profit multiplied by the effective tax rate of the group
- a 'pro-forma' tax calculation for each entity in the group
- the tax rate applied to accounting profits, either with or without adjustment for 'permanent differences'
- arrangements that seek to create an intercompany balance between the head entity and each entity in the group that effectively represents both the current tax and the deferred taxes assumed by the head entity under Abstract 52.

3.3.2. Can TFAs be used as a method for allocating taxes to members of the tax-consolidated group?

Measuring current and deferred tax amounts in the separate financial statements of each member of the tax-consolidated group based on the terms of a TFA between the entities in a tax-consolidated group would only be acceptable where the satisfied the criteria outlined in Interpretation 1052.

This would mean that a TFA *could* be used *only* where the tax funding amount was determined in a systematic and rational basis that is consistent with the broad principles of AASB 112 (UIG 1052.40).

☞ It is anticipated that many entities will choose to renegotiate their TFAs as part of the transition to A-IFRS, in order to simplify tax consolidation accounting under A-IFRS. In the simplest form, a revised TFA would require payments to or from the head entity equal in amount to each entity's current tax liability (or asset) and deferred tax assets arising from tax losses and other tax credits that are assumed by the head entity under tax consolidation.

⁹ Where the head entity is in default of its payment obligations under tax consolidation, or such default is probable, subsidiaries in the tax-consolidated group are required to recognise a liability (if any) arising under the joint and several liability requirements of the legislation governing tax consolidation, including any tax sharing agreement (see UIG 1052.15).

3.4. Specific tax consolidation accounting adjustments

3.4.1. What specific tax consolidation adjustments are required under Interpretation 1052?

After the allocation of current and deferred taxes to the separate financial statements of entities in the group has occurred, specific tax consolidation adjustments must then be made (UIG 1052.33).

These adjustments are required because:

- the head entity has the primary obligation for current tax under the tax law, and so will normally settle or recover current tax liabilities or assets that arise in relation to the subsidiaries in a tax-consolidated group – therefore, a subsidiary's current tax liability or asset needs to be derecognised immediately after its initial recognition in each reporting period (UIG 1052.41)
- the head entity obtains and retains the benefit of certain unused tax losses and unused tax credits under the operation of the tax law – therefore, a subsidiary must derecognise any deferred tax asset arising from these items that it has initially recognised in a reporting period when applying one of the allocation methods (UIG 1052.50).

☞ The need for 'specific tax consolidation adjustments' is not included under US-GAAP (SFAS 109) and therefore is not included in the proposed revised IAS 12. The adjustments are only required under Interpretation 1052 because of the legal requirements surrounding tax consolidation in Australia (as outlined above). It is unclear how these requirements might be affected by the proposed revised IAS 12 (if at all).

3.4.2. What adjustments does each subsidiary in the tax-consolidated group recognise?

The following specific tax-consolidation adjustments are required in the separate financial statements of each subsidiary:

- current tax liabilities (or assets) recognised for the period by the subsidiary are accounted for as immediately assumed by the head entity
- deferred tax assets arising from unused tax losses and unused tax credits recognised for the period by the subsidiary are accounted for as immediately assumed by the head entity
- assets and liabilities (if any) arising for the subsidiary under a tax funding arrangement are recognised as amounts receivable or payable to other entities in the group
- any difference between the net tax amounts derecognised and the TFA amount recognised is recognised as a contribution by equity participants or a distribution between the subsidiary and the head entity (UIG 1052.11).

Where a subsidiary in a tax-consolidated group is not a direct subsidiary of the head entity, any contributions by (or distribution to) equity participants arising are accounted for as contributions or distributions through the interposed parents (UIG 1052.14).

The Interpretation 1052 approach

Specific tax consolidation accounting adjustments

3.4.3. What adjustments does the head entity recognise?

In addition to the tax effects of its own transactions, events and balances, the head entity in the tax-consolidated group recognises:

- the current tax liability (or asset) and the deferred tax assets arising from unused tax losses and unused tax credits assumed from the subsidiaries in the group
- assets and liabilities (if any) arising for the head entity under a tax funding arrangement as amounts received from or payable to other entities in the group
- any difference between the net amounts recognised are treated as a contribution by (or distribution to) equity participants between the head entity and its subsidiaries (UIG 1052.12).

3.4.4. What equity accounts are affected by the specific tax-consolidation adjustments?

Interpretation 1052 does not prescribe which account or accounts must be adjusted for contributions by (or distributions to) equity participants when making the specific tax-consolidation adjustments (UIG 1052.13).

As a result, entities will need to carefully consider the nature of any contributions by (or distributions to) equity participants that arise when applying these requirements.

3.4.4.1. Equity contributions

In a straightforward assumption of a current tax liability of a subsidiary by its immediate parent entity as the head entity, the treatment might normally be expected to be easily determined – a type of ‘contributed equity’ in the subsidiary and an increase in the investment in the subsidiary by the parent.

Other commentators argue that the use of some sort of ‘reserve’ might also be considered appropriate in the subsidiary’s separate financial statements, as this clearly identifies the amounts as arising from tax consolidation and the specific accounting requirements under Interpretation 1052. This might also permit the creation of a debit reserve where a distribution is seen to have occurred.

Can ‘reserve accounting’ be adopted to simplify the accounting for equity transactions??

3.4.4.2. Distributions

Where the tax consolidation adjustments required by Interpretation 1052 result in the recognition of a distribution to an entity, that entity accounts for the distribution in accordance with the requirements of AASB 118 *Revenue* and AASB 127 *Consolidated and Separate Financial Statements* concerning dividends and other distributions. Distributions arising from tax consolidation adjustments may take the form of either a return *of* capital or a return *on* capital. The particular circumstances of a distribution need to be considered in determining the appropriate accounting (UIG 1052.45).

AASB 118 notes the following in relation to the recognition of dividends by an investor:

... When dividends on equity securities are declared from pre-acquisition net income, those dividends are deducted from the cost of the securities. If it is difficult to make such an allocation exception on an arbitrary basis, dividends are recognised as revenue unless they clearly represent a recovery of part of the cost of the equity securities.

The 'cost method' is defined in AASB 127 as follows:

The 'cost method' is a method of accounting for an investment whereby the investment is recognised at cost. The investor recognises income from the investment only to the extent the investor receives distributions from retained earnings of the investee arising after the date of acquisition. Distributions received in excess of such earnings are regarded as a recovery of investment and are recognised as a reduction of the cost of the investment.

The application of these requirements within the context of distributions arising under the specific tax consolidation adjustments of Interpretation 1052 can be problematic for the following reasons:

- the distribution is effectively an 'accounting distribution' rather than a 'legal distribution' and so does not take the normal form of being determined and declared by the directors having due regard the circumstances of the entity and any governing legislation – the directors might ordinarily be expected to determine where legal distributions are being paid from and what they represented
- the distribution made does not relate to 'profits' per se but is related to a prescribed method of accounting – therefore the focus on 'pre-acquisition net income' and 'retained earnings' in AASB 118 and AASB 127 do not really contemplate these types of distributions
- where tax losses are incurred by a subsidiary, this will give rise to a distribution (to the extent that a TFA does not require payment for the full amount of the loss) – this is counterintuitive as a tax loss is often accompanied by an accounting loss and so there are no 'profits' to distribute.

☞ To avoid the complications arising with accounting for contributions by (or distributions to) equity participants, many entities will simply choose to align their TFA with their chosen method of allocating current and deferred taxes to the entities in the group. In this way, no equity amounts will arise and no adjustments will be required.

3.4.5. What are the effects of these adjustments?

The effects of the specific tax consolidation adjustments under Interpretation 1052 are as follows:

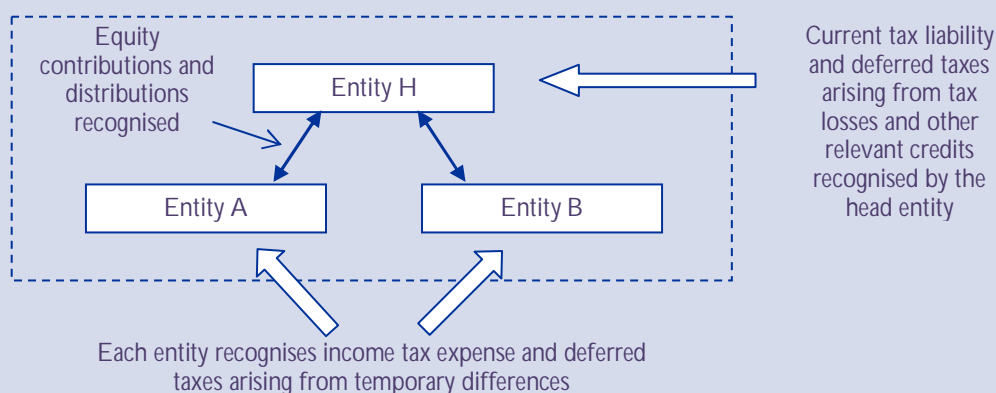
- each entity in the tax-consolidated group recognises its allocated share of the consolidated deferred tax balances and income tax expense (both current and deferred) – thereby showing its true 'cost of doing business'
- the head entity recognises the group's aggregate current tax liability and the benefit of any tax losses and tax credits in the tax-consolidated group – as the head entity has the primary obligation for tax and also keeps the benefit of any tax losses and any relevant tax loss credits/offsets under the tax consolidation legislation
- where amounts payable under any TFA that is in place within the group does not mirror these requirements, the net difference is treated as a contribution from (or distribution to) equity participants – this represents a 'non-arm's length transaction' between related entities, which would only occur due to the ownership interests between those entities.

Entities may choose to recognise separate entries for tax accounting in each entity (as discussed in section 3.2) and the 'assumption' by the head entity (as discussed above). Alternatively, a 'combined' entry can be recognised if preferred.

