2009

EXPOSURE DRAFT

TAX LAWS AMENDMENT (2009 MEASURES NO 4) BILL 2009: CONSOLIDATION

EXPLANATORY MATERIAL

(Circulated by the authority of the
Treasurer, the Hon Wayne Swan MP)

Table of contents

Chapter 1
Consolidation

Outline of chapter

1.1 Schedule 1 to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to:

- clarify the operation of certain aspects of the consolidation regime; and
- improve interactions between the consolidation regime and other parts of the law.

Context of amendments

1.2 The consolidation regime applies primarily to a group of Australian resident entities wholly-owned by an Australian resident company that choose to form a consolidated group. Specific rules provide for the membership of certain resident wholly-owned subsidiaries of a foreign holding company (a multiple entry consolidated group (MEC group)). Unless otherwise specified, references in this Chapter to a consolidated group include a MEC group.

1.3 Following a choice to consolidate, members of the group are treated as a single entity for their income tax purposes. Subsidiary entities lose their individual income tax identity on entry into a consolidated group and are treated as part of the head company.

1.4 A number of issues have arisen from the practical operation of the consolidation regime since its introduction in 2002. These amendments respond to those issues by clarifying the operation of certain aspects of the consolidation regime and improving interactions with other parts of the law.

1.5 The measures covered by these amendments were originally announced by the former government. The Government announced its intention to proceed with the amendments in the 2008-09 Budget (see Treasurer's and Assistant Treasurer's Joint Media Release No 53 of 13 May 2008). These amendments cover the enhancements to the consolidation regime listed in that media release, with the following exceptions:

- modifying the mechanism for working out the taxable income of consolidated groups that have life insurance company members where there are intra-group transactions;
- limiting intra-group liabilities owed to a leaving entity in step 3 of the exit allocable cost amount to accounting liabilities;
- ensuring that, where an entity enters into a contract that causes a capital gains tax (CGT) event to arise and before the contract is settled the entity joins or leaves a consolidated group, the entity that receives the capital proceeds will include the capital gain or loss in its taxable income (CGT straddles);
- extending the single entity rule to shareholders who dispose of their shares in the head company of a consolidated group for the purposes of the CGT discount rules and CGT event K6;
- ensuring that beneficiaries of a trust that joins or leaves a consolidated group part way through an income year are taxed on an appropriate share of the trust's net income; and
- ensuring that the entry history rule applies to determine the time that depreciating assets of a joining entity are acquired by the head company of a consolidated group.

1.6 These issues are currently under review.

Summary of new law

1.7 Schedule 1 to this Bill amends the consolidation provisions in the income tax law to clarify the operation of certain aspects of the consolidation regime and improve interactions between the consolidation regime and other parts of the law. In particular, the amendments will:

- ensure the tax cost that is set for an asset of a joining entity is able to be used for the purposes of applying other provisions of the income tax law;
- subject to certain integrity rules, allow consolidated groups to convert to MEC groups, and vice versa, with minimal tax consequences;
- improve the treatment of pre-CGT membership interests of a joining entity;
- clarify and improve the operation of various aspects of the tax cost setting rules that apply when an entity joins or leaves a consolidated group;
- treat units held in cash management trusts and certain rights to future income as retained cost base assets;
- ensure losses transferred to the head company by a joining entity that is insolvent at the joining time can be used by the head company in certain circumstances;
- remove the potential for double taxation, or a double taxation benefit, to arise where CGT event L7 happens and repeal CGT event L7 from 8 May 2007;
- reduce the capital gain that arises under CGT event L3 where a joining entity has impaired debts at the joining time;
- ensure the blackhole expenditure provisions that apply to consolidated groups also apply to MEC groups;
- ensure certain consolidation transitional rules apply to the head company of a group which has a substituted accounting period where the group consolidated after 30 June 2003 on a day prior to the first day of its income year; and
- modify the operation of the inter-entity loss multiplication rules for widely held companies.

Comparison of key features of new law and current law

New law	*Current law*
Use of the tax cost setting amount	
The head company will use the tax cost setting amount of an asset for the purpose of working out the amount included in assessable income or allowed as a deduction when applying other provisions of the income tax law.	The tax cost setting rules set the tax cost setting amount for assets held by an entity that joins a consolidated group. When a tax consequence arises in relation to an asset for a head company, the tax cost setting amount is intended to be used by the head company to determine those tax consequences. However, for the purposes of applying certain provisions in the income tax law, the head company is unable to use the tax cost setting amount of an asset.
Group restructures	
Subject to certain integrity rules, tax consequences will not arise for the on-going members of the group when: • a consolidated group converts to a MEC group; or • a MEC group converts to a consolidated group.	Significant tax consequences arise for the on-going members of a group when: • a consolidated group converts to a MEC group; or • a MEC group converts to a consolidated group.
Pre-capital gains tax proportions	
The pre-CGT status of membership interests held in a joining entity will be preserved by: • working out the proportion of pre-CGT membership interests in the joining entity; and • subject to integrity rules, attaching pre-CGT status to an equivalent proportion of membership interests when the entity leaves the group.	When an entity joins a consolidated group its membership interests cease to be recognised for income tax purposes. If the membership interests are pre-CGT assets, this status is preserved by attributing a pre-CGT factor to the underlying assets of the joining entity.

Modifications to the tax cost setting rules of a joining entity	
When an entity joins a consolidated group, the amendments will, broadly: • ensure adjustments to the allocable cost amount are not double counted; • clarify the scope of the adjustment to the allocable cost amount in respect of certain pre-joining time CGT roll-overs that applied to a joining entity's assets; and • phase out the over-depreciation adjustment to the allocable cost amount.	Under the tax cost setting rules, the tax costs of a joining entity's assets are generally reset by allocating the joining entity's allocable cost amount to each of the joining entity's assets in proportion to their market value. This allocation process ensures that, broadly, the costs incurred by the head company to acquire the joining entity's membership interests are pushed down into the tax costs of the underlying assets of the joining entity. The allocable cost amount is basically the sum of the cost bases of the head company's membership interests in the joining entity held by members of the joined group and the joining entity's liabilities. Several adjustments are made to this amount.
Modifications to the tax cost setting rules of a leaving entity	
When an entity leaves a consolidated group, the amendments will, broadly: • clarify that the liabilities taken into account in working out step 4 of the old group's allocable cost amount are the liabilities held just before the leaving time; and • ensure an appropriate amount is included in step 4 of the old group's allocable cost amount in respect of a liability when that liability was taken into account in working out the allocable cost amount for an entity that joined the group.	When an entity leaves a consolidated group, the tax costs of the membership interests in the leaving entity needs to be reconstructed. Under the tax cost setting process that applies when an entity leaves a consolidated group, the old group's allocable cost amount is worked out to determine the tax costs of the membership interests in the leaving entity.
Modifications to the tax cost setting rules of a joining or leaving entity	
When an entity joins or leaves a consolidated group, the amendments will, broadly: • clarify that the liabilities recognised by a joining or leaving entity under the tax cost setting rules are generally the same as its accounting liabilities;	Some elements of the tax cost setting rules apply both: • when an entity joins a consolidated group; and • when an entity leaves a consolidated group.

• clarify the scope of the adjustment to the allocable cost amount in respect of inherited deductions; and • if the joining or leaving entity is a general insurance company, ensure that the tax cost setting rules apply appropriately to its deferred acquisition costs, deferred reinsurance expenses and recoveries receivable.	
Retained cost base assets	
The range of assets that are treated as retained cost base assets will include: • units in a cash management trusts held by a joining entity; and • certain accrued rights to future income held by a joining entity.	Under the tax cost setting rules some assets are treated as retained cost base assets. The tax costs of retained cost base assets are generally set at an amount that is equal to the joining entity's cost of those assets.
Application of losses with a nil available fraction	
If the transferred losses of a joining entity have an available fraction of nil, the head company can apply the losses to: • reduce a net forgiven amount under the commercial debt forgiveness rules; • reduce a capital allowance that is adjusted under the limited recourse debt rules; or • reduce the capital gain that arises under CGT event L5 when the joining entity subsequently leaves the group.	When an entity joins a consolidated group, provided certain tests are satisfied, any losses of the joining entity are transferred to the head company of the group. Transferred losses are given an available fraction, worked out based on relative market values, that regulates the rate at which transferred losses can be used by the group. If a joining entity has a market value of nil, any transferred losses of the joining entity will have an available fraction of nil. Consequently, the losses can never be used by the group.
CGT event L7	
For the period between 1 July 2002 and 8 May 2007, the amount of the capital gain or capital loss that arises under CGT event L7 will be reduced if that amount is taxed under another provision in the income tax law. From 8 May 2007, CGT event L7 will be repealed.	CGT event L7 happens when: • a liability that was taken into account in working out the allocable cost amount is discharged for a different amount; and • the allocable cost amount would have been different if the discharged amount was used at the joining time.

<table>
<tr><th colspan="2">Doubtful debts and CGT event L3</th></tr>
<tr><td>The tax cost setting amount of an impaired debt held by a joining entity will be reduced by the amount of the capital gain arising under CGT event L3 (but not below zero). As a result, the capital gain arising under CGT event L3 will be reduced by an equivalent amount.</td><td>A capital gain arises under CGT event L3 if the total tax cost setting amounts for all retained cost base assets exceed the joining entity’s allocable cost amount.

Impaired debts qualify as retained cost base assets. The tax cost setting amount of impaired debts is the face value of those debts at the joining time.

As the face value of impaired debts is likely to be higher than the amount that could be recovered, the capital gain arising under CGT event L3 is overstated.</td></tr>
<tr><th colspan="2">Blackhole expenditure for MEC groups</th></tr>
<tr><td>The CGT cost base of an intra-group asset held by a MEC group will include certain expenditure paid to a third party in relation to the asset.</td><td>A capital gain arises if the capital proceeds received by a taxpayer when a CGT event happens to an asset exceed the asset’s cost base.

