


***TR 2005/D13 - Income tax: consolidation: recognising and measuring the liabilities of a joining entity under subsection 705-70(1) of the Income Tax Assessment Act 1997 where the joining time occurs in a financial reporting period of the joining entity beginning on or after 1 January 2005***

 This cover sheet is provided for information only. It does not form part of *TR 2005/D13 - Income tax: consolidation: recognising and measuring the liabilities of a joining entity under subsection 705-70(1) of the Income Tax Assessment Act 1997 where the joining time occurs in a financial reporting period of the joining entity beginning on or after 1 January 2005*

This document has been finalised by TR 2006/6.



## Draft Taxation Ruling

Income tax: consolidation: recognising and measuring the liabilities of a joining entity under subsection 705-70(1) of the *Income Tax Assessment Act 1997* where the joining time occurs in a financial reporting period of the joining entity beginning on or after 1 January 2005

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### **Preamble**

*This document is a draft for industry and professional comment. As such, it represents the preliminary, though considered views of the Australian Taxation Office. This draft may not be relied on by taxpayers and practitioners as it is not a ruling for the purposes of Part IVA of the Taxation Administration Act 1953. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office.*

## **What this Ruling is about**

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1. This Ruling deals with the recognition and measurement of liabilities of a joining entity under subsection 705-70(1) of the *Income Tax Assessment Act 1997* (ITAA 1997) where an entity joins a consolidated group during a financial reporting period of the joining entity beginning on or after 1 January 2005. The value of a joining entity's liabilities is added at step 2 in the table to section 705-60 in working out the joined group's allocable cost amount.

## **Date of effect**

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2. It is proposed that when the final Ruling is issued, it will apply both before and after its date of issue. However, the final Ruling will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the final Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

## Related Ruling

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3. TR 2004/14 deals with the recognition and measurement of liabilities of a joining entity under subsection 705-70(1) of the ITAA 1997 where an entity joins a consolidated group during a financial reporting period of that entity beginning before 1 January 2005.
4. This Ruling deals with the recognition and measurement of liabilities of a joining entity under subsection 705-70(1) of the ITAA 1997 where the joining time occurs in a financial reporting period of the joining entity beginning on or after 1 January 2005.
5. For further information about when this Ruling applies see 'When to apply this Ruling' at paragraph 106 to 108 of this Ruling.

## Ruling

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6. Subsection 705-70(1) of the ITAA 1997 provides for the recognition and measurement of accounting liabilities of entities in respect of which an allocable cost amount (ACA) is to be calculated upon entry into a consolidated group. The term 'accounting liability' refers to a liability at the joining time that can or must be recognised in a statement of financial position (balance sheet) in accordance with the accounting standards or statements of accounting concepts issued by the Australian Accounting Standards Board (AASB).
7. The purpose of subsection 705-70(1) is to recognise and measure accounting liabilities at step 2 of the ACA process in accordance with the established accounting construct that applies in Australia. Adoption of the accounting construct creates dynamic outcomes within the ACA and tax cost setting process. For instance, changes in the recognition or measurement of liabilities at step 2 may affect the measurement or aggregation of accounting profits at step 3. Recognition of these relationships is essential to correctly calculate the ACA and complete the tax cost setting process.
8. This Ruling does not provide interpretation on the application or impact of other sections and subsections which adjust or change the amount of the liability initially recognised and measured at subsection 705-70(1) in accordance with the interpretation provided below. The provisions that adjust the amount recognised at subsection 705-70(1) include subsection 705-70(1A), sections 705-75, 705-80, 705-85 and 705-59.
9. The following interpretations should be applied to subsection 705-70(1).

**‘ ... adding up the amounts of each thing (an accounting liability)... ’**

10. Liabilities are classified and measured in a statement of financial position (balance sheet) in a consistent manner. They also have to be classified according to their nature, and by whether they are current or non-current. The process of classification, measurement and addition required to be undertaken under subsection 705-70(1) should be done in the same way as in the preparation of a statement of financial position (balance sheet).

**‘ ... in accordance with \*accounting standards, or statements of accounting concepts ... ’**

11. This phrase does not provide a choice about whether to apply an accounting standard or a statement of accounting concept in the recognition and measurement of an accounting liability. Accounting standards should be applied in preference to statements of accounting concepts by all joining entities (both reporting and non-reporting entities).

12. The reference to accounting standards and statements of accounting concepts does not exclude other parts of the accounting construct such as the Urgent Issue Group (UIG) Interpretations, Framework for the Preparation and Presentation of Financial Statements (the ‘Framework’), and other authoritative pronouncements. These pronouncements should be specifically considered when recognising and measuring accounting liabilities at step 2 of the ACA process. UIG Interpretations and other authoritative pronouncements of the AASB are part of the accounting construct within which general purpose financial reports are prepared.

13. Joining entities may have previously produced statements of financial position (balance sheets) in accordance with accounting standards, statements of accounting concepts and other authoritative pronouncements. The accounting policies adopted at the joining time would usually be expected to be consistent with those previous statements (balance sheets). However, the adoption of other accounting policies in the recognition and measurement of liabilities at the joining time may occur in three circumstances. First, when new accounting standards, statements of accounting concepts and other authoritative pronouncements are required to be, or can be, adopted on or before the joining time. Second, where existing accounting standards, statements of accounting concepts and other authoritative pronouncements in Australia allow the adoption of a different accounting policy. Third, under the circumstances noted in paragraph 14 of this Ruling.

14. If an accounting transaction or event is not covered by an accounting standard, statement of accounting concept or other authoritative pronouncement of the AASB, such as the UIG Interpretations and the Framework, joining entities may consider what guidance is available in comparable standards and authoritative pronouncements in other jurisdictions. Paragraph 10 of AASB 108 *'Accounting Policies, Changes in Accounting Estimates and Errors'* outlines how entities should use judgement in developing and applying an accounting policy. Paragraph 12 of the Standard then indicates that in making this judgement the most recent pronouncements of other standard setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature and accepted industry practices may be considered to the extent they do not conflict with paragraph 11 of the Standard. Where a liability can be recognised in accordance with the Framework, application of paragraph 12 of the Standard may be relevant.