The Interpretation 1052 approach

Specific tax consolidation accounting adjustments

Diagrammatical representation of the impact after specific tax consolidation adjustments



Example illustrating specific tax consolidation adjustments

This example is based on the same fact pattern as the example on page 15 and the following additional information. The H tax-consolidated group has a tax funding arrangement in place that requires a funding contribution to the consolidated tax liability based on 30% of accounting profits. Where an entity makes an accounting loss, no TFA amount is payable or receivable.

For the purposes of this example, the H tax-consolidated group is assumed to have chosen the 'stand alone taxpayer' approach of determining tax entries in each member of the tax consolidated group.

The journal entries recognised in relation to current tax and the related specific tax consolidation adjustments are outlined below. For simplicity, accounting entries in relation to deferred taxes are ignored.

Entries in A's separate financial statements

CR	Current tax liability (\$910 x 30%)		273
DR	Current tax expense	273	
(Current tax accounting for Entity A)			
DR	Current tax liability	273	
CR	Payable to H under TFA (\$700 x 30%)		210
CR	Equity contribution		63
(Tax consolidation adjustments for Entity A)			

Entries in B's separate financial statements

DR	Deferred tax asset (tax loss) (\$510 loss x 30%)	153	
CR	Current tax income		153
(Current tax accounting for Entity B)			
CR	Deferred tax asset (tax loss)		153
DR	Equity (Distribution to H)	153	
(Tax consolidation adjustments for Entity B)			

Entries in H's separate financial statements

CR	Current tax liability (\$250 x 30%)		75
DR	Current tax expense	75	
(Current tax accounting for Entity H itself)			

Example illustrating specific tax consolidation adjustments (continued)

Entries in H's separate financial statements (continued)

CR	Current tax liability		273
DR	Receivable from A under TFA (\$700 x 30%)	210	
DR	Investment in A	63	
(Tax consolidation adjustments in relation to Entity A)			
DR	Current tax liability ⁽¹⁾	153	
CR	Investment in B ⁽²⁾		153

(Tax consolidation adjustments in relation to Entity B)

- (1) Although initially recognised as a deferred tax asset arising from tax losses in Entity B, when the consolidated tax return is prepared the tax losses notionally generated by B will be offset against the taxable profits generated by H and A. Therefore, when H recognises the assumption of the tax loss, it is used to reduce the current tax liability of the group.
- (2) In accordance with UIG 1052.11(d), the difference is to be treated as either a 'contribution by or distribution to equity participants'. For the purposes of this example, it is assumed that the distribution is effectively a 'return of capital' and used to reduce the carrying amount of the investment, rather than being recognised as a dividend. For more information on this topic, see section 3.4.6.

The aggregate current tax liability initially recognised by H is as follows:

	<u>Amount</u>
Current tax liability in respect of:	
- H itself	75
- Entity A	273
- Entity B	(153)
Aggregate current tax liability initially recognised	<u>195</u>

The current tax liability for the group is \$165 (\$550 x 30%). The aggregate current tax liability recognised by H is \$195. This \$30 difference represents the unrealised profits in the sale of inventory from A to B. The 'Illustrative Examples' that accompanying Interpretation 1052 indicate that 'asymmetrical accounting' is to be adopted in this situation, i.e. the subsidiary recognises an increase in contributed equity, but the head entity does not make an equivalent entry to recognise an increase in the carrying amount of the investment. Therefore, the following additional entry would be recognised by H:

DR	Current tax liability	30	
CR	Investment in A		30

('Asymmetrical' entry in relation to the non-taxable unrealised profits used to measure A's current tax liability)

In this manner, the current tax liability will be recognised and measured at the same amount in both the separate financial statements of the head entity and the consolidated financial statements (in so far as the current tax liability relates to the tax-consolidated group).

☞ The Illustrative Examples accompanying Interpretation 1052 provide many more examples of the use of the various methods in different situations.

3.4.6. Special considerations in relation to tax losses

When an entity in a tax-consolidated group incurs a tax loss, the current tax amount for the year notionally becomes a deferred tax asset arising from tax losses. However, under the tax consolidation rules, all tax losses generated within a tax consolidated group are deemed to be tax losses of the head entity in the tax-consolidated group.

As noted above, Interpretation 1052 requires that all tax losses (and relevant tax credits) arising in a subsidiary of a tax-consolidated group are to be treated in the same manner as current tax liabilities and accounted for as immediately 'assumed' by the head entity (UIG 1052.11(b)).

From the perspective of the tax-consolidated group, the tax loss generated by an individual member of the group may be treated as:

- partially or fully offset against other taxable profits within the tax-consolidated group in the current tax year, i.e. the tax-consolidated group as a whole does not incur a tax loss
- partially or fully recognised as a deferred tax asset by the head entity to the extent that it is 'probable' that future taxable profit will be available against which the unused tax losses and tax credits can be utilised (in accordance with AASB 112.34)
- partially or fully unrecognised as a deferred tax asset due to the tax losses failing the 'probable' recognition criteria.

Tax offsets and other credits

Under the tax consolidation legislation, the head entity in a tax-consolidated group also assumes the benefit of certain other carried forward tax offsets, such as foreign tax credits (in certain circumstances) and franking credits. To the extent that these tax offsets are assumed and accounted for by the head entity, the requirements in relation to tax losses are equally applicable to those tax offsets – this is the reference to 'relevant' unused tax credits in Interpretation 1052.

The following additional considerations would need to be taken into account:

- some tax credits are generally not recognised in the financial statements as deferred tax assets. e.g. franking credits – therefore, there would not be any accounting entries in respect of these items
- the recognition requirements for deferred tax assets that are recognised would need to be consistent with the method of allocation and any tax law restrictions on the use of the credits, e.g. foreign tax credits may be restricted to being offset against certain types of income and this may make it more difficult to satisfy the 'probable' recognition criteria
- any tax credits or offsets that are not transferred to the head entity under tax consolidation will be recognised in each entity in the normal manner.

3.4.6.1. Initial measurement under each of the methods

The initial recognition of deferred tax assets and current tax income arising in relation to incurred tax losses within each member of the tax-consolidated group will depend on the method chosen to measure current and deferred tax in each entity.

When applying the 'stand alone taxpayer' method, the initial recognition of deferred tax assets arising from incurred losses is governed by applying the 'probable' test within the entity *itself*, i.e. the ability of the entity to notionally recover the deferred tax asset itself, even though that deferred tax asset is immediately assumed by the head entity (UIG 1052.34).

When applying the 'separate taxpayer within group' and 'group allocation' methods, members of a tax-consolidated group that incur tax losses initially recognise tax-loss related deferred tax assets arising during a period to the extent that they are recoverable by the group, whether as a reduction of the current tax of other entities in the group or as a deferred tax asset of the head entity (UIG 1052.38). This amount is then assumed by the head entity and recognised as a contribution from (or distribution to) equity participants, net of the effects of any TFA.

In other words, when applying the 'separate taxpayer within group' and 'group allocation' methods, the recognition of tax income in the each subsidiary is governed by the availability of the *entire* tax-consolidated group to utilise the tax loss, either immediately or through offset against the taxable profits of future periods. Where a deferred tax asset arising from tax losses is recognised by the head entity, the assessment of the amount recognised is also made by reference to the expected future taxable profits of the *entire* tax-consolidated group.

3.4.6.2. Accounting for distributions of tax losses

The 'distribution' of tax losses effectively represents the transfer of the benefit of the tax losses to the head entity and/or other entities in the tax-consolidated group for no (or partial) consideration. As this benefit is being provided to other entities in the group due to the ownership interests between them, it is considered more meaningful under A-IFRS to treat these items as a distribution, rather than as a loss/expense. In other words, the shareholders have extracted value from the loss making entity for no consideration.

As noted above (see section 3.4.4.2), the 'distribution' may represent a return of capital or a return on capital. When an entity incurs a tax loss during the year it often also incurs an accounting loss, meaning that there may not be profits available to distribute the tax losses in the form of a normal dividend. Other commentators argue that this is an 'accounting distribution', not a legal one, and so the requirements of the *Corporations Act 2001* for dividends to be paid out of profits would not apply as the distribution is an 'accounting' distribution rather than a 'legal' one.

Ultimately, there may be some difficulty in determining the appropriate treatment of distributions associated with deferred tax assets arising from tax losses and other unused tax credits that are transferred to the head entity under tax consolidation. The use of 'reserve accounting' may partially ameliorate this issue when accounting in the separate financial statements of subsidiaries but still leaves the treatment of the 'distribution' in the head entity unresolved.

3.4.6.3. Interaction with the recognition requirements for deferred tax assets under AASB 112

In some cases, deferred tax assets arising from tax losses and credits from one entity in the tax-consolidated group may not be utilised to reduce the current tax liability of other entities during the period, resulting in a deferred tax asset in the head entity that is subject to the normal recognition requirements of AASB 112.

Where the deferred tax asset is not recognised by the head entity due to failing to meet the 'probable' recognition criteria, care needs to be taken to ensure that appropriate accounting outcomes occur. Some of the matters to consider include:

- if the head entity does not recognise a deferred tax asset arising from the tax losses, this effectively indicates that those losses are effectively worthless and so no 'distribution' would have occurred between the subsidiary and the head entity

Example

Entity H and Entity B are part of a tax-consolidated group, with Entity H being the head entity. Entity B incurs a tax loss of \$10,000 (at 30%) during the current financial year and this loss represents a capital loss that can only be offset against capital gains of the group. The capital loss cannot be utilised in the current year and is not recognised as a deferred tax asset by the head entity. The group uses the 'separate taxpayer within group' method and there is no tax funding arrangement in place within the group.

Because of the nature of the capital loss, there is effectively no distribution of *value* between Entity B and Entity H. Therefore, Entity B will not recognise a distribution and Entity H will not recognise an increase in its investment in B. Entity H will however disclose the unrecognised tax losses in accordance with the requirements of AASB 112.