Under the blackhole expenditure provisions, the cost base of an intra-group asset held by a consolidated group (but not by a MEC group) includes certain expenditure paid to a third party in relation to the asset.</td></tr>
<tr><th colspan="2">Transitional rules for groups with substituted accounting periods</th></tr>
<tr><td>The transitional concession will apply where the head company of a group has a substituted accounting period and the group consolidated between 1 July 2003 and 30 June 2004 on a day that is on or before the first day of its income year.</td><td>A transitional concession that allows the allocable cost amount of a joining entity to be increased by the undistributed, untaxed profits accrued to the group before 1 July 2003 applies to:
• a consolidated group that came into existence before 1 July 2003; or
• a consolidated group that came into existence between 1 July 2003 and 30 June 2004 provided that it came into existence on the first day of the income year of the head company starting after 30 June 2003.</td></tr>
</table>

Loss multiplication rules for widely held companies	
A widely held company will not have a relevant equity interest or relevant debt interest in a loss company at a particular time under the inter-entity loss multiplication rules unless an entity has a controlling stake in the loss company and that entity has a direct or indirect interest in, or is owed a debt by, the widely held company in respect of which, broadly: • the entity could, if a CGT event happened to the interest or debt, make a capital loss that reflects any part of the loss company's overall loss; or • the entity has deducted an amount in respect of the interest or debt, where the deduction reflects any part of the loss company's overall loss.	The inter-entity loss multiplication rules apply to an entity that has a relevant equity interest or relevant debt interest in a loss company at a particular time. Subject to certain exceptions, an entity has a relevant equity interest or relevant debt interest in a loss company at a particular time if, broadly, the entity has a controlling stake in the loss company and satisfies certain other tests. Widely held companies have difficulty in satisfying the exceptions to these tests. As a result, in some circumstances the losses of a loss company receive no tax recognition at all.

Detailed explanation of new law

Part 1 — Use of the tax cost setting amount

1.8 The tax cost setting rules operate to set the tax costs of the assets held by an entity that joins a consolidated group at the tax cost setting amount. Section 701-55 ensures the reset tax cost setting amount of the joining entity's assets are used as the basis for applying other provisions in the income tax law. For example:

- subsection 701-55(2) applies to treat the asset as if it were acquired by the head company at the joining time for an amount equal to its tax cost setting amount for the purposes of applying certain depreciating asset provisions;
- subsection 701-55(3) applies to set the opening value of trading stock at the start of the income year in which the joining time occurs at its tax cost setting amount; and
- subsection 701-55(5) applies to adjust the cost base or reduced cost base of an asset so that it equals the asset's tax cost setting amount where the CGT provisions apply to the asset.

1.9 Subsection 701-55(6) is a residual or catch all provision that applies to treat the tax cost setting amount as the cost of the asset where any provision of the income tax law not specifically mentioned in section 701-55 is to apply to an asset.

1.10 The purpose of subsection 701-55(6) is to ensure that the tax cost setting amount of an asset is appropriately recognised for income tax purposes. The use of the tax cost setting amount will depend on the particular circumstances of each case.

1.11 Subsection 701-55(6) is modified to ensure that it gives effect to its policy intent. Under these modifications, subsection 701-55(6) will apply where a provision of the income tax law, other than a provision specifically mentioned in subsections 701-55(2) to (5B), is to apply in relation to an asset by including an amount in assessable income, or by allowing an amount as a deduction, in a way that brings into account (directly or indirectly) any of the following amounts:

- the cost of the asset;
- outgoings incurred, or amounts paid, in respect of the asset;
- expenditure in respect of the asset; or
- an amount of a similar kind in relation to the asset.

[Schedule 1, item 2, subsection 701-55(6)]

1.12 In these circumstances, the other provision of the income tax law applies for the purposes of determining the amount included in assessable income or determining the amount of the deduction as if the cost, outgoing, expenditure or other amount had been incurred or paid to acquire the asset at the particular time for an amount equal to the tax cost setting amount. ***[Schedule 1, item 2, subsection 701-55(6)]***

1.13 However, subsection 701-55(6) does not apply to an asset that is trading stock. ***[Schedule 1, item 2, subsection 701-55(7)]***

1.14 Subsection 701-55(6) modifies the application of other provisions in the income tax law only for the purpose of determining the amount included in assessable income or the amount allowed as a deduction. Therefore, the deemed acquisition of the asset is recognised only for that purpose and does not affect the operation of the entry history rule (section 701-5) in relation to the asset for other purposes.

1.15 The effect of the deemed acquisition is to override the history relating to the pre-joining time expenditure incurred and deducted in respect of an asset. As the tax cost setting rules provide each asset with a new tax cost setting amount, the pre-joining time cost of an asset (including the fact this cost may have been claimed as a deduction by the joining entity prior to joining time) is not relevant history for the purpose of applying the new tax cost setting amount in accordance with subsection 701-55(6).

1.16 However, the deemed acquisition does not override facts that may be relevant in determining:

- which provision of the income tax law is to apply to the tax cost setting amount allocated to an asset; or
- how a provision of the income tax law is applied to the tax cost setting amount allocated to an asset.

1.17 These facts include, for example, the original acquisition date of an asset and whether the asset is held on revenue account or capital account.

Example 1.1: Trade receivables

Company J sells trading stock valued at $20,000 to a customer on credit (30 day term) on 25 June 2009. As Company J is taxed on an accruals basis, it includes the amount derived ($20,000) in its assessable income for the 2008-09 income year. Therefore, on 30 June 2009, Company J holds an Australian dollar trade receivable of $20,000.

On 1 July 2009, Head Co acquires all the membership interests in Company J. As a result, Company J joins Head Co's consolidated group.

Under the tax cost setting rules, the Australian dollar trade receivable is a right to receive an amount of Australian currency, and therefore is a retained cost base asset (paragraph 705-25(5)(b)). The tax cost setting amount is the amount of Australian currency concerned – that is, $20,000.

Head Co eventually collects $18,000 in respect of the Australian dollar trade receivable and writes off the balance of $2,000.

Head Co can deduct the amount of the Australian dollar trade receivable written off as a general deduction under section 8-1 or as a bad debt deduction under section 25-35.

Example 1.2: Consumable stores

Company J operates a transport business and pays $100,000 to acquire a quantity of fuel on 25 June 2009. The fuel is for use in its transport business.

Generally a taxpayer can deduct an amount for consumable stores, such as stockpiled fuel, under section 8-1 when the expenditure to acquire the consumable stores is incurred (the incurred basis) or as the consumable stores are used (the usage basis).

Company J applies the incurred basis to deduct the amount paid to acquire the fuel ($100,000) in the 2008-09 income year.

On 1 July 2009, Head Co acquires all the membership interests in Company J. As a result, Company J joins Head Co's consolidated group.

Company J still holds 70% of the fuel that it acquired on 25 June 2009 at the joining time. Under the tax cost setting rules, consumable stores are a reset cost base asset and the tax cost setting amount of the fuel is $70,000.

Head Co will be taken to have incurred an amount equal to the tax cost setting amount to acquire the fuel at the joining time.

Therefore, assuming that Head Co uses the fuel in the transport business, it can deduct the tax cost setting amount of the fuel ($70,000) in the 2009-10 income year.

Example 1.3: Long-term construction contract

Head Co acquires all of Company J's membership interests. Consequently, Company J joins Head Co's consolidated group.

Company J has a partially completed construction contract at the joining time – that is, broadly, it has partially performed some work under the contract that has not yet been completed to a stage where a recoverable debt has arisen. For accounting purposes, Company J has estimated the amount of partly earned unbilled income as $25,000.

Under the tax cost setting rules, the construction contract is a reset cost base asset. The tax cost setting amount allocated to the asset is $20,000.

If the construction contract is a revenue asset (as defined in section 977-50) of Company J, then subsection 701-55(6) will apply to specify the use of the tax cost setting amount for the contract by Head Co. That is, Head Co can use the tax cost setting amount for the contract ($20,000) to work out:

- the amount of profit to be included in assessable income under section 6-5 in respect of the contract when it is completed; or
- the loss to be deducted under section 8-1 in respect of the contract when it is completed.

Example 1.4: Rights to deferred management fees

Company J operates a retirement village business and has rights to deferred management fees – that is, rights to fees that accrue over a resident's tenure in a retirement village unit but are not payable until the time of ceasing to be a resident.

Head Co acquires all of Company J's membership interests. Consequently, Company J joins Head Co's consolidated group.

Under the tax cost setting rules, the rights to deferred management fees are a reset cost base asset and have a tax cost setting amount of $80,000.

If the rights to deferred management fees are a revenue asset (as defined in section 977-50) of Company J, then subsection 701-55(6) will apply so that Head Co can treat the tax cost setting amount ($80,000) as the cost of the asset to work out:

- the amount of profit to be included in assessable income under section 6-5 when the management fees are eventually derived; or
- the loss to be deducted under section 8-1 when the management fees are eventually derived.

Example 1.5: Rights to unbilled income for the supply of gas

Company J carries on the business of supplying gas to its customers (being both domestic and commercial gas consumers) in very similar circumstances to those in *FC of T v Australian Gas Light Co* 83 ATC 4800; (1983) 15 ATR 105.

In its profit and loss statement for the income year ended 30 June 2003, Company J recorded unbilled gas income of $25,000. Its balance sheet contained an unbilled gas asset of the same amount. The unbilled gas income is recognised as income for accounting purposes. However, it has not yet been recognised as assessable income for income tax purposes in accordance with Taxation Ruling No. IT 2095.

On 1 July 2003, Head Co acquires all of Company J's membership interests. As a result, Company J joins Head Co's consolidated group.

Under the tax cost setting rules, the rights to unbilled gas income are a reset cost base asset. The tax cost setting amount for the rights is $20,000.

If the rights to unbilled gas income of Company J are a revenue asset (as defined in section 977-50), then subsection 701 55(6) will apply so that Head Co can use the tax cost setting amount for the rights ($20,000) to work out the amount of loss or outgoing that is deductible under section 8-1.

Example 1.6: Assets held on revenue account

Company J is an investment company which held a significant share portfolio. Its investment strategy for the share portfolio is to maximise dividend yields. Where the dividend yield on investments fell, those shares would be sold and the proceeds invested in other shares with a higher dividend yield. In times of rising share values but falling dividend yields, Company J regularly switches between investments.

Although only a small proportion of the Company J's portfolio was earmarked for imminent sale at any given time, its entire investment portfolio constituted revenue assets (as defined in section 977-50). All the investments were held on the basis that, hypothetically, they could be sold as part of Company J's normal business activity, and if sold at a profit would constitute ordinary income (per *London Australia Investments Co Ltd v. FC of T* (1977) 138 CLR 106; 77 ATC 4398; 7 ATR 757).

Company J acquired two parcels of shares to add to its share portfolio:

- parcel A for a cost of $100,000; and
- parcel B for a cost of $80,000.

Company J subsequently joins Head Co's consolidated group. Under the tax cost setting rules:

- the tax cost setting amount for the parcel A shares is $105,000; and
- the tax cost setting amount for the parcel B shares is $82,000.

Head Co also holds the two parcels of shares on revenue account. It subsequently sells the parcel A shares for $120,000. The gain on the disposal of the shares is the difference between the disposal proceeds ($120,000) and the tax cost setting amount ($105,000) – that is, $15,000. Therefore, Head Co will include $15,000 in its assessable income as ordinary income (section 6-5) in respect of the disposal of the parcel A shares.