15. Where a joining entity and a head company have previously been, and will continue to be, part of an economic group that produces a consolidated statement of financial position (balance sheet) the accounting policies adopted at the joining time are expected to be consistently applied by the head company and the joining entity.

16. There is one circumstance where the requirements of the ACA calculation process would vary from what would appear in a statement of financial position (balance sheet). Assets and liabilities should be recognised and measured on a gross basis even if they have to be set off against each other under the accounting standards. For example, the set off principle required by AASB 112 *'Income Tax'* should not apply.

17. AASB 1031 *'Materiality'* explains the role of materiality in the preparation of statements of financial position (balance sheet). However, materiality is defined by reference to the users of the reported data. In the context of ascertaining the amount of liabilities in determining the ACA, and ultimately therefore the calculation of a head company's taxable income, quantitative and qualitative standards of materiality will need to be considered. Materiality for these purposes may require an approach that is more rigorous than what might be acceptable or expected in the presentation of statement of financial position (balance sheet) for other purposes.

18. In the usual case, where audited accounts are the basis for a notional statement of financial position (balance sheet) it will not warrant further inquiry as to the value of reported liabilities. However, it is possible that evidence may exist which suggests the position taken will cause the Commissioner to question the appropriateness of the entity's approach to materiality issues. Such evidence may include the consistent adoption of positions on the recognition and measurement of liabilities that are on the edge of materiality. In these circumstances liabilities may be required to be recast.

**‘...is a liability of the joining entity at the joining time ...’**

19. In order to correctly recognise and measure accounting liabilities at the joining time the phrase ‘at the joining time’ in subsection 705-70(1) has to be interpreted as if the single entity rule did not apply for this purpose.

20. In order to recognise and measure the accounting liabilities for a statement of financial position (balance sheet) at the joining time in accordance with subsection 705-70(1), the joining time has to be treated, effectively, as a reporting date. For the purposes of AASB 110 *‘Events after the Balance Sheet Date’* only, the lodgement of the first relevant consolidated income tax return which includes the joining time of the joining entity is treated as a report date.

21. The treatment of the joining time as a reporting date means that the joining time is the date that has to be considered in applying the accounting standards, statements of accounting concepts and other authoritative pronouncements that are relevant in the recognition and measurement of accounting liabilities.

**‘...that can or must be recognised in the entity’s statement of financial position...’**

22. The words ‘can or must be recognised’ refers to the relevant choice of accounting policies applied to accounting standards, statements of accounting concepts and other authoritative pronouncements of the AASB in preparing an entity’s notional statement of financial position (balance sheet). Application of the accounting construct to the recognition and measurement of accounting liabilities will, in certain circumstances, allow joining entities a choice of recognising and measuring some liabilities. In those circumstances certain liabilities ‘can’ be recognised and measured at the joining time, but need not be recognised and measured at that time. However, all other liabilities ‘must’ be recognised and measured in accordance with applicable accounting standards, statements of accounting concepts and other authoritative pronouncements.

23. The application of the accounting construct to the recognition and measurement of liabilities at step 2 of the ACA process is undertaken within the context of developing a notional statement of financial position (balance sheet) at the joining time. This notional statement (balance sheet) is otherwise part of a general purpose financial report. The application of the accounting construct should consistently apply to all joining entities, whatever their structure or legal status. The consistent application also applies whether the joining entities are reporting or non-reporting entities.

## Explanation

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### The accounting construct

24. The ACA and tax cost setting process uses a combination of economic, accounting and tax concepts in its calculation. An eight step process for working out the ACA is outlined at section 705-60. Step 2 of the ACA process is about adding accounting liabilities of the joining entity at the joining time, step 3 is about adding undistributed taxed (accounting) profits accruing to the joined group before the joining time, and step 4 is about subtracting pre-joining time distributions out of certain (accounting) profits.

25. The accounting construct includes double entry accounting conventions, Australian accounting standards, UIG Interpretations, statements of accounting concepts, the Framework and other authoritative pronouncements of the AASB together with other relevant pronouncements of professional bodies and, where relevant, other national accounting standard setting bodies, that apply to the preparation of financial reports.

26. The accounting construct should be applied to the ACA and tax cost setting process in a consistent manner in preparing a notional statement of financial position (balance sheet) which is used to recognise and measure liabilities at step 2 and retained earnings at step 3. For example, the adoption of different accounting policies within the notional statement of financial position (balance sheet) that changes the value of liabilities should be fully documented with consequential changes to assets and equity accounted for and, where necessary, used in the ACA and tax cost setting process.

### **‘...adding up the amount of each thing (an accounting liability)...’**

27. The ‘amount of each thing’ is referred to as an accounting liability in subsection 705-70(1). The meaning of the word ‘liability’ is defined in paragraph 49 of the Framework as ‘a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits’. A liability is an element of the financial statements. Paragraph 83 of the Framework states that an item that meets the definition of an element should be recognised if:

- (a) it is probable that any future economic benefits associated with the item will flow to or from the entity; and
- (b) the item has a cost or value that can be measured with reliability.

28. Guidance on the essential characteristics of a liability is provided at paragraphs 60 to 64 of the Framework. Except where required by an Australian accounting standard, if a liability or obligation does not meet the definition and recognition criteria outlined in the Framework, joining entities should not include those liabilities or obligations at step 2 of the ACA process.

29. The Framework describes the qualitative characteristics of financial reports at paragraphs 24 to 46 of that document. The Framework places emphasis on the relevance and reliability of financial information together with comparability and understandability. These characteristics should underpin the aggregation of liabilities at step 2 of the ACA process.

30. Joining entities, when recognising each accounting liability for step 2 of the ACA process, should classify and measure like items in the same consistent way as if preparing a statement of financial position (balance sheet).

### **Alternative view**

31. It has been suggested that ‘adding up the amounts of each thing’ disaggregates liabilities (an accounting liability) to a singular thing that meets the definition of a liability. It is to this singular liability that accounting standards and statements of accounting concepts are applied. There is a choice of what accounting standard or statement of accounting concept can be applied to each individual liability, even within the same class or type.