The Interpretation 1052 approach

Specific tax consolidation accounting adjustments

- the payment by the head entity under any tax funding arrangement for tax losses transferred is not of itself as basis for recognising the distribution, and may lead to an equity contribution being recognised

Example

Entity H and Entity A are part of a tax-consolidated group, with Entity H being the head entity. Entity A incurs a tax loss of \$10,000 (at 30%) during the current financial year and this loss represents revenue losses that cannot be utilised in the current year. Entity H recognises a deferred tax asset of \$4,000 (at 30%) on assessing the 'probable' criterion under AASB 112. The group uses the 'separate taxpayer within group' method and the tax funding arrangement in place within the group requires payment for the full amount of the loss, i.e. \$10,000.

Although the head entity is paying a full \$10,000 for the losses, they in effect only have value of \$4,000. Therefore, both H and A recognise the losses at \$4,000 and the \$6,000 is reflected as an equity contribution. The following entry would be recognised by Entity H:

DR	Deferred tax asset (tax losses)	4,000	
	CR	Payable to A under TFA	10,000
DR	Investment in H	6,000	

In effect, H has agreed to pay \$10,000 for an asset that is worth \$4,000. Because H would only agree to do this due to the related party relationship between the entities, the additional \$6,000 payment is effectively a contribution to A. As a result of this treatment, A would also only recognise deferred tax income of \$4,000 as this is the amount of the tax benefit obtained.

- where the 'separate taxpayer within group' method is used and more than one entity in the tax-consolidated group incurs a tax loss and the aggregate amount of the loss is not recognised by the head entity, a reasonable allocation will need to be made to the entities in the group, in a manner consistent with the allocation method utilised (UIG 1052.38)

Example

Entities H, A and B are members of a tax-consolidated group, with H being the head entity. During the year, A incurs a tax loss of \$5,000 and B incurs a tax loss of \$15,000. Entity H recognises a deferred tax asset of \$10,000. The group uses the 'separate taxpayer within group' method and there is no tax funding arrangement in place within the group.

Because H has not fully recognised the tax losses incurred by A and B, a reasonable allocation between the entities must be made, with the most easily implemented method being on the basis of the relative quantum of the losses in each entity. H has recognised half of the losses as a deferred tax asset, so A would recognise a distribution of \$2,500 ($\$5,000 \div 2$) and B would recognise a distribution of \$7,500 ($\$15,000 \div 2$).

- where adjustments are made to deferred tax assets recognised by the head entity, the effects of the adjustments affect the tax expense of the head entity only and are not adjusted against the original accounting performed when the losses were transferred – regardless of whether the TFA requires payment or not (UIG 1052.51).

Example

Entity H and Entity B are part of a tax-consolidated group, with Entity H being the head entity. Entity B incurs a tax loss of \$10,000 (at 30%) during the current financial year and this loss represents a capital loss that can only be offset against capital gains of the group. The capital loss cannot be utilised in the current year and is not recognised as a deferred tax asset by the head entity. The group uses the 'stand-alone taxpayer' method and the tax funding arrangement provides that payment is made for capital losses when utilised or recognised as a deferred tax asset.

No entries are made when the capital loss initially arises because it has no value (either to A or the group) and therefore no distribution has occurred in substance. Two years later, the recoverability of the capital loss becomes probable due to an expected capital gain and H recognises a deferred tax asset of \$10,000.

Because the benefit of the capital loss has been realised after the initial recognition of the transfer of the loss to the head entity, the benefit of the deferred tax asset being recognised is reflected by H only. H recognises the following entry:

DR	Deferred tax asset (tax losses)	10,000
	CR	Deferred tax income
		10,000

No entries are recognised by B in relation to the original capital losses. They are no longer legally the capital losses of B and the losses were effectively worthless when incurred.

However, because the TFA provides for a payment between H and B on the utilisation or recognition of the losses by H, a contribution by equity participants is recognised by both entities as follows:

DR	Investment in B	10,000
	CR	Payable to B/Cash
		10,000

(Entry recognised by H in relation to the payment for capital losses)

DR	Receivable from H/Cash	10,000
	CR	Equity (capital contribution)
		10,000

(Entry recognised by B in relation to the payment for capital losses that were worthless on initial transfer)

3.4.6.4. Tax losses of entities joining the tax-consolidated group

Under the tax consolidation legislation, there are particular rules surrounding the carry-forward and utilisation of tax losses of an entity joining a tax-consolidated group.

Eligible tax losses of subsidiary entities that join a tax-consolidated group are deemed to have been made by the head entity and therefore can be used by the head entity against the taxable income of the tax-consolidated group. There are some restrictions on the losses that can be transferred into the group, and on the ability of head entities to use transferred tax losses in certain circumstances. If a subsidiary entity leaves the tax-consolidated group, any losses brought into the group are not taken with it – instead they remain with the head entity.

Tax losses that a joining entity brings to a tax-consolidated group would be accounted for in a manner consistent with tax losses that the entity generates whilst part of the tax-consolidated group. Therefore:

- tax losses would be initially measured by the joining entity by reference to the allocation method used in the tax-consolidated group being joined – this may impact the amount of the deferred tax asset recognised
- tax losses that are lost on joining the tax-consolidated group would be derecognised by the joining entity and give rise to a tax expense
- tax losses assumed by the head entity without any consideration being paid would give rise to a distribution to equity participants

☞ To avoid the need to recognise a distribution to equity participants in relation to the tax losses of entities joining a tax-consolidated group, the tax funding arrangement (or tax sharing arrangement) should require the head entity to reimburse the joining entity for the recognised amount of the tax losses brought into the group.

When conducting the initial accounting for any business combination involving the joining entity:

- the deferred tax asset would be initially measured from the perspective of the tax-consolidated group as required by paragraph B16(i) of AASB 3 *Business Combinations* – this requires an assessment of the tax loss using the chosen allocation method for the group
- post-acquisition adjustments to any deferred tax asset recognised would be adjusted in the normal manner under paragraph 65 of AASB 3, with the head entity recognising the benefit of any tax losses subsequently recognised and an adjustment made on consolidation to goodwill¹⁰.

☞ Section 3.2.5.3 deals with how the wider impacts of tax-consolidation are taken into account in the initial accounting for a business combination.

¹⁰ Note that ED 139 *Proposed Amendments to AASB 3 'Business Combinations'* proposes to change the requirements in relation to deferred tax assets that do not satisfy the recognition criteria in AASB 112 *Income Taxes* at the date of acquisition, but which are subsequently realised. It is proposed to introduce a rebuttable presumption that acquired deferred tax benefits recognised within one year after the acquisition date are used to reduce the carrying amount of goodwill (if any). The rebuttable presumption is overcome if the recognition of the tax benefits results from a discrete event that occurred after acquisition date, in which case the effects are recognised in profit or loss or directly in equity in accordance with the normal requirements of AASB 112. It is unclear whether joining a tax-consolidated group would be a 'discrete event' that would mean that the rebuttable presumption is overcome. Furthermore, where tax benefits are recognised more than one year after acquisition date, the proposals would require that they be credited to profit or loss or directly in equity in all cases and cannot be adjusted against goodwill. The proposals in ED 139 to be intended to apply to annual reporting periods beginning on or after 1 January 2007 and include certain transitional requirements in relation to deferred tax assets arising in prior business combinations.

Example

Entity H acquires Entity D in a business combination in 20X3 and D joins the tax-consolidated group. At the time of the combination, X had deferred tax assets attributable to tax losses of \$100,000 (at a 30% tax rate), but these were recognised as part of the initial accounting for the business combination at \$60,000 on application of the 'probable' criterion in AASB 112 due to restrictions on the use of the tax losses under the tax consolidation legislation. Entity D had previously fully recognised the deferred tax asset at \$100,000. The initial accounting for the business combination gave rise to the recognition of goodwill of \$30,000, and no impairment losses have been recognised in respect of the goodwill since the combination occurred. The tax-consolidated group uses the 'separate taxpayer within group' method under Interpretation 1052 and there is no tax funding arrangement in place.

At the time of the business combination, Entity D has recognised a deferred tax asset of \$100,000, fully recognising the tax losses. However, because these losses are only recognised by the tax-consolidated group (and in the initial accounting for the business combination) at \$60,000, D must partially derecognise the tax loss before it is transferred to the head entity – the deferred tax expense arising is pre-acquisition from the perspective of the group.

D records the following entries:

DR	Deferred tax expense	40,000	
	CR	Deferred tax asset (tax losses)	40,000
		(remeasurement of tax losses on joining a tax-consolidated group)	
DR	Equity (distribution to H)	60,000	
	CR	Deferred tax asset (tax losses)	60,000
		(derecognising tax losses as assumed by H on joining a tax-consolidated group)	

H records the following entry:

DR	Deferred tax asset (tax losses)	60,000	
	CR	Investment in D	60,000
		(recognition of tax losses of acquired entity D)	

In 20X7, the tax losses remain available for use and the circumstances surrounding the recoverability of those losses mean that they are now considered 'probable'. The benefit of the additional \$40,000 is recognised by the head entity, and adjustments are made to goodwill on consolidation.

H recognises the following entry:

DR	Deferred tax asset	40,000	
	CR	Deferred tax income	40,000
		(recognition of the deferred tax asset now considered 'probable')	

The following entry is recognised on consolidation:

DR	Goodwill write-off expense	30,000	
	CR	Goodwill	30,000
		(reducing the carrying amount of goodwill to recognise the post-combination recognition of DTAs)	

Because the carrying amount of goodwill is only \$30,000, the amount of the goodwill expense recognised is limited to this amount, and a further gain is not recognised for the notional \$10,000 'excess' that has now arisen (this would result in a gain and loss in the profit or loss in any case).

Because of these entries, a net gain of \$10,000 is recognised on consolidation. If the goodwill balance was \$50,000, the gain arising on the recognition of the deferred tax asset would be fully offset by an expense arising from an equivalent reduction in the carrying amount of goodwill.