Head Co also sells the parcel B shares for $75,000. The loss on the disposal of the shares is the difference between the disposal proceeds ($75,000) and the tax cost setting amount ($82,000) – that is, $7,000. Therefore, Head Co's can deduct $7,000 as a general deduction (section 8-1) in respect of the disposal of the parcel B shares.

Example 1.7: Traditional securities

Company J acquires two assets that are traditional securities (as defined in subsection 26BB(1) of the *Income Tax Assessment Act 1936* (the ITAA 1936) on 1 July 2005 – asset A was acquired for a cost of $10,000 and asset B for a cost of $20,000.

Head Co acquires all of Company J's membership interests. Consequently, Company J joins Head Co's consolidated group.

Under the tax cost setting rules, the traditional securities held by Company J are a reset cost base asset and:

- the tax cost setting amount for asset A is $11,000; and
- the tax cost setting amount for asset B is $19,000.

Head Co subsequently disposes of asset A for $13,000. Therefore, it makes a gain of $2,000 on the disposal of the asset (ie, the amount received on the disposal of the asset ($13,000) less the tax cost setting amount ($11,000)). The amount of this gain is included in Head Co's assessable income under subsection 26BB(3).

Head Co also disposes of asset B for $15,000. Therefore, it makes a loss of $4,000 on the disposal of the asset (ie, the amount received on the disposal of the asset ($15,000) less the tax cost setting amount ($19,000)). Head Co can deduct the amount of this loss under subsection 70B(2).

Land carrying trees and rights to fell trees

1.18 When a taxpayer fells trees for sale or manufacture, the taxpayer can deduct so much of the capital costs of acquiring land carrying trees as is referable to trees that have been felled in the income year (section 70-120). A deduction is also available under section 70-120 for the capital cost of acquiring rights to fell trees, but only to the extent the amount paid is attributable to the trees that are felled in the income year. The amount that is attributable to the trees that are felled in the income year is generally worked out based on the relative market value of the trees that are felled to the land or rights.

1.19 Currently, if the trading stock provisions in Division 70 apply in relation to an asset, subsection 701-55(3) specifies the use of the tax cost setting amount. The provisions in the income tax law that allow a deduction for the capital costs relating to land carrying trees and to rights to fell trees (section 70-20) are in Division 70. However, the use of the tax cost setting amount specified in subsection 701-55(3) does not work appropriately for the purposes of applying section 70-120.

1.20 To avoid confusion, a technical amendment will clarify that subsection 701-55(6), rather than subsection 701-55(3), applies to specify how the head company uses the tax cost setting amounts allocated to land carrying trees and to rights to fell trees for the purpose of applying section 70-120. ***[Schedule 1, item 1, subsection 701-55(3)]***

Example 1.8: Land carrying trees

Company J paid $850,000 to acquire land carrying trees. At that time $50,000 is set out in the contract as being attributable to the trees.

Before the joining time, Company J fells 100% of the trees, claiming a deduction of $50,000. Company J then replants trees on the land.

Head Co acquires all of Company J's membership interests. Consequently, Company J joins Head Co's consolidated group.

At the joining time, Head Co gets a valuation of the land which documents that the market value of the land (including the trees) at the joining time is $900,000. The value attributable to the newly planted trees is $20,000.

Under the tax cost setting rules, the tax cost setting amount for the land (including the trees) is $1 million. Therefore, the tax cost setting amount attributable to the trees is $22,222
(ie, $20,000 / $900,000 x $1 million).

Head Co subsequently fells the trees, and sells the timber for $50,000. Head Co will include the amount received on the sale of the timber ($50,000) in its assessable income and can deduct the tax cost setting amount attributable to the trees ($22,222) under subsection 70-120(4).

Capital expenditure

1.21 In some cases a taxpayer can deduct an amount for capital expenditure on certain assets. For example, a deduction is allowed for capital expenditure on:

- depreciating assets that are water facilities or horticultural plants (Subdivision 40-F);
- landcare operations, electricity connections or telephone lines (Subdivision 40-G); and
- assessable income producing buildings and other capital works (Division 43).

1.22 If a joining entity is entitled to a deduction under Subdivision 40-F, Subdivision 40-G or Division 43 prior to joining a consolidated group, the head company of the group may be entitled to deduct the remaining balance of the capital expenditure in accordance with those provisions because of the operation of the single entity rule (section 701-1) and the entry history rule (section 701-5). The amount of the deduction is based on the remaining balance of the capital expenditure, rather than the tax cost setting amount allocated to the asset.

Example 1.9: Capital works

> Company J holds a building at the time it joins a consolidated group. At the joining time, Company A has undeducted construction expenditure of $75,000 in relation to the building.
>
> Under the tax cost setting rules, the building is a reset cost base asset. The tax cost setting amount allocated to the building is $300,000.
>
> Generally, a taxpayer can deduct an amount for undeducted construction expenditure in relation to capital works under Division 43. The amount that can be deducted is the undeducted construction expenditure in relation to the capital works.
>
> The deduction under Division 43 is based on the construction costs of the capital works. Therefore, Head Co can deduct the balance of the undeducted construction expenditure ($75,000) under Division 43 by applying the entry history rule (subsection 701-5).
>
> Head Co cannot claim deductions for undeducted construction expenditure in relation to the building based on the tax cost setting amount allocated to the building.

Foreign currency trade receivables

1.23 In 2004 the ATO issued a draft taxation determination (Draft Taxation Determination TD 2004/D80) which indicated that a capital gain would arise when an amount received in payment of a foreign currency denominated trade receivable exceeds its tax cost setting amount.

1.24 The ruling was withdrawn on 22 August 2006 following the former government's announcement to modify the operation of subsection 701-55(6).

1.25 To ensure taxpayer's are not disadvantaged by the withdrawal of Draft Taxation Determination TD 2004/D80, a transitional modification will be made to preserve the CGT character of the gain or loss that arises when the amount received in payment of a foreign currency denominated trade receivable exceeds its tax cost setting amount, provided the amount was derived between 1 July 2002 and 23 August 2006.

1.26 The transitional modification will apply if:

- the tax cost of a joining entity's asset was set at the joining time at the asset's tax cost setting amount;
- the asset is a trade receivable that is denominated in foreign currency;
- CGT event C2 happens to the asset between the joining time and 23 August 2006;
- just before the CGT event, the head company of the group held the asset because of the operation of the single entity rule (subsection 701-1(1)); and
- disregarding section 118-20, there is a capital gain or capital loss from the event.

[Schedule 1, item 3]

1.27 In these circumstances, except to the extent that any capital gain or capital loss from the event is attributable to currency exchange rate fluctuations, the following provisions do not apply to the CGT event:

- section 6-5 (about ordinary income);
- any other provision that includes an amount in assessable income (other than a CGT provision);
- section 8-1 (about amounts that can be deducted);
- any other provision that allows a deduction for the amount;
- section 118-20 (which reduces a capital gain by the amount that it is otherwise assessable).

[Schedule 1, item 3]

1.28 This transitional provision will preserve the position set out in Draft Taxation Determination TD 2004/D80 until 23 August 2006. After that date, an asset that is a trade receivable denominated in foreign currency may be treated as being on revenue account.
Subsection 701-55(6) will apply to ensure that the tax cost setting amount for the asset can be used to determine the amount that is included in assessable income or allowed as a deduction.

Example 1.10: Foreign currency trade receivable – no foreign currency exchange gain or loss tax consequences

This example in based on the example in Draft Taxation Determination TD 2004/D80 (which has been withdrawn). The example assumes no foreign currency exchange gain or loss tax consequences.

On 1 May 2003, Company J derives ordinary income of $100 by selling trading stock to Entity Z on credit for US$80. At that time, A$1 is equivalent to US$0.80.

Company J joins Head Co's consolidated group on 1 July 2003. Under the tax cost setting rules, a tax cost setting amount of A$85 is allocated to the trade receivable. There are no currency fluctuations between 1 May 2003 and 1 July 2003.

Entity Z pays US$80 (which translates to A$100) to Company J in settlement of its trade debt on 30 November 2003. Under the consolidation provisions, Head Co is taken to receive that A$100 payment.

The amount received by Head Co (A$100) exceeds the cost base (being the tax cost setting amount) of the foreign currency trade receivable of A$85. None of the excess is attributable to a currency exchange rate effect. Therefore, Head Co makes a capital gain under CGT event C2 of $15.

Example 1.11: Foreign currency trade receivable – foreign currency exchange loss tax consequences

On 1 May 2003 Company J derives ordinary income of $100 by selling trading stock to Entity Z on credit for US$80. At that time, A$1 is equivalent to US$0.80.

Company J joins Head Co's consolidated group on 1 July 2003 when A$1 is equivalent to US$0.75 and the trade receivable translates to A$106.67. Under the tax cost setting rules, a tax cost setting amount of A$106.67 is allocated to the trade receivable. As the trade receivable is a revenue asset in the hands of Company J, subsection 701-55(6) applies to the tax cost setting amount.

Entity Z pays US$80 to Company J in settlement of its trade debt on 30 November 2003. At that time, under the exchange rate, A$1 is equivalent to US$0.80c and A$100 cash is received by Head Co.

The amount received by Head Co (A$100) is less than the tax cost setting amount of the foreign currency trade receivable (A$106.67) and a capital loss of $6.67 arises under CGT event C2.

However, this difference is wholly attributable to the movement in the exchange rate from 1 July 2003 to 30 November 2003.

Division 775 does not apply to the right to receive foreign currency as, under the entry history rule, Head Co is taken to have acquired the right prior to 1 July 2003 and has not elected for the Division to apply to the right.

Therefore, Head Co can deduct the amount of the difference ($6.67) under section 8-1 (reducing the capital loss to nil).

Part 2 — Group restructures

1.29 In this Part, references to a consolidated group do not include a MEC group.

1.30 Under the consolidation regime wholly-owned groups are treated as single taxpaying entities for their income tax purposes. Wholly-owned groups that have an Australian resident head company can form a consolidated group. Resident wholly-owned subsidiaries of a foreign holding company can form a MEC group.

1.31 When a change in the group structure occurs, it can result in:

- a consolidated group converting to a MEC group (section 719-40); or
- a MEC group converting to a consolidated group (section 703-55).

1.32 Currently, when a group conversion occurs, the old group ceases to exist and a new group comes into existence. As a result, significant tax consequences inappropriately arise for members of the old group that become members of the new group — that is, for entities that are on-going members of the group. For example:

- the tax cost setting rules that apply when an entity ceases to be a member of (or leaves) a consolidated group or MEC group operate to set the tax costs of the membership interests in each subsidiary member that leaves the old group, potentially causing a capital gain to arise because, for example, CGT event L5 happens; and
- the tax cost setting rules that apply when an entity becomes a member of (or joins) a consolidated group or MEC group operate to reset the tax costs of the assets of each subsidiary member that joins the new group.