32. This view is not consistent with the authoritative guidance in the Framework. The preferred view is noted at paragraphs 27 to 30 of this Ruling.

### **‘...in accordance with \*accounting standards, or statements of accounting concepts...’**

#### ***Role of accounting standards***

33. The term ‘accounting standards’ is defined in subsection 995-1(1) of the ITAA 1997 as having ‘the same meaning as in the *Corporations Act 2001*’. Section 9 of the *Corporations Act 2001* provides that the term ‘accounting standards’ means:

- (a) an instrument in force under section 334; or
- (b) a provision of such an instrument as it so has effect.

34. Subsections 334(1) and 334(2) of the *Corporations Act 2001* provide:

- (1) The AASB may make accounting standards for the purpose of this Act. The standards must be in writing and must not be inconsistent with this Act or the regulations.
- (2) A standard made under subsection (1) is a disallowable instrument for the purposes of section 46A of the *Acts Interpretation Act 1901*.



35. For financial reporting periods beginning on or after 1 January 2005 Australian Accounting Standards have been replaced by, or harmonised with, International Financial Reporting Standards (IFRS). These Australian accounting standards, referred to in this Ruling as Australian equivalent International Reporting Standards (AIFRS), must be applied in recognising liabilities and developing a balance sheet (previously referred to as a statement of financial position).

### ***UIG Interpretations***

36. AASB 1048 '*Interpretations and Applications of Standards*' lists at Table 1 after paragraph 9 and Table 2 after paragraph 10, those Interpretations that must be followed when considering what accounting policies should be applied to the preparation of financial reports. AASB 1048 will be updated regularly to accommodate new or remove redundant Interpretations.

37. UIG Interpretations do not have the same legal status as standards and are treated as external documents by the *Acts Interpretation Act 1901*. Paragraph 9 of AASB 108 notes that Implementation Guidance for Australian Accounting Standards issued by the AASB does not form part of those Australian Accounting Standards. However, the International Accounting Standards Board (IASB) includes Interpretations originated by the International Financial Reporting Interpretations Committee as part of the International Financial Reporting Standards. To give AASB Interpretations similar mandatory compliance within Australia, but not the same legislative position as standards, the AASB has introduced AASB 1048.

### ***Role of statements of accounting concepts***

38. PS 5 '*The Nature and Purpose of Statements of Accounting Concepts*' issued by the AASB, at paragraphs 8 and 9, states:

8. Statements of Accounting Concepts do not override or amend Accounting Standards and other authoritative pronouncements including UIG Consensus Views.
9. Statements of Accounting Concepts do not have legal force for entities reporting under the Corporations Act.

39. Statements of accounting concepts provide part of the construct within which accounting standards and other authoritative pronouncements are made by the AASB when establishing a view on particular accounting issues. The statement of accounting concepts, together with the Framework, are also used as guidance in preparing financial reports when there are no accounting standards or UIG Interpretations that deal with the specific accounting policy on a particular topic. This matter is further dealt with at paragraphs 41 to 45 of this Ruling.

***The use of the word ‘or’***

40. In the context of subsection 705-70(1), it is considered that in the compound phrase ‘accounting standards, or statements of accounting concepts’, the words accounting standards and statements of accounting concepts are used collectively rather than as alternatives. Therefore, in recognising and measuring liabilities for step 2 purposes, statements of accounting concepts are to be applied after consideration of accounting standards and other authoritative pronouncements of the AASB in accordance with the established accounting construct in the order of preference as set out at paragraphs 10 to 12 of AASB 108 *‘Accounting Policies, Changes in Accounting Estimates and Errors’* (see paragraph 42).

***Inclusion of the Framework and other authoritative pronouncements***

41. Within the accounting construct entities make decisions about the recognition and measurement of elements included in the financial reports. In recognising and measuring the elements, entities apply accounting policies or principles which are set out in accounting standards, UIG Interpretation, statements of accounting concepts, the Framework and other authoritative pronouncements as recognised by the AASB.

42. The hierarchical construct for dealing with accounting policies to be applied to transactions associated with the general purpose financial reports is provided in AASB 108 *‘Accounting Policies, Changes in Accounting Estimates and Errors’*. Paragraph 10 of that Standard states that ‘[i]n the absence of an Australian Accounting Standard that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is... relevant ... and reliable...’. Paragraphs 11 and 12 of the Standard then state:

11. In making the judgement described in paragraph 10, management shall refer to, and consider the applicability of, the following sources in descending order:
  - (a) the requirements and guidance in Australian Accounting Standards dealing with similar and related issues; and
  - (b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Framework.
12. In making the judgement described in paragraph 10, management may also consider the most recent pronouncements of other standard setting bodies that use a similar conceptual framework ....to the extent that these do not conflict with the sources in paragraph 11.

43. The Framework is referred to at paragraph 11 of AASB 108 and elsewhere in the standards. The Framework sets out the objects of financial reports, assumptions underlying financial reports, the qualitative characteristics of financial reports, the elements of financial reports, and the recognition criteria for the elements of financial statements. For financial reporting periods beginning on or after 1 January 2005, the Framework effectively replaces Statements of Accounting Concepts 3 and 4.

### ***Applying a different choice of accounting policies at the joining time***

44. Within the accounting construct the choice of accounting policies for recognising and measuring liabilities at the joining time may be different to those policies that were used previously for financial statement or other reporting purposes. This may occur where either:

- new accounting standards, statements of accounting concepts or other authoritative pronouncements are required to be, or can be, adopted on or before the joining time;
- existing accounting standards, statements of accounting concepts or other authoritative pronouncements in Australia allow the adoption of a different accounting policy that is relevant; or
- where the circumstances noted in paragraph 45 occur.