The Interpretation 1052 approach

Specific tax consolidation accounting adjustments

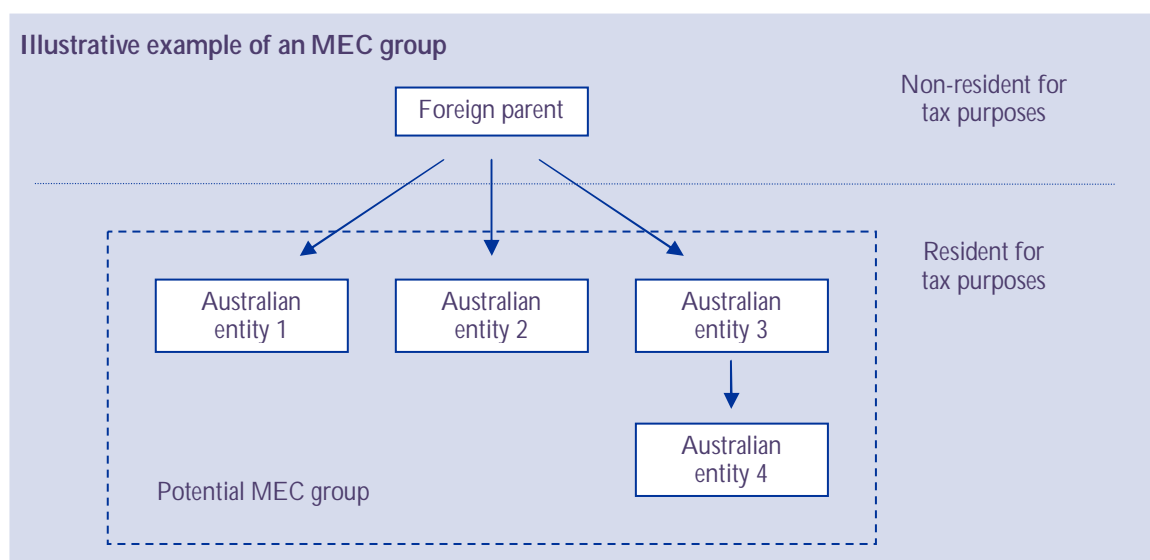
3.4.7. 'Multiple entry consolidated' (MEC) groups

Interpretation 1052 notes that it applies to 'multiple entry consolidated' (MEC) groups in the same way as 'traditional' tax-consolidated groups (UIG 1052.23).

A MEC group is one where various Australian entities are controlled 100% by a foreign, non-resident parent. All the subsidiaries of the foreign parent together form a tax-consolidated group and one of the Australian entities are designated as the head entity. Unlike for a 'normal' tax-consolidated group, the ultimate holding company in the wholly-owned group is therefore not automatically considered to be the head entity.

Groups of entities that are eligible to form an MEC group may instead choose to form a number of 'normal' tax-consolidated groups, rather than fully tax-consolidating all Australian resident entities. In other words, the 'all or nothing' approach applicable to 'normal' tax-consolidated groups do not apply to MEC groups.

☞ The requirements surrounding the formation of, and options available for, potential MEC groups are complex and are a specialist tax area. Specialist tax advice should be sought where considered appropriate.



The accounting concepts and approach for MEC groups are the same as for other tax-consolidated groups. However, a number of additional issues can arise due to the lack of one Australian ultimate parent entity being identified as the 'head entity'.

Often MEC groups do not have tax funding arrangements in place due to foreign taxation restrictions or other reasons. This can create unusual accounting outcomes when the general principles of Interpretation 1052 are applied, particularly when the head entity in the tax-consolidated group is not the ultimate Australian parent.

The 'interposed parent' requirements of Interpretation 1052 are particularly important when accounting for MEC groups, with the foreign parent, depending on the accounting framework being utilised, also recognising contributions by (or distributions to) equity participants even though that entity is outside the tax-consolidated group.

Example

Consider the diagram above. Assume that the MEC group has elected to tax-consolidate, 'Australian Entity 1' has been nominated as the head entity in the tax-consolidated group and that there is no tax funding arrangement in place.

Under Interpretation 1052, Australian Entity 1 will be required to recognise the current tax liability for the entire tax consolidated group. However, because there is no TFA, it will not receive any payment for those current tax liabilities assumed. Furthermore, Australian Entity 1 does not have investments (directly or indirectly) in the other members of the tax-consolidated group in the way that would exist in a 'normal' tax-consolidated group. Therefore, the assumption of the current tax liability will be recognised as follows:

DR	Equity
CR	Current tax liability

In effect, Australian Entity 1 makes a 'distribution' to the Foreign Parent for the amount of the current tax liability assumed. In other words, by forcing the entities to form an MEC group and by not putting a TFA into place, the Foreign Parent is extracting value from the head entity as current tax liabilities are incurred by the other members of the group. In accordance with the requirements of Interpretation 1052, the entities that originally incurred the current tax liabilities will recognise an equivalent contribution from the Foreign Parent.

In MEC groups where the entities consistently make taxable profits, eventually the equity of the head entity may be eroded by the 'distributions' being made. This may eventually necessitate a 'real' equity contribution by the Foreign Parent to the head entity. Whilst unusual, an equivalent outcome would have occurred under Abstract 52 because both the current tax liability and deferred tax balances were expensed. Because under Abstract 52 the deferred taxes were also recognised by the head entity, the issue under that pronouncement would generally arise more quickly.

4. Disclosure requirements

4.1. Overview

Interpretation 1052 requires the disclosure of the following information by a head entity and by a subsidiary in a tax-consolidated group (UIG 1052.16):

- the relevance of tax consolidation to the entity, including the part of the reporting period for which it applies to the entity where it is not applicable for the whole of the reporting period, or its application prior to implementation, and the name of the head entity
- the method adopted for measuring the current and deferred tax amounts in the tax-consolidated group
- information about the nature of any tax funding arrangement and tax sharing agreement, including significant terms and conditions that may affect the amount, timing and uncertainty of future cash flows
- the net amount recognised for the period under tax-consolidation contributions by (or distributions to) equity participants, its major components and the accounts affected.

Tax consolidation contributions by (or distributions by) equity participants would ordinarily only impact the equity balances of subsidiaries in a tax-consolidated group, not the head entity (other than the head entity in a MEC). In the head entity, the carrying amount of investments in subsidiaries will be increased by tax consolidation contributions and will be reduced by tax consolidation distributions, unless the distributions are post-acquisition and so recognised as income. All impacts would be fully eliminated on consolidation.

4.2. Example disclosures

- ☞ The following example disclosures have been obtained from the Deloitte 'Consolidated Model Financial Reports – First-time adoption of Australian Equivalents to International Financial Reporting Standards'. A copy of the full model financial report can be obtained from the Deloitte web site: www.deloitte.com.au.

Accounting policy note

Tax consolidation

The company and all its wholly-owned Australian resident entities are part of a tax-consolidated group under Australian taxation law. DTT Consolidated Limited is the head entity in the tax-consolidated group. Tax expense/income, deferred tax liabilities and deferred tax assets arising from temporary differences of the members of the tax-consolidated group are recognised in the separate financial statements of the members of the tax-consolidated group using the 'separate taxpayer within group' approach by reference to the carrying amounts in the separate financial statements of each entity and the tax values applying under tax consolidation. Current tax liabilities and assets and deferred tax assets arising from unused tax losses and tax credits of the members of the tax-consolidated group are recognised by the company (as head entity in the tax-consolidated group).

Due to the existence of a tax funding arrangement between the entities in the tax-consolidated group, amounts are recognised as payable to or receivable by the company and each member of the group in relation to the tax contribution amounts paid or payable between the parent entity and the other members of the tax-consolidated group in accordance with the arrangement. Further information about the tax funding arrangement is detailed in note 4 to the financial statements. Where the tax contribution amount recognised by each member of the tax-consolidated group for a particular period is different to the aggregate of the current tax liability or asset and any deferred tax asset arising from unused tax losses and tax credits in respect of that period, the difference is recognised as a contribution from (or distribution to) equity participants.

Tax note disclosures about tax consolidation

Relevance of tax consolidation to the consolidated entity

The company and its wholly-owned Australian resident entities have formed a tax-consolidated group with effect from 1 July 2003 and are therefore taxed as a single entity from that date. The head entity within the tax-consolidated group is DTT Consolidated Limited. The members of the tax-consolidated group are identified at Note 54.

Where the decision to tax consolidate has not been notified to the Australian Taxation Office, the following wording should also be included: "The decision to consolidate for tax purposes has not yet been formally notified to the Australian Taxation Office."

Nature of tax funding arrangements and tax sharing agreements

Entities within the tax-consolidated group have entered into a tax funding arrangement and a tax-sharing agreement with the head entity. Under the terms of the tax funding arrangement, DTT Consolidated Limited and each of the entities in the tax-consolidated group has agreed to pay a tax equivalent payment to or from the head entity, based on the current tax liability or current tax asset of the entity. Such amounts are reflected in amounts receivable from or payable to other entities in the tax-consolidated group.

The tax sharing agreement entered into between members of the tax-consolidated group provides for the determination of the allocation of income tax liabilities between the entities should the head entity default on its tax payment obligations. No amounts have been recognised in the financial statements in respect of this agreement as payment of any amounts under the tax sharing agreement is considered remote.

Tax consolidation contributions by (or distributions to) equity participants

In the example above, the nature of the tax funding arrangement is such that no tax consolidation contributions by (or distributions to) equity participants would be expected to arise. However, this will not always be the case and the following example must be adapted to suit the circumstances of the entity.