Minimal tax consequences for on-going members

1.33 Subdivision 719-BA will ensure that there will be minimal tax consequences when, at a particular time (the conversion time):

- a consolidated group is created from a MEC group; or
- a MEC group is created from a consolidated group.

[Schedule 1, item 11, subsection 719-120(1)]

1.34 Subdivision 719-BA applies only in relation to entities that were members of the old group just before the conversion time and are members of the new group at that time – that is, entities that are on-going members of the group. ***[Schedule 1, item 11, subsection 719-120(2)]***

1.35 Therefore, Subdivision 719-BA does not apply to:

- entities that are members of the new group but were not members of the old group just before the conversion time – that is, entities that are new members of the group; or
- entities that were members of the old group before the conversion time that cannot be members of the new group at that time, such as entities that were transitional foreign-held subsidiaries or transitional foreign-held indirect subsidiaries (see section 701C-10 and 719-10 of the *Income Tax (Transitional Provisions) Act 1997*).

New group retains the history of the old group

1.36 When Subdivision 719-BA applies, the head company of the new group will retain the history of the head company of the old group. That is, everything that happened in relation to the head company of the old group before the conversion time is instead taken to have happened in relation to:

- if the head company of the old group is the same entity as the head company of the new group, that entity in its role as the head company of the new group; or
- otherwise, the head company of the new group.

[Schedule 1, item 11, subsection 719-125(1)]

1.37 This includes everything that, immediately before the conversion time, was taken to have happened in relation to the head company of the old group because of:

- the single entity rule (section 701-1);
- the entry history rule (section 701-5);
- the effects of a choice under section 703-75 to continue a consolidated group or MEC group after an interposed company becomes a new head company;
- the effects under section 719-90 that arise because of a change in the head company of a MEC group; and
- any previous applications of Subdivision 719-BA.

[Schedule 1, item 11, subsection 719-125(2)]

1.38 The provisions which ensure that the head company of the new group retains the history of the head company of the old group (subsections 719-125(1) and (2)) have effect for:

- the head company core purposes in relation to an income year ending after the conversion time;
- the entity core purposes in relation to an income year ending after the conversion time; and
- the purpose of determining the balance of the franking account of the head company, or provisional head company, of the new group at or after the conversion time.

[Schedule 1, item 11, subsection 719-125(3)]

1.39 However, subsections 719-125(1) and (2) do not override:

- the exit history rule (section 701-40); and
- a provision of the income tax law to which the exit history rule is subject because of exceptions to the core rules (section 701-85).

[Schedule 1, item 11, subsection 719-125(4)]

1.40 Consequently, if, for example, the old group is a transitional group, the new group will also be a transitional group. Similarly, if an entity that is an on-going member is a transitional entity or chosen transitional entity, the entity will retain that status. Therefore, sections 701-40, 701-45 and 701-50 of the *Income Tax (Transitional Provisions) Act 1997*) will apply when these entities leave the new group.

Certain provisions do not apply when an entity joins the new group

1.41 The provisions that ordinarily apply when an entity joins a consolidated group or MEC group, other than the single entity rule (subsection 701-1(1)), do not apply to an on-going member that joins the group because of a group conversion. In particular, the following provisions do not apply:

- the modification to the operation of the same business test that ordinarily applies when an entity becomes a subsidiary member of a consolidated group or MEC group (section 165-212E);
- the consolidation provisions in Part 3-90 that ordinarily apply when an entity joins a consolidated group or MEC group (other than the single entity rule and Subdivision 719-BA); and
- the transitional consolidation provisions in Part 3-90 of the *Income Tax (Transitional Provisions) Act 1997* that ordinarily apply when an entity joins a consolidated group or MEC group.

[Schedule 1, item 11, subsections 719-130(1), (2) and (5)]

Certain provisions do not apply when an entity leaves the old group

1.42 Similarly, the provisions that ordinarily apply when an entity leaves a consolidated group or MEC group will not apply when an on-going member ceases to be a member of the group because of a group conversion, unless the entity becomes an eligible tier-1 company in respect of the new MEC group. That is, unless the entity becomes an eligible tier-1 company in respect of a new MEC group:

- the consolidations provisions in Part 3-90 that ordinarily apply when an entity leaves a consolidated group or MEC group (other than Subdivision 719-BA) do not apply; and
- the transitional consolidation provisions in Part 3-90 of the *Income Tax (Transitional Provisions) Act 1997* that ordinarily apply when an entity leaves a consolidated group or MEC group do not apply.

[Schedule 1, item 11, subsections 719-130(3), (4) and (5)]

Certain provisions continue to apply

1.43 Where an on-going member becomes an eligible tier-1 company in respect of a new MEC group, tax consequences will continue to arise for the head company of the old consolidated group in respect of the disposal of the membership interests in the on-going member to the foreign resident company. Therefore, the tax cost setting amount of those membership interests will continue to be worked out under Division 711.

1.44 Despite subsections 719-130(1) and (3), where a consolidated group is created from a MEC group as result of a conversion, Subdivision 719-K (sections 719-550 to 719-570), together with any other provision to the extent that it is necessary for the application of the Subdivision, will continue to apply. Subdivision 719-K determines the tax cost setting amount for pooled interests when, among other things, an eligible tier-1 company ceases to be a member of a MEC group. Subject to the limitations set out in subsection 719-560(2), a pooled interest is a membership interest that an entity, other than an entity that is a member of the MEC group, holds in an eligible tier-1 company of the MEC group. ***[Schedule 1, item 11, section 719-135]***

1.45 The following provisions will continue to apply when a MEC group is created from a consolidated group as result of a conversion:

- item 4 of the table in subsection 707-320(2), which applies to adjust the group's available fraction for each bundle of transferred losses if there is an increase in the market value when the group is created because a subsidiary member of the consolidated group becomes an eligible tier-1 company of the MEC group (known as a transfer-up);

- sections 719-300 and 719-325, which apply when a MEC group is created because a new eligible tier-1 company joins the old group and have the effect of:

  – deeming prior group losses to be transferred losses; and

  – if the group has existing bundles of transferred losses, adjusting the available fraction for each of those bundles and for prior group loss bundle; and

- sections 719-700 and 719-720 , which apply to set the reference time for the head company of the MEC group for any future application of the loss integrity rules in Subdivisions 165-CC and 165-CD.

1.46 Section 719-130 does not affect the operation of these provisions because they are not triggered by an on-going member joining a MEC group or leaving a consolidated group.

1.47 Similarly, the following provisions will continue to apply when a consolidated group is created from a MEC group as result of a conversion:

- sections 719-260 and 719-280, which deem a continuity of ownership test failure to happen to the head company of the MEC group in relation to unused losses because the MEC group ceases to exist;
- sections 719-455 and 719-465, which deem a continuity of ownership test failure to happen to the head company of the MEC group in relation to bad debts because the MEC group ceases to exist; and
- sections 719-705 and 719-725, which deem a changeover time and an alteration time under the loss integrity rules for the head company of the MEC group because the MEC group ceases to exist.

1.48 Section 719-130 does not affect the operation of these provisions because they are not triggered by an on-going member joining a consolidated group or leaving a MEC group.

Consequential amendments

1.49 Sections 703-65 to 703-80 contain special rules if a shelf company is interposed into a consolidated group or MEC group and becomes the head company of the group. When the special rules apply, everything that happened in relation to the original head company before the completion time is taken to have happened in relation to the interposed company instead of in relation to the original head company.

1.50 A consequential amendment will clarify that everything that happened in relation to the original head company because of a group conversion involving a MEC group is also taken to have happened in relation to the interposed company. ***[Schedule 1, items 5 and 6, paragraph 703-75(2)(d)]***

1.51 Similarly, sections 719-90 and 719-95 sets out the effects if there is a change in the head company of a MEC group since the previous income year. In these circumstances, everything that happened in relation to the original head company before the start of the income year for which there is a new head company is taken to have happened in relation to the new head company.

1.52 A consequential amendment will clarify that everything that happened in relation to the original head company because of a group conversion involving a MEC group is also taken to have happened in relation to the new head company. ***[Schedule 1, item 10, paragraph 719-90(2)(ca)]***

1.53 In addition, consequential amendments will clarify that:

- the members of a MEC group are the head company of the group and the subsidiary members of the group;
- the members of a potential MEC group are, broadly, the eligible tier-1 companies of the group and the subsidiary members of the group.

[Schedule 1, items 7, 8 and 12, subsection 719-25(3) and the definition of 'member' in subsection 995-1(1)]

Circumstances in which a company is eligible to be appointed as the provisional head company of a MEC group

1.54 Where the provisional head company of a MEC group ceases to be wholly-owned by its foreign holding company (that is, a cessation event happens), it is no longer eligible to be the head company of the group. In these circumstances, the MEC group will need to appoint a new provisional head company so that the group can continue to exist.

1.55 Where a MEC group is created part way through an income year and a cessation event happens to the original provisional head company in the same income year as the MEC group was created, the new provisional head company must have been a member of the MEC group from the start of the original provisional head company's income year (subparagraph 719-65(3)(d)(ii)).

1.56 Therefore, if the MEC group comes into existence after the start of the original provisional head company's income year because, for example, a MEC group is created from a consolidated group, and the cessation event happens before the end of that income year, the MEC group is effectively prevented from appointing a new provisional head company because no company is capable of satisfying the requirements in subparagraph 719-65(3)(d)(ii).

1.57 To overcome this difficulty, a company will be eligible to be appointed as the new provisional head company of a MEC group in these circumstances provided the company was a member of the MEC group from the time the MEC group came into existence. ***[Schedule 1, item 9, subparagraph 719-65(3)(d)(i)]***

Part 3 — Pre-CGT proportions

1.58 When an entity joins a consolidated group its membership interests cease to be recognised for income tax purposes. If those membership interests are pre-CGT assets (that is, interests acquired before 20 September 1985 that have not stopped being pre-CGT assets under the CGT provisions), the existing law preserves this status by attributing a pre-CGT factor to the underlying assets of the joining entity.

1.59 Due to the mechanics of the pre-CGT factor calculation, depending on the circumstances, only a proportion of the pre-CGT status of the group's membership interests in a joining entity is maintained when that entity later leaves the group. As a result, small and medium sized groups that have a significant proportion of pre-CGT membership interests may be disadvantaged by electing into the consolidation regime.