45. A change in accounting policies may be applicable to the joining time where a transaction or event has not been previously recognised and:

- there is no existing standard or other authoritative pronouncement from the AASB that deals with recognition and measurement of the transaction or event;
- the transaction or event meets the essential characteristics and recognition criteria in the Framework for a liability to be included;
- the choice of accounting policy selected to recognise and measure the transaction or event satisfies the concepts of relevance and reliability outlined at paragraph 10 of AASB 108 and in the Framework; and
- the accounting policy is applied to the notional statement of financial position (balance sheet) at the joining time to recognise and measure not only liabilities, but assets and equity.

46. Different accounting policies may be relevant when the definition of an asset for tax cost setting purposes includes certain assets to which ACA will be allocated that were not previously recognised and measured in the entity's statement of financial position (balance sheet). If another accounting policy that satisfies the above criteria allowed appropriate recognition of these assets, or some of these assets, in the notional statement of financial position (balance sheet) then related changes to liabilities and equity would also need to be recognised and measured at the joining time. The resultant change in liabilities would be included at step 2 of the ACA process. The changes may also impact elsewhere in the ACA and tax cost setting process, for example at step 3 of the ACA process.

47. Accounting standards and authoritative pronouncements of the AASB do not cover all possible transactions and events that may be relevant to the recognition and measurement of assets, liabilities and equity in a statement of financial position (balance sheet). Where an accounting standard or other authoritative pronouncement of the AASB does deal with transactions and events then those standards and pronouncements are mandatory for reporting entities. Transactions and events not dealt with, or differently dealt with, in those standards and pronouncements may be recognised as assets, liabilities and equity in the statement of financial position (balance sheet) where they meet the relevant definitions used in the Framework.

48. Where the circumstances described in paragraphs 44 to 47 exist, the selection and application of accounting policies to deal with assets, liabilities or equity that meet the relevant definitions used in the Framework should comply with paragraphs 10 to 12 of AASB 108. These paragraphs of AASB 108 have been previously noted above at paragraph 42 of this Ruling.

49. Where different accounting policies are applied at the joining time for the purposes of ACA and the tax cost setting process, those policies should be applied to recognise and measure changes in assets, liabilities and equity in a notional statement of financial position (balance sheet) at the joining time. As a result of changes in accounting policies that recognise and measure liabilities at step 2, there may be changes to the aggregated values at other steps of the ACA and tax cost setting process. For instance, in many cases a change in recognition of liabilities at step 2 will impact on the value of accounting profits at step 3 of the ACA process. These related impacts must be considered in the ACA and tax cost setting process when adopting different accounting policies.

50. Changes to accounting policies in the circumstances noted in the previous paragraph should be fully documented and the accounting impact of the change measured in the notional statement of financial position (balance sheet) at the joining time. Where the change impacts on the values applied at other steps in the ACA and tax cost setting process, these changes should be recognised and fully applied to that process in a consistent manner.

## ***Use of consistent accounting policies within an economic entity***

51. Joining entities that have previously been controlled by the head company or another parent entity that would normally be producing consolidated financial statements, would be expected to have applied congruent accounting policies in producing general purpose financial reports in each of those entities. These congruent accounting policies should continue to be applied in each joining entity and the head company at the joining time for the purposes of the ACA and tax cost setting process.

52. AASB 127 '*Consolidated and Separate Financial Statements*' at paragraph 4 describes control as 'the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities'. A controlled entity would include all entities that could become members of an income tax consolidated group where those entities meet the requirements for being a member of the group as set out at section 703-15 of the ITAA 1997. The head company and the controlled entities would be expected to adopt similar congruent policies unless not required by another standard or authoritative pronouncement.

## **Circumstances that diverge from application of the accounting construct**

### ***Reversal of set off (offset)***

53. Subject to an exception in respect of the treatment of linked assets and liabilities, section 705-58 requires Part 3-90 of the ITAA 1997 to be applied separately to each asset and liability even though under the accounting construct they would be set off against each other when presented in a statement of financial position (balance sheet). Within the Australian accounting standards set off is referred to as offset. AASB 101 '*Presentation of Financial Statements*' at paragraph 32 states:

Assets and liabilities, and income and expense, shall not be offset unless required or permitted by an Australian Accounting Standard.

54. There are two principal Australian Accounting Standards where offset is required for presentation: AASB 112 '*Income Tax*' and AASB 132 '*Financial Instruments: Disclosure and Presentation*'. AASB 112 deals with offset at paragraphs 71 to 76 of that standard. Offset applies to current tax assets and liabilities in certain circumstances. Offset also applies to deferred tax assets and liabilities: these are dealt with in this Ruling at paragraphs 59 and 60. AASB 132 deals with the offset of financial assets and liabilities at paragraphs 42 to 50 of that Standard.

55. Offset is primarily a presentation issue in the statement of financial position (balance sheet). In the absence of offset, assets and liabilities should be recognised and measured in accordance with the accounting construct. When offset is reversed entities may still have a choice of how to recognise and measure linked or related assets and liabilities.

56. The choice of recognition and measurement of liabilities at subsection 705-70(1) that have not been offset should be made within the context of the objectives of ACA and tax cost setting process. The choice of recognition and measurement of the assets and liabilities in the notional statement of financial position (balance sheet), by applying the relevant accounting policies within the established accounting construct, should encompass consideration of the following issues:

- what accounting policy has previously been consistently applied by the entity and the economic group for the recognition and measurement of the linked assets and liabilities prior to offset in the notional statement of financial position (balance sheet);
- the accounting policy adopted at the joining time should similarly apply to all linked or related assets, liabilities and in consequence retained earnings within the notional statement of financial position (balance sheet);
- the choice in the recognition and measurement of the unbundled liabilities for step 2 must be aligned to, and have the same characteristics as, the recognition of the linked or related assets for which cost or market value is measured in the tax cost setting process; and
- the operation and application of section 705-59 in dealing with the linked assets and liabilities and the potential application of CGT Event L7 in dealing with linked liabilities.