The net amount recognised for the period under tax consolidation contributions by (or distributions to) equity participants, its major components and the accounts affected are as follows:

	Company	
	2005 \$'000	2004 \$'000
Major components of tax consolidation contributions by (or distributions to) equity participants		
Net assumptions of tax liabilities of members of the tax-consolidated group	-	-
Excess of tax funding contributions over tax liabilities assumed	-	-
Assumptions of unused tax losses and tax offsets of members of the tax-consolidated group at other than full consideration	-	-
Amounts payable to and receivable from entities joining or leaving the tax-consolidated group under tax sharing and funding arrangements	-	-
<i>[Describe other impacts]</i>	-	-
Net amount recognised	-	-
Accounts affected		
Dividend income		
Investments in subsidiaries	-	-
Share capital*	-	-
Reserves*		
<i>[describe]</i>	-	-
<i>[describe]</i>	-	-
Retained earnings		
<i>[describe]</i>	-	-
<i>[describe]</i>	-	-
Net amount (as above)	-	-

* likely to only be relevant in the separate financial statements of subsidiaries

5. Unresolved issues

5.1. Pre-implementation effects of tax consolidation

5.1.1. How should tax-consolidation be treated prior to its formal implementation?

Interpretation 1052 does not deal with the issue of how to treat the pre-implementation effects of tax consolidation on an entity, i.e. where tax consolidation legislation has been enacted or substantively enacted but the entity has not yet formally elected to implement tax consolidation (see UIG 1052.27).

There are two main views as to how this issue should be treated under A-IFRS. Each of these views is outlined below.

☞ Most entities would have entered tax consolidation by their date of transition to A-IFRS, lessening the impact of this issue for many entities. However, this issue still remains relevant in relation to restated business combinations prior to an entity's date of transition, as the difference in views may mean that the critical date is 'implementation date' rather than 'substantive enactment' date of the tax consolidation legislation (21 October 2002). A related issue also arises in relation to acquisitions of entities that occur in stages, whereby a business combination occurs when control is achieved, but the entity only enters the tax-consolidated group once 100% ownership is achieved (see section 3.2.5.3).

5.1.1.1. 'Change in tax status' view

This view considers the implementation of tax consolidation to be a *voluntary* change in tax status which should only be recognised in the financial statements of the financial reporting period for which a definite decision to implement has been made.

This view is supported by Interpretation 125 *Income Taxes – Changes in the Tax Status of an Entity or its Shareholders*, which deals with accounting for the impacts of a change in tax status but does not explicitly deal with which accounting period a change in tax status should be recognised.

Interpretation 125 alludes to the fact that an 'event', e.g. a public listing or move to another country, gives rise to the change in tax status (UIG 125.1). Furthermore, it notes that the change in tax status may have an 'immediate' effect on current tax assets and liabilities, along with deferred tax assets and liabilities (UIG 125.2).

This commentary therefore *implies* that the impact of a change in tax status is recognised when the event that gives rise to the change in status occurs. This appears to be particularly the case where the change in tax status is *voluntary* – such as a public listing or changing domicile.

Under this view, the voluntary election to tax consolidate is in substance no different from a change in tax status that results from a public listing or change in domicile. Each of these events are then not recognised until the event that gives rise to the change in tax status occurs, i.e. the public listing occurs, the domicile is changed, or an election to tax consolidate is made.

There may also be support for this view under SFAS 109, which requires the effect of a voluntary change in tax status to be recognised on the approval date or on the filing date if approval is not necessary and that a change in tax status from a change in tax law is recognised on the enactment date.

5.1.1.2. The 'change in accounting estimate' view

AASB 112 requires that the measurement of deferred tax liabilities and assets reflect the tax consequences that would follow from the manner in which the entity expects, at the reporting date, to recover or settle the carrying amount of its assets and liabilities (AASB 112.51).

Under this view, the effects of the anticipated implementation of tax consolidation should be recognised in the financial statements, even though the implementation date may be some time after reporting date.

Applying this view would require an analysis of the likely impacts of tax consolidation on the entity's tax bases at some point in the future, and take these into account in the first period (after substantive enactment of the tax consolidation legislation on 21 October 2002) in which it becomes likely that tax consolidation will be implemented.

This view would effectively mean that the full impacts of tax consolidation will need to be recognised in an entity's opening A-IFRS balance at the date of transition to A-IFRS, *unless* it can be clearly illustrated a decision not to implement had been made at that date (1 July 2004 for June balancing entities). This is a substantially different treatment than under UIG 39/UIG 52 where the superseded AASB 1020 was being applied, as the full effects of tax consolidation were only recognised once a *decision* to implement was made.

Recent developments at the IASB level

The IASB is considering the impacts of changes in tax status as part of its joint convergence project with the FASB on income taxes.

Considering differences between IAS 12 and SFAS 109, the IASB decided (at its meeting held in March 2005) the following with respect to the effect of a change in an entity's tax status on current and deferred taxes:

- the scope of the guidance in SIC-25 would not be narrowed to address only a change in an entity's tax status from taxable to non-taxable and vice versa
- the tax consequences addressed by SIC-25 would not be narrowed to address only deferred tax consequences, but would continue to cover both current and deferred tax consequences.
- the staff would ask the FASB to consider extending the scope of SFAS 109 to address both current and deferred tax consequences of any change in tax status of an entity or its shareholders that affects the tax assets and liabilities of an entity, and thus converge with SIC-25 in that respect.
- the following guidance, included in SFAS 109, would be added to SIC-25: The effect of (a) an election for a voluntary change in tax status is recognised on the approval date or on the filing date if approval is not necessary and (b) a change in tax status that results from a change in tax law is recognised on the date that the tax law is enacted or substantively enacted.

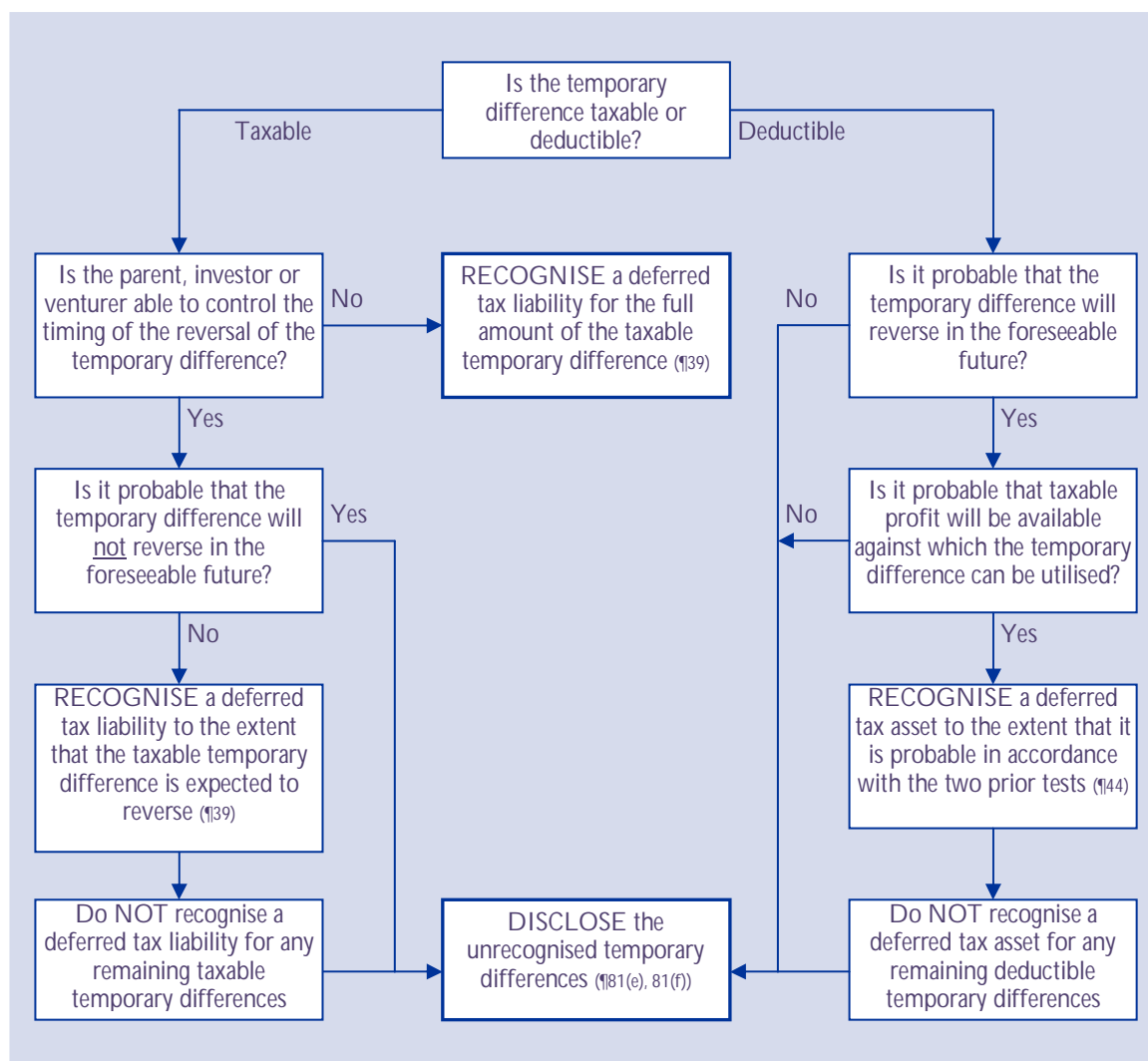
The effect of these decisions is that tax consolidation would most likely be considered a 'voluntary change in tax status' that is only recognised 'on the approval date or on the filing date if approval is not necessary'. This could resolve this issue in the longer term on the reissue of IAS 12/AASB 112.

However, in the meantime, this IASB decision may also favour treating tax consolidation as a voluntary change in tax status.

5.2. Tax consolidation and investments in subsidiaries

5.2.1. General requirements in relation to deferred taxes and investments

The following flowchart provides an overview of the application of the recognition exception for investments in subsidiaries, branches and associates and interests in joint ventures under AASB 112. References are to paragraphs of AASB 112.



5.2.2. What impacts does tax consolidation have on deferred taxes associated with investments?

5.2.2.1. General requirements

Interpretation 1052 notes that the head entity may be required to recognise a deferred tax asset or liability in its separate financial statements in relation to temporary differences arising on its investments in subsidiaries in the tax-consolidated group. Differences between the carrying amounts of the investments and the associated tax bases may arise due to the head entity's accounting for tax-consolidation contributions by or distributions to equity participants, whereas the tax bases of the investments may indirectly reflect the aggregate tax values of the subsidiaries' assets and liabilities. Paragraphs 39 and 44 of AASB 112 specify the circumstances in which such deferred taxes are not required to be recognised (UIG 1052.54).