1.60 To overcome these concerns, the mechanism for preserving the pre-CGT status of membership interests in a joining entity will be modified. The new mechanism will involve working out the proportion (measured by market value) of membership interests in the joining entity that have pre-CGT status – that is, the pre-CGT proportion. The pre-CGT proportion is used when an entity leaves a consolidated group to work out the number of its membership interests that are pre-CGT assets. ***[Schedule 1, items 14, 15 and 30, subsection 705-125(1) and the definition of 'pre-CGT proportion' in subsection 995-1(1)]***

1.61 The pre-CGT proportion is the amount worked out using the formula:

$$\frac{\text{Market value of pre-CGT membership interests}}{\text{Market value of all membership interests}}$$

where:

- the market value of pre-CGT membership interests is the sum of the market value of each membership interest in the joining entity that:
  - is held by a member of the group at the joining time; and
  - is a pre-CGT asset; and

- the market value of all membership interests is the sum of the market value of each membership interest in the joining entity that is held by a member of the group at the joining time.

[Schedule 1, item 16, subsection 705-125(2)]

1.62 When the entity ceases to be a member of the consolidated group, subject to integrity rules, some or all of the membership interests in the leaving entity will be treated as pre-CGT assets, worked out using the formula:

$$\left(\begin{array}{l}\text{Number of membership interests}\\ \text{in the leaving entity held by}\\ \text{members of the old group}\end{array}\right) \times \left(\begin{array}{l}\text{Leaving entity's}\\ \text{pre-CGT proportion}\end{array}\right)$$

[Schedule 1, items 21, 22 and 24, subsections 711-65(1) and 711-65(4)]

1.63 For the purposes of applying this formula, the leaving entity's pre-CGT proportion is the amount worked out under section 705-125. ***[Schedule 1, item 24, subsection 711-65(4)]***

Example 1.12: Pre-CGT proportion – single class of shares

Company J has 10,000 ordinary shares on issue. Head Co owns all 10,000 shares, 8,000 of which are pre-CGT assets. The remaining 2,000 shares are post-CGT assets.

On 1 July 2002 Head Co forms a consolidated group. Company J is a subsidiary member of the group. The net market value of Company J at the joining time is $450,000. Each share has a market value of $45.

The pre CGT proportion of the membership interests in Company J is calculated as follows:

$$\frac{\text{Market value of pre-CGT shares}}{\text{Market value of all shares}}$$

$$= \frac{\$360{,}000}{\$450{,}000}$$

$$= 80\%.$$

On 1 July 2004, Head Co sells 1,000 shares to a third party. As a result, Company J leaves Head Co's consolidated group.

The pre-CGT proportion of Head Co's membership interests in Company J is 80%. Therefore, assuming that subsection 711-70(1) has not applied to reduce the pre-CGT proportion to nil, 8,000 shares are pre-CGT assets.

Head Co chooses to sell 1,000 shares that are pre-CGT assets. Therefore, of the 9,000 shares that Head Co continues to hold in Company J:

- 7,000 shares are pre-CGT assets; and
- 2,000 shares are post-CGT assets.

Example 1.13: Pre-CGT proportion – more than one class of shares

Company Z has 50 class A shares and 50 class B shares on issue.

Head Co owns:

- 25 of Company Z's class A shares – these shares are pre-CGT assets as they were acquired by Head Co prior to 20 September 1985 and have not stopped being pre-CGT assets under the CGT provisions; and
- 30 of Company Z's class B shares – these shares are post-CGT assets as they were acquired by Head Co after 19 September 1985.

Company Y, which is wholly-owned by Head Co, owns:

- 25 of Company Z's class A shares – these shares are pre-CGT assets as they were acquired by Company Y prior to 20 September 1985 and have not stopped being pre-CGT assets under the CGT provisions; and
- 20 of Company Z's class B shares – these shares are post-CGT assets as they were acquired by Company Y after 19 September 1985.

On 1 July 2003, Head Co forms a consolidated group. Company Y and Company Z are subsidiary members of the group.

The net market value of Company Z at the joining time is $5 million. The market value of each Class A share is $60,000 ($3 million in total) and the market value of each Class B share is $40,000 ($2 million in total).

The pre-CGT proportion of the membership interests in Company Z is calculated as follows:

$$\frac{\text{Market value of pre-CGT shares}}{\text{Market value of all shares}}$$

$$= \frac{\$3{,}000{,}000}{\$5{,}000{,}000}$$

$$= 60\%.$$

On 15 May 2008, Company Y sells the 45 shares it holds in Company Z to a third party. As a result, Company Z leaves Head Co's consolidated group.

The pre-CGT proportion of the membership interests in Company Z is 60%. As Company Z has two classes of shares, the pre-CGT proportion is applied separately to each class as if the shares in that class were all the shares held by the old group in the leaving entity. Therefore:

- 30 of the class A shares are pre-CGT assets (ie, 50 x 60%); and
- 30 of the class B shares are pre-CGT assets (ie, 50 x 60%).

Of the 45 shares sold by Company Z, Head Co chooses to sell 25 class A shares that are pre-CGT assets and 20 class B shares that are pre-CGT assets.

Head Co continues to hold 55 shares in Company Z:

- 25 class A shares, 5 of which are pre-CGT assets; and
- 30 class B shares, 10 of which are pre-CGT assets.

Application of Division 149 to the head company

1.64 Division 149 sets out when an asset acquired before 20 September 1985 will stop being a pre-CGT asset for CGT purposes.

1.65 Broadly, for an asset's pre-CGT status to be maintained, entities must be able to demonstrate that the same ultimate owners who held (directly or indirectly) more than 50 per cent of the beneficial interests in the asset, and in the ordinary income derived from the asset, just before 20 September 1985 have continued to hold more than 50 per cent of these interests at the relevant time.

1.66 An integrity rule will apply to ensure broadly consistent treatment for membership interests in a leaving entity that are taken to be pre-CGT assets under the pre-CGT proportion rules.

1.67 As a result of the integrity rule, the pre-CGT proportion of a leaving entity at the leaving time is nil if the leaving entity held assets when it became a subsidiary member of the old group (disregarding the single entity rule (subsection 701-1(1)) and:

- some or all of the assets stopped being pre-CGT assets under Division 149 at a time when they were held by the head company of the group (because of the single entity rule), provided that the leaving entity was a subsidiary member of the group at that time; or

- some or all of the assets would have stopped being pre-CGT assets under Division 149 at a time when they were held by the head company of the group (because of the single entity rule) if they had been pre-CGT assets just before that time, provided that the leaving entity was a subsidiary member of the group at that time.

[Schedule 1, item 26, subsection 711-70(1)]

Application of CGT event K6

1.68 CGT event K6 (section 104-230) happens if certain CGT events happen to pre-CGT shares in a company or pre-CGT interests in a trust and, just before the time of the event, the market value of the post-CGT property of the company or trust, or of other entities in which the trust has a direct or indirect interest, is 75 per cent or more of the net value of the company or trust.

1.69 An integrity rule will apply to ensure broadly consistent treatment for membership interests in a leaving entity that are taken to be pre-CGT assets under the pre-CGT proportion rules.

1.70 The integrity rule will apply if the leaving entity ceases to be a member of the old group and, as a result, one of the following CGT events happens to one or more of its membership interests:

- CGT event A1 (disposal of a CGT asset);

- CGT event C2 (cancellation, surrender and similar endings of an intangible CGT asset);

- CGT event E1 (creating a trust over a CGT asset);

- CGT event E2 (transferring a CGT asset to a trust); or
- CGT event E8 (disposal by a beneficiary of a capital interest in a trust)

[Schedule 1, item 26, subsection 711-70(2)]

1.71 In these circumstances, for the purpose of applying CGT event K6 (section 104-230) in relation to those membership interests, the 75 per cent test in subsection 104-230(2) is applied at the leaving time, disregarding the single entity rule (subsection 701-1(1)). This ensures the market value of intra-group assets, including membership interests held in other subsidiary members acquired on or after 20 September 1985, are taken into account in applying the 75 per cent test. ***[Schedule 1, item 26, subsection 711-70(3)]***

1.72 In addition, if CGT event K6 applies, then, for the purposes of working out the amount of the capital gain, the operation of subsection 104-230(6) is modified in relation to each post-CGT asset identified under subsection 104-230(2) that has its tax cost set at the leaving time under:

- section 701-45, which sets the tax costs of assets consisting of liabilities owed to the leaving entity by members of the group; and
- section 701-50, which sets the tax costs of assets consisting of certain membership interests held by the leaving entity after it leaves the group.

[Schedule 1, item 26, subsection 711-70(4)]

1.73 In these circumstances, for the purpose of applying subsection 104-230(6), the cost base of the asset at the leaving time will be taken to be the asset's tax cost setting amount. ***[Schedule 1, item 26, subsection 711-70(4)]***

Consequential amendments

1.74 Consequential amendments will:

- modify a cross reference in subsection 705-125(4);
- repeal the existing pre-CGT factor rules in section 705-165, section 705-205, section 705-245, the note to subsection 711-65(2), subsection 711-65(5), section 713-245 and section 713-270; and

- repeal the definition of 'pre CGT factor' in subsection 995-1(1).

[Schedule 1, items 17, 18, 19, 20, 23, 25, 27, 28 and 29]

Modifications to the tax cost setting rules when an entity joins a consolidated group

1.75 Under the tax cost setting rules, the tax costs of a joining entity's assets are generally reset by allocating the joining entity's allocable cost amount to each of the joining entity's assets in proportion to their market value. This allocation process ensures that, broadly, the costs incurred by the head company to acquire the joining entity's membership interests are pushed down into the tax costs of the underlying assets of the joining entity.

1.76 The allocable cost amount is basically the sum of the cost bases of the head company's membership interests in the joining entity held by members of the joined group and the joining entity's liabilities. Several adjustments are made to this amount.

1.77 The amendments will clarify and improve the operation of the tax cost setting rules when an entity joins a consolidated group to:

- ensure adjustments to the allocable cost amount are not double counted;
- clarify the scope of the adjustment to the allocable cost amount in respect of certain pre-joining time CGT roll-overs that applied to a joining entity's assets; and
- phase out the over-depreciation adjustment to the allocable cost amount.

Part 4 — No double counting of amounts in the allocable cost amount

1.78 Under the tax cost setting rules, several adjustments are made to the allocable cost amount. In some circumstances the adjustments to the allocable cost amount can be duplicated. As a result, the tax costs allocated to the joining entity's assets can be distorted.

1.79 A duplication can arise, for example, because integrity measures in the income tax law prevent the duplication of losses by reducing the cost base of shares. This adjustment to the cost base of shares causes a potential double adjustment to the allocable cost amount because:

- it may be reflected in an adjustment to step 1;

- it may be reflected in reduced undistributed profits of the joining entity at step 3; and / or
- it may be reflected in the tax losses of the joining entity at step 5.