57. The reference to each and every liability in section 705-58 and to each liability in subsection 705-70(1) is not taken to imply that within the recognition and measurement choices available for linked or related assets and liabilities there is a requirement to unbundle to the lowest individual amount. Linked or related liabilities (and assets) can be treated as a singular amount for the purposes of subsection 705-70(1), and also for section 705-59, in certain circumstances. These circumstances include, but are not limited to, situations where the transactions underlying the linked assets and liabilities have some or all of the following characteristics:

- the underlying rights and obligations or contracts operate with standard conditions and clauses;
- they are settled with the same counterparty or through the same exchange or clearing house mechanism; and

- they are expected to be settled at the same time and, therefore, settled in the same financial period.

58. Within the accounting construct, unbundling of certain types of rights and obligations is limited by the treatment of agreements equally proportionately unperformed. This matter is dealt with, for example, at paragraph 91 of the Framework.

### ***Deferred tax assets and liabilities not set off (offset)***

59. AASB 112 *'Income Tax'* requires the offset of deferred tax assets and liabilities. The reversal of offset of deferred tax assets and liabilities does not mean the recognition and measurement criteria for deferred tax assets and liabilities have changed. For instance, deferred tax assets associated with tax losses that do not meet the recognition criteria in AASB 112 would not be included in the measurement of the deferred tax asset amount after offset is reversed.

60. Once an accounting liability has been recognised and measured as required by subsection 705-70(1), certain other calculation processes may apply to those liabilities at step 2. Subsection 705-70(1A) applies to deferred tax liabilities. Section 705-75 applies to certain deferred tax assets and section 705-80 applies to certain deferred tax assets and liabilities. Again, through the application of step 5 and 6 of the ACA process, deferred tax assets associated with losses become excluded assets for the purpose of tax cost setting. Further, the deferred tax assets associated with certain inherited deductions of the head company also become excluded assets through the application of step 7 of the ACA process. Correct outcomes are achieved in the ACA process when the measurement of the deferred tax assets and liabilities in the notional statement of financial position (balance sheet) at the joining time is not dealt with on a offset basis.

### ***Application of UIG Interpretations 1039 and 1052***

61. UIG Abstracts 39 and 52 were developed by the Urgent Issues Group of the AASB to deal with accounting matters that arise as a result of taxpayers electing to form or join a tax consolidated group. UIG Abstract 39 was superseded by UIG Interpretation 1039 *'Substantive Enactment of Major Tax Bills in Australia'* for financial reporting periods beginning on or after 1 January 2005. Because tax consolidation was substantially enacted in October 2002, UIG Interpretation 1039 is not relevant for entities joining a tax consolidated group in financial reporting period of the joining entities beginning on or after 1 January 2005.

62. UIG Interpretation 1052 '*Tax Consolidation Accounting*' is applicable for annual reporting periods ending on or after 31 December 2005. Early adoption of the Interpretation is permitted for financial reporting periods beginning on or after 1 January 2005 that end before 31 December 2005. UIG Interpretation 1052 applies to all entities joining a tax consolidated group where the joining time takes place in a financial reporting period of the joining entities beginning on or after 1 January 2005.

***Application of materiality to subsection 705-70(1)***

63. AASB 1031 '*Materiality*' explains the role of materiality in making judgments in the preparation and presentation of financial reports. Paragraph 9 states in part:

Information is material if its omission, misstatement or non-disclosure has the potential, individually or collectively to:

- (a) influence the economic decisions of users taken on the basis of the financial report; or
- (b) affect the discharge of accountability by the management or governing body of the entity.

64. Paragraph 15 of AASB 1031 provides some quantitative thresholds for the purposes of financial statement reporting in the context of accounting standards applied to general purpose financial reports.

65. Application of materiality to subsection 705-70(1) should be approached in a different context to that applied for financial reporting. In the context of subsection 705-70(1) liabilities are recognised and measured at step 2 of the ACA and tax cost setting process, which is ultimately part of the lodgement of the consolidated tax return. The public officer of the head company discharges accountability by attesting that 'the information in this return is true and correct'. The appropriate quantitative and qualitative level of materiality for determining the 'true and correct' view is more precise than what might be acceptable or expected in the presentation of a statement of financial position (balance sheet) for other purposes.

66. When considering the application of materiality to determining the amount of a liability for step 2 of the ACA process the operation of CGT Event L7 should be considered. CGT Event L7 is applicable where certain liabilities are taken into account in working out the ACA, but those liabilities are then later discharged for a different realised amount. Capital gains and losses may result in these circumstances.



**Alternative views**

67. It has been suggested that the phrase ‘in accordance with accounting standards, or statements of accounting concepts’ provides a choice between applicable accounting standards and statements of accounting concepts to the extent a choice is available. The choice arises because the word ‘or’ can be read in its ordinary disjunctive manner. The choice between accounting standards and statements of accounting concepts could allow the adoption of different recognition and measurement policies to that which the joining entity had previously adopted for a statement of financial position or other general purpose financial reports.

68. It has further been suggested that subsection 705-70(1) can be interpreted to exclude consideration of other authoritative pronouncements on recognition and measurement of a liability that have been issued by the AASB as the legislation does not specifically mention those pronouncements.

69. Adoption of these views would be contrary to the established accounting construct that has developed in Australia. The preferred view is noted at paragraph 33 to 43 of this Ruling.

**‘...is a liability of the joining entity at the joining time...’*****Meaning of ‘at the joining time’***

70. Section 705-10 of the ITAA 1997 deals with the application and object of Subdivision 705-A, the basic case. Subsection 705-10(1) introduces the concept of the joining time and states:

This subdivision has effect, subject to section 701-15, for the head company core purposes set out in subsection 701-1(2) if an entity (the **joining entity**) becomes a subsidiary member of a consolidated group (the **joined group**) at a particular time (the **joining time**).

71. The phrase ‘at the joining time’ is not defined in the income tax consolidation legislation or elsewhere in the income tax law. The concept of the joining time is referred to in a number of places in the consolidation legislation. For the purposes of subsection 705-70(1) the phrase ‘at the joining time’ should be interpreted as if the single entity rule did not apply to cause the accounting liabilities to be that of the head company at that time.