This issue can arise on consolidation due to the differences between the aggregate carrying amounts of the net assets arising on consolidation in respect of each subsidiary and the tax base of the investment in the immediate parent entity. This issue is not dealt with or alluded to in Interpretation 1052 because it only deals with accounting for the impacts of tax consolidation in the separate financial statements of the members of the tax-consolidated group.

Because of the recognition exceptions for investments, any deferred taxes arising in relation to entities in a tax-consolidated group would only be recognised where the temporary differences giving rise to them are expected to reverse, and in the case of deferred tax assets, it is probable that taxable profit will be available against which the temporary difference can be utilised (AASB 112.39, AASB 112.44). However, the temporary differences arising must still be calculated and disclosed (AASB 112.81(e), (f)).

The application of these requirements in light of tax consolidation can be problematic, because it introduces additional complexity into the determination of the realisation of investments.

In very simplistic terms, the CGT cost base of an investment in an entity that is leaving a tax-consolidated group is assigned a value equal to the aggregate tax values of the assets less liabilities of the leaving entity in a so-called 'reverse ACA' calculation¹¹.

There are several views as to whether and if so, how, temporary differences in relation to investments within tax-consolidated groups should be calculated. Some of these views are outlined below.

5.2.2.2. The 'end of time' view

Under this view, it is assumed that all entities in the tax-consolidated group will eventually leave the group at some point in the future. This would then require an annual computation of the so-called 'reverse ACA' calculation in order for the temporary difference associated with the investment to be determined.

There are then two further views as to how this notional 'reverse ACA' calculation should be performed:

- determining managements' expectations as to when the entity will leave the tax-consolidated group and forecasting what the tax base might be at that point in time (even though there may currently be no intention to dispose of the investment)
- performing the calculation based on information available at the reporting date as if the entity were to be disposed at the reporting date¹²

¹¹ The actual calculation is more complex than outlined, but is simplified in this analysis for the purposes of illustration. Appropriate taxation advice should be sought where considered necessary.

Unresolved issues

Tax consolidation and investments in subsidiaries

It would be practically difficult to 'forecast' the likely tax base of an investment within a tax-consolidated group. This is due to the way in which the 'reverse ACA' calculation is dependent upon the tax values of the entity's assets and liabilities, thereby changing every time a tax value changes, e.g. tax depreciation, purchase of a new asset, etc.

The alternative approach of calculating the tax base of the investment as the aggregate tax bases available at each reporting date, ignoring the expected method of realisation, i.e. presume it will be sold at reporting date. Some commentators argue that this approach is not consistent with the concept of measuring deferred taxes taking management's expectations into account, but at least it would be more easily applied.

The 'end of time' view is conceptually equivalent to the requirement to recognise a deferred tax liability on revalued land even though the entity may have no intention to dispose of the land in the foreseeable future¹³. It also is consistent with the approach taken to all other investments outside tax-consolidated groups.

5.2.2.3. The 'change in tax status' view

Under this view, an entity leaving a tax-consolidated group would be considered a voluntary change in tax status, i.e. the entity no longer is taxed as part of the tax-consolidated group, but is taxed either as a stand alone taxpayer, or alternatively as part of another tax-consolidated group (with different reset tax values).

Using this approach would result in no deferred tax being recognised until such time as an entity leaves the tax-consolidated group. Whilst the entity was a member of the group, the investment would be considered to have no tax consequences because all transactions and balances between entities in the tax-consolidated group are ignored for tax purposes.

This approach would be consistent with the option of treating the pre-implementation effects of tax consolidation as a change in tax status (see section 5.1.1.1).

5.2.2.4. The 'foreseeable future' view

This view would only calculate any temporary differences (and so deferred taxes) arising from investments within the tax-consolidated group in the event that management expect that an investment is expected to leave the group in the foreseeable future.

This then would permit a more realistic temporary difference to be calculated and subsequently recognised as a deferred tax balance (automatically for deferred tax liabilities, but subject to the 'probable' criterion for deferred tax assets).

Although a pragmatic approach, there is limited support for this approach under AASB 112 as the 'foreseeable future' criterion is applied to the *recognition* requirement for deferred taxes associated with investments, not the *measurement* of the temporary difference arising.

☞ If divergent accounting treatments result on this issue, the Urgent Issues Group may ultimately need to provide further guidance. This issue will become more important if the IASB ultimately decides to remove the investments recognition exceptions from IAS 12 as part of the IASB/FASB convergence project on accounting for income taxes.

¹² This approach would also be consistent with the IASB/FASB proposals for amendments to the definition and concept of a 'tax base' which is focussed on the concept of the tax value available at reporting date taking into account the entity's current tax status and elections under taxation law ..

¹³ See Interpretation 121 *Income Taxes – Recovery of Revalued Non-Depreciable Assets*.

5.2.2.5. Disclosures about the deferred tax consequences of investments under AASB 112

No matter which view is adopted by an entity in relation to the deferred tax consequences of investments within tax-consolidated groups, in the majority of cases no deferred tax liability will be recognised due to the recognition exceptions in paragraphs 39 and 44 of AASB 112. This is because of the following reasons:

- in many cases, temporary differences arising would not be expected to reverse in the foreseeable future, i.e. the entity is not expected to leave the tax-consolidated group
- in relation to any deductible temporary differences arising, this usually indicates the expectation of a capital loss and it may be difficult to meet the 'probable' criterion due to the tax treatment surrounding the recoverability of capital losses

Although deferred tax liabilities and assets may not be commonly recognised, AASB 112 requires the following disclosures:

- the amount of deductible temporary differences for which no deferred tax asset is recognised in the balance sheet (AASB 112.81(e))
- the aggregate amount of temporary differences associated with investments in subsidiaries, branches, and associates and interests in joint ventures, for which deferred tax liabilities have not been recognised (AASB 112.81(f)).

Because of the uncertainty surrounding the measurement of deferred taxes associated with investments within the tax-consolidated group, it is recommended that entities consider providing additional disclosures in conjunction with the above disclosures so that the approach adopted is transparent to the users of the financial statements. Example wording for each view are included in the table on the next page.

Unresolved issues

Tax consolidation and investments in subsidiaries

Example disclosures

The following examples can be adapted to suit the individual circumstances of each tax-consolidated group, depending upon the view taken in relation to the deferred tax consequences of investments within tax-consolidated groups and other factors. The disclosures are designed to accompany the disclosures made in accordance with paragraphs 81(e) and 81(f) of AASB 112. An example of the disclosures under paragraph 81(f) which follows immediately below:

	Consolidated		Company	
	2005	2004	2005	2004
	\$'000	\$'000	\$'000	\$'000
Taxable temporary differences in relation to investments in interests not recognised as deferred tax liabilities and assets, attributable to:				
- subsidiaries in the tax-consolidated group (1)	-	-	-	-
- foreign subsidiaries	-	-	-	-
- jointly controlled entities and associates	-	-	-	-
- <i>{other – describe}</i>	-	-	-	-
Aggregate taxable temporary differences not recognised as deferred tax liabilities	-	-	-	-

'End of time' view – using reporting date 'reverse ACA' calculation

- (1) Under the tax law, the taxable profit made by a tax-consolidated group in relation to an entity leaving the group depends on a range of factors, including the tax values and/or carrying values of the assets and liabilities of the leaving entities, which vary in line with the transactions and events recognised in each entity. The above taxable temporary differences include an amount of \$x (parent entity \$y) that arises in relation to investments within the tax-consolidated group. This temporary difference represents the taxable profit that would be realised if the investments within the tax-consolidated group (or the net assets arising on consolidation in relation to those investments) were disposed of at the reporting date at their carrying amounts. Because the consolidated entity has no current intention to dispose of these investments, a deferred tax liability has not been recognised in relation to these taxable temporary differences. Furthermore, the taxable profit or loss ultimately made on disposal of the investments within the tax-consolidated group may be higher or lower than this amount depending upon when the entity leaves the tax-consolidated group and the assets and liabilities that the leaving entity holds at that time.

'Change in tax status' view

- (1) Under the tax law, the taxable profit made by a tax-consolidated group in relation to an entity leaving the group depends on a range of factors, including the tax values and/or carrying values of the assets and liabilities of the leaving entities, which vary in line with the transactions and events recognised in each entity. The taxable profit or loss ultimately made on any disposal of the investments within the tax-consolidated group will therefore depend upon when each entity leaves the tax-consolidated group and the assets and liabilities that the leaving entity holds at that time.

The consolidated entity considers the effects of entities entering or leaving the tax-consolidated group to be a change of tax status that is only recognised when those events occur. As a result, temporary differences and deferred tax liability have not been measured or recognised in relation to investments within the tax-consolidated group.

'Foreseeable future' view (see comments regarding validity of this approach in section 5.2.2.4)

- (1) Under the tax law, the taxable profit made by a tax-consolidated group in relation to an entity leaving the group depends on a range of factors, including the tax values and/or carrying values of the assets and liabilities of the leaving entities, which vary in line with the transactions and events recognised in each entity. The taxable profit or loss ultimately made on any disposal of the investments within the tax-consolidated group will therefore depend upon when each entity leaves the tax-consolidated group and the assets and liabilities that the leaving entity holds at that time.

Because the consolidated entity has no current intention to dispose of these investments, a deferred tax liability has not been recognised in relation to investments within the tax-consolidated group. Furthermore, temporary differences that might arise on disposal of the entities in the tax-consolidated group cannot be reliably measured because of the inherent uncertainties surrounding the nature of any future disposal that might occur. However, the directors believe that certain non-taxable transactions could be put in place within the tax-consolidated group before any disposal that could reduce any taxable amount that might arise to nil. Because the directors have no current intention to dispose of these investments and because of the existence of these tax planning opportunities, the directors believe the minimum amount of any temporary difference arising would be nil.