1.80 The object of section 705-62 is to prevent a particular amount from being taken into account twice when calculating the allocable cost amount for the joining entity for the purpose of promoting the object of Subdivision 705-A. ***[Schedule 1, item 32, subsection 705-62(1)]***

1.81 The object of Subdivision 705-A, which is set out in subsections 705-10(2) and (3), is broadly:

- to recognise the head company's cost of becoming a holder of the joining entity's assets as an amount reflecting the group's cost of acquiring the entity; and
- to align the costs of the assets with the costs of membership interests, and to preserve this alignment until the entity ceases to be a subsidiary member, in order to:
  - prevent double taxation of gains and duplication of losses; and
  - remove the need to adjust costs of membership interests in response to transactions that shift value between them, as the required adjustments occur automatically.

1.82 Section 705-62 applies if two or more provisions of the income tax law operate with the result of:

- altering the allocable cost amount for the joining entity because of a particular economic attribute of the joining entity; or
- altering the allocable cost amount for another entity that becomes a subsidiary member of the group at the joining time because of a particular economic attribute of the joining entity.

[Schedule 1, item 32, subsection 705-62(2)]

1.83 Where section 705-62 applies, only the alteration that is most appropriate, in the light of the object of Subdivision 705-A, is to be made. ***[Schedule 1, item 32, subsection 705-62(3)]***

1.84 For the purposes of section 705-62, the economic attributes of the joining entity include the joining entity's:

- retained profits;
- distributions of profits to other entities;
- realised and unrealised losses;
- deductions; and
- accounting liabilities (within the meaning of subsection 705-70(1)).

[Schedule 1, item 32, subsection 705-62(4)]

1.85 The question as to which alteration is most appropriate is a matter of judgement for the head company of the consolidated group.

Example 1.14: No double counting of adjustments to the allocable cost amount

Holding Co incorporates Admin Co with $200. Admin Co uses the $200 to incorporate Beta Co. Beta Co realises a tax loss of $50, and has assets of $150 remaining.

There is an alteration in underlying majority ownership of Holding Co so that Subdivision 165-CD applies to reduce the reduced cost base of Admin Co's membership interests in Beta Co, and Holding Co's membership interests in Admin Co, by $50 to $150. For the purposes of this example, any tax effects arising as a result of the alteration have been ignored.

Holding Co then forms a consolidated group.

Under the current law, the tax cost setting rules apply to Admin Co as follows.

- Step 1 of the allocable cost amount is the reduced cost base of Holding Co's membership interests in Admin Co (ie, $150) – the reduced cost base of the membership interests is used because the market value of those membership interests is less than or equal to their reduced cost base.
- No other steps apply, so Holding Co's allocable cost amount for Admin Co is $150.
- This allocable cost amount will be allocated to the membership interests in Beta Co (the only asset of Admin Co).

Under the current law, the tax cost setting rules apply to Beta Co as follows.

- Step 1 of the allocable cost amount is the reduced cost base of Admin Co's membership interests in Beta Co (ie, $150).
- The step 1 amount is reduced by the amount of losses accruing to joined group before the joining time (ie, $50) under step 5 of the allocable cost amount.
- Holding Co's allocable cost amount for Beta Co is $100.
- This allocable cost amount will be allocated to the assets of Beta Co.

This is an inappropriate outcome. Holding Co invested $200 in Admin Co which, in turn, invested $200 in Beta Co. Beta Co had a tax loss of $50. Therefore, the correct tax cost setting amount for both companies should be $150.

Applying section 705-62, the allocable cost amount for Admin Co will be unchanged — that is, it will continue to be $150.

However, Holding Co determines that, to prevent double counting, the step 5 adjustment should not be made. This is because the loss has already been taken into account in calculating the step 1 amount for Beta Co. As a result, the allocable cost amount for Beta Co will be increased to $150.

Part 5 — Pre-joining time roll-overs

1.86 Step 3A of the allocable cost amount (section 705-93) adjusts the allocable cost amount where a joining entity has a deferred capital gain or loss that arose because of an intra-group CGT roll-over before the joining time.

1.87 The adjustment at step 3A of the allocable cost amount is intended to prevent the deferred gain or loss arising from the pre-joining time CGT roll-over in relation to an asset held by the joining entity from being included in the tax costs of a joining entity's assets as a result of the tax cost setting process. This adjustment prevents the deferred gain or loss from being indefinitely deferred for tax purposes.

1.88 Currently the step 3A adjustment is deficient because, for example:

- the adjustment does not apply in all circumstances where a CGT roll-over applied to an asset that was transferred to the joining entity before the joining time from another entity in the group; and
- the adjustment does not apply if a subsequent CGT event (such as CGT event G1) happened to the roll-over asset where that CGT event does not cause the deferred gain or loss to be brought to account for tax purposes.

1.89 To overcome these concerns, section 705-93 will be modified so that a step 3A amount arises where:

- before the joining time, there was a Subdivision 126-B roll-over or a section 160ZZO roll-over in relation to an asset (existing paragraph 705-93(1)(a));
- at the joining time, as a result of the Subdivision 126-B roll-over or the section 160ZZO roll-over, the roll-over asset has a deferred capital gain or a deferred capital loss;
- the originating company in relation to the Subdivision 126-B roll-over, or the transferor in relation to the section 160ZZO roll-over:
  - – was a foreign resident; or
  - – is a stick entity in relation to the joined group;
- the recipient company in relation to the Subdivision 126-B roll-over, or the transferee in relation to the section 160ZZO roll-over:
  - – was an Australian resident; and
  - – is a spread entity in relation to the joined group;
- if the recipient company was previously a subsidiary member of another consolidated group, the conditions in section 104-182 (which prevents CGT event J1 from happening if the recipient company ceases to be a subsidiary member of a consolidated group at the time the group breaks up) were not satisfied at any time in relation to the other group between:

  - the Subdivision 126-B roll-over and the joining time; or
  - the section 160ZZO roll-over and the joining time;

- the roll-over asset is not a pre-CGT asset at the joining time (existing paragraph 705-93(1)(e)); and
- the roll-over asset becomes that of the head company of the joined group because the single entity rule (subsection 701-1(1)) applies when the joining entity becomes a subsidiary member of the group (existing paragraph 705-93(1)(f)).

[Schedule 1, items 36 to 40, paragraphs 705-93(1)(aa), (b), (c) and (d)]

1.90 The step 3A amount is the amount of the deferred roll-over gain or the deferred roll-over loss. ***[Schedule 1, item 41, subsection 705-93(2)]***

1.91 If the step 3A amount is a deferred roll-over gain, the allocable cost amount is reduced by the amount of the deferred roll-over gain. If the step 3A amount is a deferred roll-over loss, the allocable cost amount is increased by the amount of the deferred roll-over loss. ***[Schedule 1, item 35, item 3A of the table in section 705-60]***

1.92 An asset has a ***deferred roll-over gain*** at a particular time if:

- before that time there was a CGT roll-over because a CGT event happened in relation to the asset; and
- as a result of the roll-over all or part of a capital gain from the CGT event was disregarded.

[Schedule 1, item 45, paragraphs (a) and (b) of the definition of 'deferred roll-over gain' in subsection 995-1(1)]

1.93 The amount of the deferred roll-over gain is the amount of the capital gain that was disregarded, reduced by the amount (if any) by which the gain has been taken into account in working out a net capital gain or net capital loss in relation to the asset between the roll-over time and the particular time. ***[Schedule 1, item 45, the definition of 'deferred roll-over gain' in subsection 995-1(1)]***

1.94 An asset has a ***deferred roll-over loss*** at a particular time if:

- before that time there was a CGT roll-over because a CGT event happened in relation to the asset; and

- as a result of the roll-over all or part of a capital loss from the CGT event was disregarded.

[Schedule 1, item 46, paragraphs (a) and (b) of the definition of 'deferred roll-over loss' in subsection 995-1(1)]

1.95 The amount of the deferred roll-over loss is the amount of the capital loss that was disregarded, reduced by the amount (if any) by which the loss has been taken into account in working out a net capital gain or net capital loss in relation to the asset between the roll-over time and the particular time. ***[Schedule 1, item 46, the definition of 'deferred roll-over loss' in subsection 995-1(1)]***

1.96 A ***stick entity***, in relation to a consolidated group, means a member of the group that is:

- the head company of the group;
- a chosen transitional entity; or
- a transitional foreign held subsidiary.

[Schedule 1, item 48, paragraph (a) of the definition of 'stick entity' in subsection 995-1(1)]

1.97 A ***stick entity***, in relation to a MEC group, means a member of the group that is:

- the head company of the group;
- a chosen transitional entity;
- a transitional foreign held subsidiary; or
- an eligible tier-1 company.

[Schedule 1, item 48, paragraph (b) of the definition of 'stick entity' in subsection 995-1(1)]

1.98 A ***spread entity***, in relation to a consolidated group or a MEC group, means a member of the group that is not a stick entity in relation to the group. ***[Schedule 1, item 47, the definition of 'spread entity' in subsection 995-1(1)]***

1.99 Section 705-147 modifies the operation of step 3A of the allocable cost amount (section 705-93) in the case of a group formation to:

- apportion the step 3A amount among the first level interposed entities; and

- take account of a roll-over asset that is a membership interest in an entity that becomes a subsidiary member at the formation time.

1.100 As a result of the amendments to section 705-93, consequential amendments to section 705-147 clarify the scope of its operation and remove redundant elements of the section. ***[Schedule 1, item 42, subsection 705-147(3)]***

1.101 Section 705-150 adjusts the step 3A amount for pre-formation time CGT roll-overs by the head company to a subsidiary member. The amendments broaden the scope of section 705-93. As a result, section 705-150 is no longer necessary and can be repealed. ***[Schedule 1, item 43]***

1.102 As a result of the modifications to section 705-93 and the repeal of section 705-150, consequential amendments will:

- remove the reference to section 705-150 in paragraph 104-505(1)(b); and
- replace the reference to section 705-150 with a reference to section 705-93 in section 126-165 of the *Income Tax (Transitional Provisions) Act 1997*.

[Schedule 1, items 34 and 49, paragraph 104-505(1)(b) of the ITAA 1997 and section 126-165 of the Income Tax (Transitional Provisions) Act 1997]

1.103 Section 705-227 modifies the operation of step 3A of the allocable cost amount (section 705-93) for linked entities that join a consolidated group to:

- apportion the step 3A amount among the first level interposed entities; and
- take account of a roll-over asset that is a membership interest in a linked entity that is held by another linked entity.