72. The joining time is an event that takes place ‘at a particular time’ and acts as a trigger for certain processes to occur within income tax consolidation. Once the act of joining has occurred at the joining time the single entity rule is in operation. This means subsidiary members of a consolidated group are taken to be parts of the head company for the purposes of working out the head company’s income tax liability and amount of loss. However, for step 2 purposes, it is the accounting liabilities of the joining entity at the joining time that are relevant. Treating the particular time referred to in the legislation as if the single entity rule did not apply for this

purpose enables the pre-joining time accounting liabilities of a joining entity to be determined for the purpose of subsection 705-70(1).

### ***The joining time as a reporting date***

73. For the purposes of subsection 705-70(1) and the associated ACA process the joining time is considered to be a reporting date. The lodgement of the first relevant consolidated income tax return which includes the joining time of the joining entity is considered to be a report date for the purposes of AASB 110 '*Events after the Balance Sheet Date*'.

74. Where a joining entity does not prepare, on a regular basis, or had not previously prepared, a statement of financial position (balance sheet) or other general purpose financial report then the reporting period for that entity is taken to be the same as that used for its income year. Entities that use the financial year or tax income year as a substitute for the reporting period are then enabled to determine which accounting standards, UIG Interpretations and other authoritative pronouncements of the AASB are applicable at the joining time, and apply those in recognising and measuring the liabilities presented on an entity's notional statement of financial position (balance sheet).

75. Recognition of a reporting date and report date results in two outcomes:

- it defines which standards, authoritative pronouncements and statements of accounting concepts are applicable to the recognition and measurement of liabilities at the joining time; and
- it applies the established accounting construct to events occurring after the joining time, but before the lodgement of the relevant consolidated income tax return, which may impact on the recognition and measurement of liabilities.

76. The established accounting construct of accounting standards, other authoritative pronouncements including UIG Interpretations and statements of accounting concepts are applicable from a particular operative date. For accounting standards, these dates are normally expressed either in respect of annual reporting periods beginning on or after a certain date or ending on or after a certain date. UIG Interpretations may similarly apply to reporting periods, or from a specific date, or from the date of a specific event. Statements of accounting concepts have an operative date, as do other authoritative pronouncements, as outlined in those pronouncements.

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77. Accounting standards and other interpretative guidance that apply to annual reporting periods beginning on or after 1 January 2005 are relevant for step 2 purposes if the joining time occurs in a financial reporting period of the joining entity beginning on or after 1 January 2005.

78. Recognition of the joining time as a reporting date means that all accounting standards, authoritative pronouncement or statement of accounting concept of the AASB, which are applicable as at that date are applied to the recognition and measurement of liabilities at that time. Accounting standards, authoritative pronouncements and statements of accounting concepts are applicable to the joining time where they apply:

- for financial reporting periods beginning at a date before the joining time;
- for financial reporting periods beginning on the same date as the joining time;
- for financial reporting periods ending on a date later than the joining time where the financial reporting period either begins on, or includes, the joining time;
- from a specific date or event that has occurred before the joining time takes place; or
- in accordance with subsection 334(5) of the *Corporations Act 2001*, the directors of the entity have elected for early adoption of the accounting standard for financial statement purposes and that election is dated on or before the lodgement date of the relevant consolidated income tax return. (This early adoption is not available to joining entities that do not fall within the scope of subsection 334(5).)

79. Accounting standards (except in respect of the early adoption of a standard noted above), other authoritative pronouncements and statements of accounting concepts are not relevant to the joining time where they apply:

- to financial reporting periods beginning after the joining time date;
- to financial reporting periods ending after the joining time where the first day of that period is also after the joining time date; or
- from a specific date or event that has occurred after the joining time date.

80. Adoption of different accounting standards, other authoritative pronouncements and statements of accounting concepts at a later time that are considered to be not relevant to the joining time do not retrospectively impact on the recognition and measurement of liabilities at step 2 of the ACA process.

***Application of AASB 110 'Events after the Balance Sheet Date'***

81. For the purposes of subsection 705-70(1) the lodgement of the first relevant consolidated income tax return after the joining time is considered to be a report for the purposes of AASB 110 *'Events after the Balance Sheet Date'*. Paragraph 8 of AASB 110 states that 'an entity shall adjust the amount recognised in its financial statements to reflect adjusting events after the reporting date'. Paragraph 3(a) defines an adjusting event as 'those that provide evidence of conditions that existed at the reporting date'. Paragraph 9 provides examples of adjusting events after the reporting date that require an entity to adjust the amounts recognised in its financial statements, or to recognise items that were not previously recognised.

82. Adjusting events should be distinguished from those non-adjusting events that are indicative of conditions that arose after the reporting date. Paragraph 10 of AASB 110 states that 'an entity shall not adjust the amounts recognised in its financial statements to reflect non-adjusting events after the reporting date'. Paragraphs 11 and 22 of that Standard provides an example of such non-adjusting events.

83. For the purposes of recognising and measuring liabilities at step 2 of the ACA process, events occurring after the joining time, but prior to the lodgement of the related consolidated income tax return, should be considered where they meet the criteria outlined in paragraph 3(a) of AASB 110. This approach is in accordance with the accounting construct and will in some circumstances assist groups consolidating for income tax purposes to identify the correct value of liabilities at step 2.

84. If an adjustment to certain liabilities for events occurring after implementation date as described above would not be material, either collectively or individually, entities may choose not to adjust those liabilities at step 2. In these instances, CGT Event L6 or L7 will be applicable to the events to recognise the difference as a capital gain or capital loss.

**Alternative views**

85. It has been suggested that in the absence of legislative guidance as to the interpretation of 'joining time', entities may choose to apply a different view of each circumstance where the phrase 'joining time' is used in the legislation. Thus where the joining time and first time application of a new accounting standard or UIG Interpretation occurs on the same day, they may be considered to have happened either simultaneously, or in a sequence nominated by the entity. For instance, where accounting standards apply from the same day as the joining time the entity can choose whether or not to recognise the particular standard.