5.3. Potential tax issues

Whilst the focus of this document is on the accounting aspects of tax consolidation, there are some additional considerations from a taxation perspective that need to be understood by entities in forming their accounting policies for tax consolidation under A-IFRS. This section seeks to provide a brief summary of some of these accounting related tax issues, but does not purport to be a full summary of all issues that may arise, nor a comprehensive analysis of the tax law perspective of tax consolidation.

Because the tax issues arising from Interpretation 1052 can have a 'real' impact on tax-consolidated groups, the tax issues arising can be of high importance in determining how to apply Interpretation 1052. The taxation issues may outweigh other considerations arising, particularly because the impacts of Interpretation 1052 are eliminated in the consolidated financial statements.

Real tax issues that have negative impacts can arise.

Some examples of the tax consequences of accounting for tax consolidation under Interpretation 1052 are outlined below.

5.3.1. Impact on the 'ACA' calculation

The tax law surrounding tax consolidation refers to the use of accounting values in some places, the most obvious being the 'allocable cost amount' (ACA) and 'reverse ACA' calculations for entities joining or leaving a tax-consolidated group.

Whilst the Tax Commissioner has released his views on various aspects of recognising and measuring accounting liabilities for the purposes of the tax consolidation legislation¹⁴, a number of issues remain unresolved and the advent of Interpretation 1052 has also changed the accounting treatment.

Some of the relevant matters to consider include:

- if an entity chooses to use consolidated carrying amounts under the separate taxpayer within group method (compared with using stand alone entity carrying amounts) for the measurement of deferred tax liabilities under Interpretation 1052, what impact will this have on the ACA for an entity joining a group? Will the position on exit be impacted via the reverse ACA calculations?
- could there be any application of CGT Event L7 to crystallise an immediate capital gain on implementing Interpretation 1052?
- what will be the impact (if any) on the ACA calculation if a target joining a group has elected to use a different accounting method than the acquiring group under Interpretation 1052?
- could the treatment of intra-group transactions under the Interpretation affect an entity's reverse ACA position?
- will retrospective adjustments to accounting treatments on the transition to Interpretation 1052 have any impacts on past or future tax treatments of items?

For these reasons, it will be important to undertake appropriate due diligence on a go forward basis prior to both acquisitions and divestments to ensure that no unintended tax consequences arise from the impact of Interpretation 1052 on entry ACA or reverse ACA calculations.

¹⁴ See for instance, Taxation Ruling TD 2004/14 'Income tax: consolidation: recognising and measuring the liabilities of a joining entity under subsection 705-70(1) of the Income Tax Assessment Act 1997'

5.3.2. Other considerations

In addition to the effects on ACA (or reverse ACA) calculations, there are other areas of uncertainty that arise and may be relevant for entities to consider as part of their planning for the implementation of Interpretation 1052.

These issues include:

- whether distributions to equity participants under the Interpretation be regarded as ‘dividends’ for tax purposes. This is primarily an issue for foreign owned MEC groups (or those with transitional foreign held subsidiaries) If such distributions are regarded as dividends, entities would need to consider:
 - whether the distribution is ‘frankable’ and, if so:
 - to what extent do the benchmark franking rules affect the franking credits to be attached to the distribution; and
 - do the franking credit streaming rules apply, for example, to allow the Commissioner to impose an additional franking debit on the distributing entity; and
 - whether the distribution is also a ‘dividend’ for withholding tax purposes (both domestically and under Australia’s double tax agreements).

We will be seeking clarification from the Australian Taxation Office (‘ATO’) regarding these issues through the National Tax Liaison Group International Financial Reporting Standards tax subcommittee.

Further, for foreign owned ‘MEC groups’ (or those groups with transitional foreign held subsidiaries), a foreign resident recipient of such a distribution would need to assess whether the distribution is assessable under their local law. Even if such distributions are not assessable under their local law, a foreign resident recipient may need to implement system changes to ensure that the accounting ‘receipt’ is ultimately not included in their tax calculations.

- how will equity contributions under the Interpretation be regarded for tax purposes. For example, could such contributions:
 - result in share capital tainting? In relation to foreign owned MEC groups, could the equity contributed to an ‘eligible tier-1 company’ result in share capital tainting? In relation to domestically owned consolidated groups, an issue arises as to whether the share capital account of a subsidiary member of the group can be ‘tainted’ whilst it is a member of the group (which would have implications if the subsidiary left the consolidated group).

There is further uncertainty in relation to share capital tainting because the share capital tainting rules are being re-written and there is currently little guidance about their final form. Further, we understand that it is currently intended that these rules will apply retrospectively.
 - be considered to be an ‘injection of capital’ that would impact the ability of tax-consolidated groups to carry forward and utilise tax losses (particularly in relation to MEC groups)?

We understand that such equity contributions will generally not impact the ability of tax-consolidated groups to carry forward and utilise tax losses (on the basis that there may be no impact on the market value of the group). However, formalised guidance from the ATO would be beneficial.

In light of the significance of the impact of the above matters and the uncertainty surrounding their ultimate treatment, it will be important to give serious consideration as to the merits of some preventative strategies such as:

- maintaining separate equity accounts in which to record transactions arising from the implementation of Interpretation 1052; and/or
- implementing a TFA or, if a TFA already exists, aligning the method of allocating taxes to members of the tax-consolidated group with the chosen method of allocating current and deferred taxes to entities within the group.¹⁵

☞ The key message is that tax-consolidated groups should not blindly apply Interpretation 1052 without fully considering the tax consequences that can arise. Some of these may be 'sleeper' issues that will not be able to be retrospectively addressed.

¹⁵ Note, however, that such an alignment may not accord with commercial practicalities.

6. Transitional impacts

6.1. What are the transitional requirements of Interpretation 1052?

Interpretation 1052 is applicable to annual reporting periods ending on or after 31 December 2005 (UIG 1052.18). The Interpretation may be applied to annual reporting periods beginning on or after 1 January 2005 that end before 31 December 2005 (due to, for example, a change in reporting date) only in the context of adopting all Australian equivalents to International Financial Reporting Standards (UIG 1052.19).

☞ Interpretation 1052 cannot be applied in the context of pre-2005 Standards and therefore UIG Abstract 52 will continue to apply to annual reporting periods beginning before 1 January 2005, e.g. the financial year ended 30 June 2005 for June reporting entities.

To ensure full compliance with A-IFRS, there are no specific transitional provisions in relation to Interpretation 1052. Therefore, the general requirements of AASB 1 *First-time Adoption of Australian Equivalents to International Financial Reporting Standards* must be followed¹⁶.

Therefore, in general terms:

- *full* retrospective application of the requirements of Interpretation 1052 will be required at the date of transition
- comparative information in the entity's first A-IFRS compliant report will need to be fully restated in accordance with the new requirements.

However, the commentary to Interpretation 1052 notes that in some cases, the need for specific transitional adjustments may be avoided. There are two main 'short-cuts' that are permitted and these are briefly discussed below.

6.1.1. Dividends from subsidiaries used to fund head entity tax payments

When considering transitional adjustments, the head entity (and any interposed parents) need to determine whether the application of Interpretation 1052 from the date that tax consolidation was implemented to the date of transition would have resulted in carrying amounts for investments in subsidiaries that are materially different from those previously determined at the date of transition. This is particularly likely to be the case where there was no tax funding arrangement and there were no dividends or other distributions from subsidiary to fund the head entity's tax payments. Dividends or other distributions used to fund the head entity are likely to offset any equity contributions that would otherwise arise on the retrospective application of Interpretation 1052. Any adjustment of investment carrying amounts at the date of transition is recognised via retained earnings (UIG 1052.63).

¹⁶ Whilst AASB 1 has mandatory and optional exemptions to full retrospective application of A-IFRS, it unfortunately does not contain any general exemptions in relation contributions by and distributions to equity participants such as those that arise under Interpretation 1052.

Therefore, no transitional adjustments to the carrying amount of investments in subsidiaries are likely to be required *if*:

- prior to transition, a tax-consolidated group did *not* have a TFA in place, and
- the head entity's payment of tax on behalf of the group is effectively funded through distributions from subsidiaries.

In these circumstances, the retrospective application of Interpretation 1052 would lead to an increase in the carrying amount of investments in subsidiaries for current tax liabilities previously assumed, but these would most likely be offset by treating some part of the distributions made as a return of capital (see section 3.4.4), thereby reducing the carrying amount back to its existing cost. As a result, retrospective application of Interpretation 1052 would not change the carrying amount of investments as they would be likely to increase and decrease by the same amount.

Example illustrating why the 'short-cut' works

Entity H and Entity A are part of a tax-consolidated group, with H being the head entity. The tax-consolidated group was formed on 1 July 2003 and there is no tax funding arrangement in place. During the first year under tax consolidation, A's profit and taxable income was \$100. Assume that there are no temporary differences arising. H recognised a current tax liability of \$30 in relation to A's taxable income. Although no TFA was in place, A paid a dividend of \$30 to H to fund its share of the consolidated tax payment.

Treatment under A-GAAP

Under A-GAAP, A would have reported a profit of \$100 and a dividend distribution of \$30. H would have recognised an income tax expense of \$30 in respect of A and also recognised dividend income of \$30.

Treatment under A-IFRS

Under A-IFRS, retrospective adjustments should theoretically be made to reflect the \$30 current tax liability as a contribution by equity participants, decreasing the retained earnings of A and increasing contributed capital and resulting in an increase in the carrying amount of H's investment in A of \$30.

However, because the dividend of \$30 paid by A was effectively used to fund the H's tax payment, this amount was effectively paid out of the \$30 'additional profits' recognised under A-GAAP. Because these 'additional profits' would be reclassified on retrospective application of Interpretation 1052 to capital or reserves, the dividend would change its nature under A-IFRS and be paid out of these other equity accounts, rather than retained earnings. Furthermore, this distribution from A would also change its characteristics on receipt by H and effectively be a return of capital, being the contribution in respect of the current tax liability.