1.104 As a result of the amendments to section 705-93, consequential amendments to section 705-227 clarify the scope of its operation and remove redundant elements of the section. ***[Schedule 1, item 44, subsection 705-227(3)]***

Part 6 — Phasing out over-depreciation adjustments

1.105 In some cases the amount of the reset tax cost setting amount that would otherwise apply to an over-depreciated asset of a joining entity is reduced (section 701-50).

1.106 The over-depreciation adjustment prevents the indefinite deferral of tax on the profits sheltered due to the over-depreciation of the asset. This can arise where the accelerated depreciation of assets has brought forward the joining entity's depreciation deductions, thus deferring the payment of tax on its profits. The profits remain untaxed when the entity joins the group where:

- the asset is over-depreciated at that time;
- the profits have been distributed to another entity that was entitled to the former inter-corporate dividend rebate; and
- the profits have not been distributed to another entity that did not have access to the former inter-corporate dividend rebate.

1.107 Currently, to work out whether the reset tax cost setting amount of an over-depreciated asset of a joining entity needs to be reduced by an over-depreciation adjustment, the joining entity needs to determine whether it paid unfranked or partly franked dividends to shareholders that were entitled to the former inter-corporate dividend rebate prior to the joining time. The inter-corporate dividend rebate for unfranked dividends was removed from 1 July 2004 following the introduction of the simplified imputation system.

1.108 To reduce compliance costs, the over-depreciation adjustment will effectively be phased out from 1 July 2009. Consequently, a joining entity will have to look only at the five years of dividend history prior to the joining time to determine whether an over-depreciation adjustment is required. ***[Schedule 1, item 51, paragraph 705-50(2)(b)]***

Modifications to the tax cost setting rules when an entity leaves a consolidated group

1.109 When an entity leaves a consolidated group, the tax costs of the membership interests in the leaving entity needs to be reconstructed.

1.110 Under the tax cost setting process that applies when an entity leaves a consolidated group, the old group's allocable cost amount is worked out to determine the tax costs of the membership interests in the leaving entity.

1.111 The amendments will clarify and improve the operation of the tax cost setting rules when an entity leaves a consolidated group to:

- clarify that the liabilities taken into account in working out step 4 of the old group's allocable cost amount are the liabilities held just before the leaving time; and

- ensure that an appropriate amount is included in step 4 of the old group's allocable cost amount when subsection 711-45(8) applies.

Part 7 — Leaving time liabilities: ensuring that liabilities held just before the leaving time are included in step 4 of the old group's allocable cost amount

1.112 When an entity leaves a consolidated group, the group's cost of the membership interests in the leaving entity is set so that it reflects the cost to the group of the net assets of the leaving entity. The cost of the membership interests in the leaving entity is determined by working out the old group's allocable cost amount. The old group's allocable cost amount broadly consists of the terminating values of the leaving entity's assets less the value of the liabilities and certain equity interests of the leaving entity.

1.113 For these purposes, the liabilities that are included in step 4 of the old group's allocable cost amount are the liabilities of the leaving entity at the leaving time (section 711-45).

1.114 In *Handbury Holdings Pty Ltd v Commissioner of Taxation* [2008] FCA 1787, a subsidiary member left a consolidated group when debt held by a non-group member was converted to equity. The taxpayer argued that the debt was not included in step 4 of the old group's allocable cost amount because it was not a liability that the leaving entity takes with it when it ceases to be a subsidiary member of the group.

1.115 The Federal Court concluded that subsection 711-45(1) includes liabilities held by the leaving entity just before the leaving time. As a result, the debt is included in step 4 of the old group's allocable cost amount. The Federal Court reached this conclusion on the basis that it produced an outcome that promotes the objects of the consolidation regime. That is, it ensured that the taxpayer was appropriately taxed on a substantial economic gain that arose when the entity left the group. However, it is noted that the taxpayer has lodged an appeal against the Federal Court's decision.

1.116 To remove any doubt, the amendments will clarify that step 4 of the old group's allocable cost amount applies to liabilities of the leaving entity that exist just before the leaving entity ceases to be a subsidiary member of the group — that is, just before the leaving time. ***[Schedule 1, items 53, 54, 55, 56, 57, 59, 60, and 61, sections 711-20, 711-25, 711-45 and 713-265]***

Part 7 — Leaving time liabilities: entry amount of a liability is different to its exit amount

1.117 The amount of the liability that is subtracted from the old group's allocable cost amount under step 4 (section 711-45) is adjusted if a subsidiary member of the old group held the liability at the time that it joined the consolidated group and the amount of the liability recognised at the joining time is different to the amount of the liability at the leaving time (subsection 711-45(8)).

1.118 Subsection 711-45(8) was introduced to ensure a consistent outcome with the outcome that would have occurred if the liability had been discharged prior to the leaving time triggering CGT event L7 (section 104-530).

1.119 A capital gain or capital loss arises under CGT event L7 when:

- a liability is discharged for an amount that is different to the amount of the liability recognised at the joining time; and
- the allocable cost amount is different to what it would have been if the different amount of the liability had been used to work out the allocable cost amount.

1.120 As discussed later in this chapter, to reduce compliance costs, CGT event L7 is to be repealed.

1.121 Subsection 711-45(8) has a wider role than CGT event L7. That is, it prevents the double taxation of economic gains, or a double tax benefit from arising, in the hands of the head company when an entity leaves a consolidated group. Therefore, subsection 711-45(8) needs to be retained.

1.122 However, modifications to subsection 711-45(8) will reduce compliance costs by limiting the circumstances in which it applies. The modifications will also clarify the operation of the subsection.

1.123 As a result, the amount at step 4 of the old group's allocable cost amount will be adjusted under subsection 711-45(8) only when:

- a liability mentioned in subsection 711-45(5), an employee share interest mentioned in subsection 711-45(6), a share mentioned in subsection 711-45(6A) or debt interest mentioned in subsections 711-45(7), was taken into account in working out the allocable cost amount for a subsidiary member (whether or not the leaving entity) of the old group in accordance with Division 705 (the original entry ACA);

- the entry amount is different from the exit amount; and
- the original entry ACA exceeds or falls short of the amount (the adjusted ACA) that it would have been if the exit amount, instead of the entry amount, had been taken into account in working it out.

[Schedule 1, item 58, subsection 711-45(8)]

1.124 Subsection 711-45(8) will not apply if a liability that the leaving entity takes with it is different to the liability that existed at the joining time. For example, if the original entry ACA for a joining entity included a provision for long service leave and that liability is fully paid-out before the entity leaves the consolidated group (resulting in a tax deduction for the head company), subsection 711-45(8) will not apply to the long service leave provision that the leaving entity takes with it. This is because the provision that the leaving entity takes with it accrued after the joining time and is different to the provision included in the original entry ACA.

1.125 The entry amount is:

- in the case of a liability – the amount of the liability that was taken into account in working out the original entry ACA after taking into account any adjustments made under sections 705-70, 705-75 or 705-80; or
- in the case of an employee share interest, share or debt interest referred to in subsection 711-45(6), (6A) or (7) – the amount that was taken into account in working out the original entry ACA.

[Schedule 1, item 58, subsection 711-45(9)]

1.126 If a liability that was taken into account in working out the original entry ACA has been partly paid-out before the leaving time, the entry amount will be the unpaid part of the liability that was taken into account in working out the original entry ACA.

1.127 The exit amount is the amount of the liability, employee share interest, share or debt interest that was taken into account under step 4 of the old group's allocable cost amount following the application of subsections 711-45(5), (6), (6A) and (7)). ***[Schedule 1, item 58, paragraph 711-45(8)(b)]***

1.128 Where subsection 711-45(8) applies, the step 4 amount is altered by:

- if the original entry ACA exceeds the adjusted entry ACA, increasing the step 4 amount by the amount of the excess; or
- if the original entry ACA falls short of the adjusted entry ACA, reducing the step 4 amount by the amount of the shortfall.

[Schedule 1, item 58, subsection 711-45(10)]

Example 1.15: Provision for long service leave

Head Co acquires all of the membership interests in Company J on the 1 July 2009. As a result, Company J joins Head Co's consolidated group.

Company J's financial reports at the joining time include a liability of $10,000 for the provision for long service leave.

In working out the allocable cost amount for Company J at the joining time (the original entry ACA), the amount of the liability included in step 2 is $7,000 (the entry amount). The amount of the accounting liability ($10,000) is reduced by the amount of the future income tax deduction in respect of the liability ($3,000) to work out the step 2 amount (subsection 705-75(1)).

On 30 June 2011, Company J leaves Head Co's consolidated group as all of its membership interests are acquired by a non-group member.

Company J's financial reports at the leaving time include a liability of $20,000 for the provision for annual leave. The provision has increased since the joining time due to the accrual of an additional liability of $10,000.

The amount of the liability included in step 4 of the old group's allocable cost amount for Company J at the leaving time is worked out under section 711-45.

The amount of the accounting liability included under subsection 711-45(1) for the provision for long service leave at the leaving time is $20,000. As Company J will be entitled to a future income tax deduction in respect of the liability, subsection 711-45(3) applies to reduce this amount by the amount of the future income tax deduction ($6,000).

However, as the liability for the provision for long service leave is recognised at a later time for income tax purposes than it is for accounting purposes, subsection 711-45(5) applies to reduce the amount to be added at step 4 for liability to nil (the exit amount).

Subsection 711-45(8) will apply to the liability for the provision for long service leave because:

- subsection 711-45(5) applies to the liability;
- the entry amount ($7,000) is different from than the exit amount (nil); and
- the amount of the original entry ACA for Company J would have been $7,000 lower if the exit amount was used instead of entry amount to work it out — that is, the amount of the original entry ACA exceeds the amount of the adjusted entry ACA by $7,000.

Consequently, the amount included at step 4 of the old group's allocable cost amount for Company J in respect of the liability for the provision for long service leave is $7,000.

Example 1.16: Foreign exchange liability

Prior to joining time Company J borrowed US$100. At that time, A$1 was equivalent to US$0.80c. Company J therefore received A$125 cash on issue of the foreign exchange (forex) liability.

Head Co acquires all of the membership interests in Company J on the 1 July 2009. As a result, Company J joins Head Co's consolidated group.

At the joining time, A$1 is equivalent to US$0.75. Therefore, Company J's financial reports at the joining time include a forex liability of A$133.33 and a forex loss of A$8.33. As the loss is not deductible for income tax purposes, Company J has a deferred tax asset of A$2.50.

In working out the allocable cost amount for Company J at the joining time (the original entry ACA), the amount of the liability included in step 2 is A$130.83 (the entry amount). In this regard, the amount of the accounting liability (A$133.33) is reduced by the amount of the future income tax deduction in respect of the liability ($2.50) to work out the step 2 amount (subsection 705-75(1)).

On 30 June 2010, Company J leaves Head Co's consolidated group as all of its membership interests are acquired by a non-group member.