86. The Commissioner's view is that 'joining time' takes its meaning from its context. The context for subsection 705-70(1) is the preparation of a notional statement of financial position (balance sheet) for the joining entity by applying accounting standards and UIG Interpretations to the joining time in a like manner to all joining entities.

87. There is a view that 'adding up the amounts of each thing (an accounting liability) ... at the joining time' does not represent a report. Subsection 705-70(1), together with other relevant subsections, describes the process and rules of aggregation for step 2 in the calculation of the ACA at the joining time. The joining time is not a reporting date. It is just an event, or a snapshot, at which time liabilities for the purpose of step 2 are aggregated. Events occurring after the joining time are not relevant.

88. The Commissioner's view is that the application of AASB 110 within the established accounting construct and the adoption of a reporting date/report date are required to achieve the intent of subsection 705-70(1).

**'...that can or must be recognised in the entity's statement of financial position...'**

***Consistent rules to be applied by all joining entities***

89. For the purposes of subsection 705-70(1) all entities entering income tax consolidation, whatever their structure or legal status, whether a reporting entity or non-reporting entity, are obliged to recognise and measure liabilities at the joining time in accordance with the applicable accounting standards, authoritative pronouncements and statements of accounting concepts. Paragraph 5.68 of the Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002 supports this position. The paragraph states:

The accounting standards and statements of accounting concepts may not apply to all entities. However, if an entity joins a consolidated group then it is necessary to identify the relevant liabilities by reference to those liabilities that can or must be identified under the accounting standards or statements of accounting concepts. This requirement enables consistent rules to be applied in determining the allocable cost amount for all entities that join a consolidated group.

90. The accounting construct in Australia applies to reporting entities. Reporting entities are defined in SAC 1 '*Definition of the Reporting Entity*' (SAC 1) at paragraph 40, and in various AASB standards, as:

entities (including an economic entity) in respect of which it is reasonable to expect the existence of users of general purpose financial reports for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources.

91. Paragraph 41 of SAC 1 requires that:

Reporting entities shall prepare general purpose financial reports. Such reports shall be prepared in accordance with Statements of Accounting Concepts and Accounting Standards.

92. In preparing general purpose financial reports for reporting entities APS 1 '*Conformity with Accounting Standards and UIG Consensus Views*' requires all members of the professional accounting bodies in Australia to follow UIG Interpretations and other authoritative pronouncements of the AASB as well as accounting standards and statements of accounting concepts.

93. All entities that are not reporting entities are considered to be non-reporting entities. Non-reporting entities are not required to prepare general purpose financial reports in accordance with the established accounting concepts. However, if general purpose financial reports are prepared, it is common practice for the reports to be prepared in accordance with accounting standards and UIG Interpretations and other authoritative pronouncements.

94. A statement of financial position (balance sheet) is part of a general purpose financial report. For the purposes of recognising and measuring liabilities at step 2, the same established accounting construct should be applied by all entities in a consistent manner, whether reporting or non-reporting, as if they were part of a notional statement of financial position (balance sheet).

#### ***The use of 'can or must'***

95. The phrase 'can or must' is not defined in the income tax law. In the context of subsection 705-70(1), the word 'can' is taken as meaning 'to be able to'. That is, 'can' refers to a joining entity's ability to recognise and measure certain liabilities at the joining time. If a joining entity at the joining time is able to recognise and measure liabilities in accordance with the established accounting construct, then those liabilities may be recognised and measured even if that entity is not required to do so. Exercising choice is discussed at paragraph 44 to 50 of this Ruling.

96. The word 'must' in the context of subsection 705-70(1) is taken to mean an obligation or a necessity. That is, any liability that 'must' be recognised and measured under the accounting construct is required to be recognised and measured according to the accounting policy set out within the construct.

97. The choices joining entities have as to the accounting policies that are applicable in the recognition and measurement of relevant liabilities are embodied in the accounting construct. This choice of whether an amount can be recognised does not, however, override the recognition and measurement of those liabilities as required by a relevant accounting policy within the accounting construct. That is, where the accounting construct requires that joining entities must recognise and measure a liability in a particular way under the

accounting standard, 'can' does not override this requirement. 'Can' does not mean that a different recognition and measurement policy may be adopted by applying another authoritative pronouncement which is in conflict with the requirements set out in the relevant accounting standards.

***Recognised in the entity's statement of financial position (balance sheet)***

98. Australian Equivalent International Financial Reporting Standards (AIFRS) are applicable for financial reporting periods beginning on or after 1 January 2005. These standards refer to the 'balance sheet' not what was previously referred to as the 'statement of financial position'. Paragraph 8 of AASB 101 *'Presentation of Financial Statements'* defines a financial report to include a 'balance sheet'. Subsection 292(1) of the *Corporations Act 2001* requires certain entities to prepare annual financial reports. Subsection 295(1) requires the financial statements for the year to be part of the financial report, and subsection 295(2) requires that the financial report includes a balance sheet as at the end of the year. Subsection 292(1) requires disclosing entities, public companies, large proprietary companies and registered schemes to prepare annual financial statements. Subsection 296(1) then states '...the financial report for a financial year must comply with the accounting standards'.

99. The AIFRS standards therefore must be observed by companies and other disclosing entities required to lodge annual financial statements which include a balance sheet (statement of financial position). It is this balance sheet (statement of financial position) that all entities joining an income tax consolidated group should notionally create at the joining time to demonstrate that liabilities have been recognised and measured in accordance with the established accounting construct. The development of a notional balance sheet (statement of financial position) at the joining time that includes all recognised and measured liabilities for the purposes of subsection 705-70(1) is integral to the validation of those liabilities and correctly capturing the amounts that would otherwise impact on the correct calculation of ACA and its application in the tax cost setting process.

100. Where previously applied accounting policies change for the reasons outlined in paragraphs 44 to 47 of this Ruling it is expected that the change will be consistently applied to the head company and all joining entities that were members of the existing economic entity at the joining time. To demonstrate that congruent policies have been applied at the joining time the head company should develop a notional balance sheet (statement of financial position) at the joining time using accounting policies that are congruent with those applicable to the joining entities it has previously controlled.