The impacts of this treatment are outlined below. This table only shows the net impacts of the profit and tax adjustments mentioned above.

	A-GAAP amount	Retrospective application of Interpretation 1052	Change in treatment of dividend	A-IFRS amount
A's retained earnings:				
Accounting profit for the prior year	100	(30)	-	70
Less: dividend paid	(30)	-	30	-
Closing balance	70	(30)	30	70
A's capital and reserves	-	30	(30)	-
H's investment in A	-	30	(30)	-
H's retained earnings:				
Income tax expense	(30)	30	-	-
Dividend received from A	30	-	(30)	-
Closing balance	-	30	(30)	-

As can be seen from the above analysis, there is no impact on the total equity or its components of either A or H from a retrospective application of Interpretation 1052. This is because the payment of the dividend out of the 'additional profits' that A made under A-GAAP effectively represents a return of the contributed capital that arises under A-IFRS.

Transitional impacts

What are the transitional requirements of Interpretation 1052?

6.1.2. TFA arrangements previously sought to 'push down' deferred taxes

When applying UIG Abstract 52, some entities put in place a TFA that had the effect of creating intercompany payables and receivables between each entity in the tax-consolidated group and the head entity that had two components:

- a 'current component' that effectively represented the contribution towards the current tax liability of the group, and
- a 'non-current component' that effectively represented the deferred tax assets or liabilities of the subsidiary.

The effect of this type of TFA arrangement was such that it had the intention of reflecting in a subsidiary the tax amounts relating to its transactions and balances, which it could not recognise directly (due to UIG 52.11). Under Abstract 52, the subsidiary would have recognised the amounts as current and deferred tax expense (income) and as current and non-current intercompany balances, with no contributions by or distributions to equity participants. In substance, this is the same outcome required by Interpretation 1052, based on the principle that there is no such contribution or distribution where the TFA amounts equate to the amount initially recognised by the subsidiary. Therefore, it may be appropriate for subsidiary to reclassify as deferred tax balances at the date of transition the non-current intercompany balance that arose under TFA, without having to recognise contributions or distributions to the head entity (UIG 1052.65).

In other words, because Abstract 52 would not permit the direct recognition of deferred tax balances in the separate financial statements of subsidiaries, some tax-consolidated groups chose to 'recreate' these balances in the affected entities by couching the terms of a TFA to require the recognition of an equivalent intercompany payable or receivable. Therefore, Interpretation 1052 notes that in substance the accounting approach required by the Interpretation was already being implemented and so no contribution to or distribution by equity participants had occurred. However, for this 'in substance' argument to hold true, the head entity must reverse existing intercompany balances relating to deferred tax balances arising from subsidiaries' temporary (or timing) difference that were previously recognised by the head entity under Abstract 52 (UIG 1052.65).

☞ To obtain the benefits of this concessional treatment, it is paramount that affected groups correctly revise their TFAs before the end of their first reporting period under A-IFRS, e.g. before 30 June 2006 for June reporting entities.

6.2. What adjustments will be required?

Because in general full retrospective application of Interpretation 1052 is required on transition to A-IFRS, an entity's prior accounting for tax consolidation will need to be revisited and restated. This could mean a number of years for some entities where tax consolidation was adopted soon after enactment. Materiality will need to be borne in mind when adjustments are made.

Transitional adjustments related to Interpretation 1052

The table below outlines some of the adjustments that may be required as part of the adoption of Interpretation 1052 on transitional to A-IFRS.

	Adjustments required in books of...		
	Head entity	Subsidiaries	Consolidation
Derecognise deferred taxes associated with subsidiaries	✓		
Recognise deferred taxes associate with own transactions, events and balances in accordance with AASB 112 and Interpretation 1052, i.e. based on <i>reset</i> tax values and the <i>carrying amounts</i> within each entity (or on consolidation if that approach is taken)	✓	✓	
If carrying amounts within each entity are being utilised in the calculation of deferred taxes, recognise deferred taxes related to fair value adjustments and other adjustments made outside the books of members of the tax-consolidated group, i.e. consolidated carrying amounts are no longer used in the computation of deferred taxes within each entity, but only recognised on consolidation			✓
Recognise deferred taxes associated with investments within the tax-consolidated group where the recognition criteria have been satisfied, i.e. primarily an expectation that temporary differences associated with investments are expected to reverse in the foreseeable future, with an additional 'probable' recognition criteria for deferred tax assets			✓
Where pre-transition business combinations are restated, appropriate adjustments to deferred taxes associated with the combination will need to be made for the impacts of tax consolidation, depending upon when the business combination occurred, i.e. prior to substantive enactment or implementation date depending on how the pre-implementation effects of tax consolidation are dealt with (see section 5.1.1)			✓
Treat the assumption by the head entity of the current tax of prior periods as a contribution from (or distribution to) equity participants, net of any tax funding arrangement payments (unless the entity qualifies for one of the 'short-cut' methods outlined in section 6.1)	✓	✓	(elimination)
Treat any amounts paid under a tax contribution arrangement on formation of the tax-consolidated group as a contribution from (or distribution to) equity participants, i.e. for the head entity's assumption of the deferred tax balances of subsidiaries	✓	✓	(elimination)

6.3. Practical considerations

As noted in the introduction, Interpretation 1052 will have no bearing on income tax accounting in the consolidated financial statements. It will however, impact accounting within the separate financial statements of the entities in the tax-consolidated group. In many cases, a class order may be in place within the tax-consolidated group and if not, the vast majority of the financial reports prepared would be special purpose financial reports prepared for compliance with the *Corporations Act 2001* and so unlikely to be subject to public scrutiny.

Therefore, the separate financial statements of the ultimately parent entity in the group is where the requirements of Interpretation 1052 are likely to have the most visible impact from a reporting perspective. Affected groups should therefore keep the requirements of Interpretation 1052 in perspective and look for the best outcome for the lowest amount of initial and on-going effort.

There are however three *key* factors to consider:

- whether tax funding arrangements are adequate or need to be revised or put in place (see section 3.3).
- cost benefit analysis on optimal accounting outcomes compared with the cost of systems modification, particularly in light of costs already incurred to implement tax consolidation and the uncertainties of the acceptability of the various methods under the forthcoming revised IAS 12 (see section 3.2.7)
- the potential unfavourable tax consequences arising from accounting approaches adopted (see section 5.3)

Some wider consideration points are outlined in the table on the next page.

Practical considerations on implementation of Interpretation 1052

Choosing a method

- Are there any favourable or unfavourable tax consequences from the method we might choose?
- Which method aligns most closely with the bases under which the consolidated tax return is prepared?
- Which method would result in the least amount of system change?
- Do we need to consider the impacts of the impending changes to IAS 12 or the US GAAP effects when setting our method?

Transitional adjustments

- What transitional adjustments are required in relation to tax consolidation at the date of transition to A-IFRS? What areas are affected and are the adjustments material?
- Is the necessary information available to determine the opening balance adjustments in each entity with sufficient accuracy?
- Are we eligible to use any of the 'short-cut methods' on transition? If not, can we put any processes or transactions in place to take advantage of the methods?
- What impacts might adjustments have on the reported solvency of individual entities in the tax-consolidated group, subsidiary level banking arrangements or bonus plans, taxation arrangements (e.g. tainting), etc?
- What impacts will the new requirements have on comparative information in our first A-IFRS financial report?

Tax funding arrangements (TFAs) and tax sharing agreements (TSAs)

- What TFAs and/or TSAs are currently in place within the tax-consolidated group?
- What has been the key determinant(s) of the terms of the TFAs and/or TSAs?
- It is commercially acceptable to implement or revise TFAs to take into account the requirements of Interpretation 1052?
- Can any amendments to TFAs be implemented before the beginning of our first A-IFRS reporting period to minimise one-off adjustments in the first year?
- Do the TFAs or TSAs need to be amended to take into account the effect of entities joining or leaving the tax-consolidated group, e.g. to require reimbursement for tax losses brought into the group?

Impacts on the wider A-IFRS transition process

- What adjustments to our systems and processes will be necessary to accommodate the accounting methodology in Interpretation 1052? Have these aspects been budgeted for and costed?
- What impacts will Interpretation 1052 have on our overall A-IFRS implementation project? Does our timetable allow adequate time to consider the impacts and issues?
- Are there flow on impacts to other areas, such as dividend planning, banking covenants, bonus plans and other factors at the subsidiary level, etc?

Appendix

Abbreviations used in this document

Abbreviation	Meaning
AASB	Australian Accounting Standards Board
AASB 112	Accounting Standard AASB 112 <i>Income Taxes</i> , equivalent to IAS 12 <i>Income Taxes</i>
Abstract 52	Urgent Issues Group Abstract 52 'Income Tax Accounting under the Tax Consolidation System', the precursor to Interpretation 1052 that is applied under A-GAAP.
A-IFRS	Australian equivalents to IFRS, comprising Accounting Standards and UIG Interpretations
A-GAAP	Australian generally accepted accounting principles currently applied before the transition to the A-IFRS
FASB	Financial Accounting Standards Board of the United States of America
IAS 12	International Financial Reporting Standard IAS 12 <i>Income Taxes</i>
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IFRIC	International Financial Reporting Interpretations Committee, a committee of the IASB.
Interpretation 1052	Urgent Issue Group Interpretation 1052 <i>Tax Consolidation Accounting</i> , approved by the AASB at its meeting held on 8-9 June 2005.
SFAS 109	United States Statement of Financial Accounting Standards No. 109 'Accounting for Income Taxes', largely equivalent to IAS 12/AASB 112 and currently being considered by the IASB as part of the joint IASB/FASB convergence project on income taxes.
TFA	Tax funding arrangement – a formal or informal arrangement between members of a tax-consolidated group whereby payments are made to or from the head entity and its subsidiaries to fund the payment of tax on behalf of the tax-consolidated group, reimburse subsidiaries for the benefits of tax losses and offsets assumed and other tax-related amounts.
UIG	Urgent Issues Group, a committee of the AASB.

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