

Income recognition – method used by head company

The head company of a consolidated group is the only entity the income tax law recognises for the purposes of working out the income tax liability or losses of the group. The method of income recognition used by the company will directly affect that calculation.

The consolidation legislation does not prescribe an accounting method, nor does it limit the choice of method of income recognition. The basis of income recognition used by a business should be the most appropriate method for the type of income it derives. In most cases, a choice to consolidate will have no effect on the appropriate basis of income recognition.

→ Taxation Determination TD 2005/3

A consolidated group can be made up of entities conducting a range of business activities, bringing income to account by the same or different methods. A business needs to adopt the method of accounting that gives a 'substantially correct reflex of the taxpayer's true income' (*CT v Executor Trustee and Agency Co of South Australia Limited* (1938) 63 CLR 108).

**Earnings
method
usually most
appropriate**

The earnings method of accounting will usually be the most appropriate method to be used by a company unless it is an 'artificial, unreal and unreasonably burdensome method of arriving at the income derived' (*FCT v Firstenberg* (1976) 27 FLR 34; 76 ATC 4141; (1976) 6 ATR 297).

Income that is the subject of specific provisions of the *Income Tax Assessment Act 1936* or *1997* will continue to be governed by those provisions.

Taxation Ruling TR 98/1: *Income Tax: determination of income; receipts versus earnings* provides guidance on determining income and the use of the receipts (cash) versus earnings (accruals) methods of accounting.

Paragraph 17 of the ruling states:

When accounting for income in respect of a year of income, a taxpayer must adopt the method that, in the circumstances of the case, is the most appropriate. A method of accounting is appropriate if it gives a substantially correct reflex of income. Whether a particular method is appropriate to account for the income derived is a conclusion to be made from all the circumstances relevant to the taxpayer and the income.

The alternate methods and their appropriateness to different types of income are then discussed.

Paragraph 39 deals specifically with incorporated entities and makes it clear that the earnings method is the preferred method of income recognition:

The factors that would mitigate against the receipts method being appropriate for business income of a company include:

- The commercial and accounting principles and practices governing accounts kept by companies generally require the accruals (earnings) method of bookkeeping; and
- A company generally relies upon employees; it is not able to provide personal services.

**Same method
likely to be
appropriate
for all business
activities**

Paragraph 22 of TR 98/1 is also relevant to consolidated groups, which operate for income tax purposes as one entity but in reality are a mix of divisions or business activities. It states:

Where a taxpayer has business income from more than one business activity, a separate evaluation should be made for each activity and a determination made as to which method is appropriate for the accounting of that income. In most cases, the same method is likely to be appropriate for income from all of these business activities. Fine distinctions are not necessary where the differences between the various business activities are not significant.

The effect of the single entity rule is to treat the head company of a consolidated group as holding all the assets and liabilities of its subsidiaries, and as having entered into the transactions of its subsidiaries. Subsidiary members are treated as if they are parts or divisions of the head company for income tax purposes → Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraph 2.26.

The process of consolidation will have little impact on the choice of method of income recognition. However, in a limited number of cases where consolidating the group's business activities results in a change in the extent of a particular type of business activity, or a grouping of subsidiaries with similar business activities but different income recognition methods, the method may need to be reconsidered. While it is possible for different methods of income recognition to be used within divisions of the same consolidated group, that would be unusual, unless of course there is income subject to specific tax law provisions.

References

Income Tax Assessment Act 1997, section 6-5

Income Tax Assessment Act 1997, section 701-1

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 2.12 – 2.29

Taxation Ruling TR 98/1 – Income Tax: determination of income; receipts versus earnings

Taxation Determination TD 2005/3 – Income tax: consolidation: will a choice to consolidate under Part 3-90 of the *Income Tax Assessment Act 1997* affect the method of income recognition of the consolidated group?

Revision history

Section C9-1-120 first published 5 April 2004.

Further revisions are described below.

Date	Amendment	Reason
26.10.05	Reference to new taxation determination.	

Proposed changes to consolidation

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

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