**Alternative views**

101. It has been suggested that 'can or must be recognised' provides entities with a choice of what recognition and measurement criteria to adopt for determining the amount of liabilities. The effect of the choice is that entities may recognise and measure certain liabilities that 'can be recognised' and include those on the balance sheet (statement of financial position) instead of, or as well as, those liabilities that 'must be recognised' in the balance sheet (statement of financial position). Therefore, accounting standards do not have to be followed if an alternative recognition policy is available. These different recognition approaches will allow the adoption of accounting policies based upon statements of accounting concepts and other authoritative pronouncements (for example, those produced by other national standard setting bodies).

102. The Commissioner's view is that this interpretation of 'can or must' is not the intent of subsection 705-70(1). Application of the accounting framework to subsection 705-70(1) would not support such an interpretation to be applied to recognising and measuring liabilities at step 2 of the ACA process. The appropriate application of accounting standards, statements of accounting concepts and other authoritative pronouncements is provided at paragraphs 33 to 39 and 41 to 43 of this Ruling. The application of choice of accounting policies at the joining time, where appropriate, is considered at paragraphs 44 to 50 of this Ruling.

103. The phrase 'can or must' is also not intended to be interpreted as if a joining entity can choose to apply and adopt different accounting policies in determining the accounting liability in the notional balance sheet (statement of financial position), except from the choices that exist within the established AIFRS accounting construct.

104. It has been further suggested that the balance sheet refers to the form of general purpose financial reports mandated for reporting entities by AASB 101 *'Presentation of Financial Statements'*. Joining entities may or may not be reporting entities. While reporting entities must produce a balance sheet of financial position, non-reporting entities do not have to produce such a statement. For the purposes of calculating the ACA at step 2, non-reporting entities can choose what recognition and measurement criteria to apply to liabilities from either accounting standards or statements of accounting concepts and not place those liabilities within a balance sheet.

105. The Commissioner's view is that all entities (reporting and non-reporting entities) are required to apply the same accounting construct to the recognition and measurement of liabilities at step 2 of the ACA process.



**TR 2005/D13****When to apply this Ruling**

106. This Ruling is applicable to entities that join a tax consolidated group during a financial reporting period of the joining entity beginning on or after 1 January 2005. The following table provides guidance as to when this Ruling applies and when TR 2004/14 applies to a joining entity for the purposes of step 2 of the ACA process on entry.

Joining date	Financial reporting period of the joining entity within which joining time occurs		Which standard and framework	Which TR is applicable to the joining entity
	Begins	Ends		
31 December 2004	1/01/04	31/12/04	AASB Australian GAAP	TR 2004/14
1 January 2005	1/01/05	31/12/05	AASB AIFRS	TR 2005/D13
30 June 2005	1/07/04	30/06/05	AASB Australian GAAP	TR 2004/14
1 July 2005	1/07/05	30/06/06	AASB AIFRS	TR 2005/D13
30 November 2005	1/12/04	30/11/05	AASB Australian GAAP	TR 2004/14
1 December 2005	1/12/05	30/11/06	AASB AIFRS	TR 2005/D13

107. 'AASB Australian GAAP' are those accounting standards and associated framework applicable to reporting entities for financial accounting periods that do not begin on or after 1 January 2005.

108. 'AASB AIFRS' are those accounting standards and associated concepts applicable to reporting entities for financial accounting periods that begin on or after 1 January 2005.

109. A particular Australian accounting standard or paragraph of that standard identified and referred to in this Ruling may change subsequent to the release of this Ruling. This may occur through the insertion of additional paragraphs to a particular accounting standard or the deletion of paragraphs in the standard. Where such a change occurs, the contents of the standards or paragraph referred to in this Ruling will be applicable notwithstanding any change in the number of the paragraph of the relevant standard referred to in this Ruling.

## Your comments

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110. We invite you to comment on this draft Taxation Ruling. Please forward your comments to the contact officer by the due date.

**Due date:** 4 November 2005  
**Contact officer:** Andy Milton  
**E-mail address:** andy.milton@ato.gov.au  
**Telephone:** (02) 9374 1930  
**Facsimile:** (02) 9374 1221  
**Address:** PO BOX 1216  
 Hurstville NSW 2220

## Detailed contents list

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*Previous draft:*

Not previously issued as a draft

*Related Rulings/Determinations:*

TR 92/20; TR 2004/14

*Subject references:*

- AASB
- Accounting construct
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- accounting standards
- allocable cost amount
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- notional statement of financial position
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*Legislative references:*

- TAA 1953 Pt IVA
- ITAA 1997 Pt 3-90
- ITAA 1997 701-1(2)
- ITAA 1997 701-15
- ITAA 1997 703-15
- ITAA 1997 Subdiv 705-A
- ITAA 1997 705-10
- ITAA 1997 705-10(1)
- ITAA 1997 705-58
- ITAA 1997 705-59
- ITAA 1997 705-60
- ITAA 1997 705-70(1)
- ITAA 1997 705-70(1A)
- ITAA 1997 705-75
- ITAA 1997 705-80
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- Corporations Act 2001 334(2)
- Corporations Act 2001 334(5)
- AIA 1901
- AIA 1901 46A

*Other references:*

- Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002
- AASB Framework for the Preparation and Presentation of Financial Statements
- AASB 101 Presentation of Financial Statements
- AASB 108 Accounting Policies, Changes in Accounting Estimates and Errors
- AASB 110 Events after the Balance Sheet Date
- AASB 112 Income Tax
- AASB 127 Consolidated and Separate Financial Statements
- AASB 132 Financial Instruments: Disclosure and Presentation
- AASB 1031 (AAS 5) Materiality
- AASB 1048 Interpretations and Applications of Standards
- APS 1 Conformity with Accounting Standards and UIG Consensus Views
- PS 5 The Nature and Purpose of Statements of Accounting Concepts
- SAC 1 Definition of the Reporting Entity
- UIG Interpretation 1039 Substantive Enactment of Major Tax Bills in Australia
- UIG Interpretation 1052 Tax Consolidation Accounting

## ATO references

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