At that time A$1 is equivalent to US$0.85c. Therefore, Company J's financial reports at the leaving time include a forex liability of A$117.65.

The amount of the liability included in step 4 of the old group's allocable cost amount for Company J at the leaving time is worked out under section 711-45.

The amount of the accounting liability included under subsection 711-45(1) for the forex liability is A$117.65.

However, as the forex liability is recognised at a later time for income tax purposes than it is for accounting purposes, subsection 711-45(5) applies to increase the amount to be added at step 4 for liability to A$125 (the exit amount).

Subsection 711-45(8) will apply to the forex liability because:

- subsection 711-45(5) applies to the liability;
- the entry amount (A$130.83) is different from than the exit amount (A$125); and
- the amount of the original entry ACA for Company J would have been A$5.83 lower if the exit amount was used instead of entry amount to work it out — that is, the amount of the original entry ACA for Company J exceeds the amount of the adjusted entry ACA by A$5.83.

Consequently, the amount included at step 4 of the old group's allocable cost amount for Company J in respect of the forex liability is increased by A$5.83 to $130.83.

Example 1.17: Foreign exchange liability – partial repayment after the joining time

Assume the same facts as for Example 1.17 except that US$50 of the US$100 forex liability is repaid after joining time when A$1 is equivalent to US$0.78.

Therefore, Head Co makes a repayment of A$64.10 and realises a foreign exchange loss of A$1.60 for tax purposes. After taking into account the tax benefit to Head Co of the loss of A$0.48 (A$1.60 x 30%)), the repayment has an after-tax cost of A$63.62.

When Company J leaves the consolidated group, A$1 is equivalent to US$0.85. Therefore, Company J's financial reports at the leaving time include a forex liability of A$58.82.

The amount of the accounting liability included under subsection 711-45(1) for the forex liability is A$58.82.

However, as the forex liability is recognised at a later time for income tax purposes than it is for accounting purposes, subsection 711-45(5) applies to increase the amount to be added at step 4 for liability to A$62.50 (the exit amount).

For the purpose of working out whether subsection 711-45(8) applies, the entry amount for the forex liability is A$67.21 — that is, the amount of the forex liability taken into account in working out the original entry ACA (A$130.83) reduced by the after-tax cost of the amount paid-out by Head Co before the leaving time ($A63.62).

Subsection 711-45(8) will apply to the forex liability because:

- subsection 711-45(5) applies to the liability;
- the entry amount (A$67.21) is different from than the exit amount (A$62.50); and
- the amount of the original entry ACA for Company J would have been A$4.71 lower if the exit amount was used instead of entry amount to work it out — that is, the amount of the original entry ACA for Company J exceeds the amount of the adjusted entry ACA by A$4.71.

Consequently, the amount included at step 4 of the old group's allocable cost amount for Company J in respect of the forex liability is increased by A$4.71 to A$67.21.

Modifications to the tax cost setting rules when an entity joins or leaves a consolidated group

1.129 Some elements of the tax cost setting rules apply both:

- when an entity joins a consolidated group; and
- when an entity leaves a consolidated group.

1.130 The amendments will clarify and improve the operation of the tax cost setting rules when an entity joins or leaves a consolidated group to:

- clarify that the liabilities recognised by a joining or leaving entity under the tax cost setting rules are generally the same as its accounting liabilities;
- clarify the scope of the adjustment to the allocable cost amount in respect of inherited deductions; and
- if the joining or leaving entity is a general insurance company, ensure that the tax cost setting rules apply appropriately to its deferred acquisition costs, deferred reinsurance expenses and recoveries receivable.

Part 8 — Accounting principles

Modifications when an entity joins a consolidated group

1.131 When an entity joins a consolidated group, the allocable cost amount for the joining entity is increased by the value of its liabilities at the joining time (step 2 of the table in section 705-60).

1.132 Generally, as a starting point, the step 2 amount includes the value of a joining entity's liabilities that are recognised under the accounting standards or under statements of accounting concepts made by the Australian Accounting Standards Board.

1.133 Where the joining entity does not apply the accounting standards or statements of accounting concepts to prepare a statement of its financial position, the liabilities of the joining entity that can or must be recognised under those standards as at the joining time must be taken into account for the purposes of working out the step 2 amount.

1.134 In *Envestra Ltd v Federal Commissioner of Taxation* [2008] FCA 249; 2008 ATC 20-012, the Federal Court confirmed that a joining entity cannot adopt an accounting standard to measure a liability for consolidation purposes if it did not adopt that accounting standard for the recognition and measurement of the liability for financial reporting purposes.

1.135 To remove doubt, the amendments will modify the tax cost setting rules to confirm this position.

1.136 That is, the amendments clarify that a matter is in accordance with the ***accounting principles*** if it is in accordance with:

- accounting standards; or
- if there are no accounting standards applicable to the matter, authoritative pronouncements of the Australian Accounting Standards Board that apply to the preparation of financial statements.

[Schedule 1, item 84, the definition of 'accounting principles' in subsection 995-1(1)]

1.137 In this regard, authoritative pronouncements of the Australian Accounting Standards Board can be relevant in the preparation of financial statements and would be considered when recognising and measuring accounting liabilities (and other elements on the balance sheet). These include:

- the Urgent Issue Group Interpretations;

- the Framework for the Preparation and Presentation of Financial Statements;
- statements of accounting concepts issued by the Australian Accounting Standards Board; and
- other authoritative pronouncements of the Australian Accounting Standards Board.

1.138 Broadly, when an entity joins a consolidated group, the joining entity's ***accounting principles for tax cost setting*** must be applied for the purposes of working out the allocable cost amount for the joining entity. These are the:

- the accounting principles that the joining entity actually used to prepare its financial reports just before the joining time; or
- if the joining entity did not prepare financial reports just before the joining time, the accounting principles that it would use if it were to prepare its financial reports just before the joining time.

[Schedule 1, item 70 and 85, subsection 705-70(3) and the definition of 'accounting principles for tax cost setting' in subsection 995-1(1)]

1.139 If the joining entity used audited accounts as the basis for preparing its financial reports just before the joining time, the accounting principles applied in the preparation of those audited accounts are the joining entity's accounting principles for tax cost setting.

1.140 Therefore, for the purpose of working out the step 2 of the allocable cost amount for a joining entity, the amendments clarify that the liabilities that are taken into account are those liabilities that, in accordance with the joining entity's accounting principles for tax cost setting, are liabilities of the entity. That is

- for the purpose of applying section 705-70, the liabilities of the joining entity that are taken into account are those liabilities that, in accordance with the joining entity's accounting principles for tax cost setting, are liabilities of the entity;
- the adjustment to step 2 under section 705-80, if any, applies to an accounting liability that is taken into account at a later time than is the case in accordance with the joining entity's accounting principles for tax cost setting; and

- if an adjustment is made to step 2 of the allocable cost amount under section 705 85, the step 2 amount is increased by, if relevant, the market value of each thing that, in accordance with the joining entity's accounting principles for tax cost setting, is equity in the entity at the joining time, where the thing is also a debt interest.

[Schedule 1, items 67, 68, 69, 71 and 72, subsections 705-70(1), 705-70(1A), 705-80(1) and 705-85(3)]

1.141 In addition, when an entity joins a consolidated group:

- the tax cost setting rules in relation to finance leases under section 705-56 applies to a lease held by the joining entity that, in accordance with its accounting principles for tax cost setting, is classified as a finance lease;

- the consolidation provisions apply separately to each asset and liability even if, in accordance with accounting principles, they are required to be set off against each other (section 701-58);

- the exception for the treatment of linked assets and liabilities in section 701-59 refers to the assets and liabilities of the joining entity that, in accordance with the entity's accounting principles for tax cost setting, are linked; and

- the undistributed profits taken into account under step 3 of the allocable cost amount (section 705-90) are the amounts that, in accordance with the joining entity's accounting principles for tax cost setting, are retained profits of the entity.

[Schedule 1, items 64, 65, 66, 73 and 74, subsections 705-56(1), 705-58(1), 705-59(2), and 705-90(2)]

Modifications when an entity leaves a consolidated group

1.142 When an entity leaves a consolidated group, the old group's allocable cost amount is reduced by the value of the liabilities that the leaving entity takes with it when it ceases to be a member of the group (step 4 of the table in section 711-20).

1.143 Broadly, when an entity leaves a consolidated group, the leaving entity's ***accounting principles for tax cost setting*** must be applied for the purposes of working out the old group's allocable cost amount for the leaving entity. These are the:

- the accounting principles that the group actually used to prepare its financial reports just before the leaving time; or
- if the group did not prepare financial reports just before the leaving time, the accounting principles that it would use if it were to prepare its financial reports just before the leaving time.

[Schedule 1, item 77 and 85, subsection 711-45(1A) and the definition of 'accounting principles for tax cost setting' in subsection 995-1(1)]

1.144 If the group used audited accounts as the basis for preparing its financial reports just before the leaving time, the accounting principles applied in the preparation of those audited accounts are the leaving entity's accounting principles for tax cost setting.

1.145 Therefore, for the purpose of working out the step 4 of the old group's allocable cost amount for a leaving entity, the amendments clarify that the liabilities that are taken into account are those liabilities that, in accordance with the leaving entity's accounting principles for tax cost setting, are liabilities of the leaving entity at the leaving time. Therefore:

- the liabilities that are recognised under step 4 of the old group's allocable cost amount (section 711-45) are those things that, in accordance with the leaving entity's accounting principles for tax cost setting, are liabilities of the leaving entity at the leaving time;
- the adjustment to step 4 of the old group's allocable cost amount under subsection 711-45(5) applies to an accounting liability that is taken into account at a later time for tax purposes than for accounting purposes in accordance with the leaving entity's accounting principles for tax cost setting; and
- if subsection 711-45(7) applies, step 4 of the old group's allocable cost amount is increased by the market value of each thing that, in accordance with the leaving entity's accounting principles for tax cost setting, is equity in the leaving entity at the leaving time, where the thing is also a debt interest.

[Schedule 1, items 75, 76, 78 and 79, subsections 711-45(1), 711-45(5) and 711-45(7)]

1.146 In addition, when an entity leaves a consolidated group, the amendments clarify that the exit history rule (section 701-40) applies, so far as is relevant, to any liability or other thing that, in accordance with the accounting principles, is a liability. ***[Schedule 1, item 63, subsection 701-40(2)]***

Modifications when a partnership joins or leaves a consolidated group

1.147 Under Subdivision 713-E , special modifications are made to the tax cost setting rules when:

- an entity that is a partner in a partnership becomes a subsidiary member of a consolidated group; or
- a partnership becomes, or ceases to be, a member of a consolidated group.

1.148 The amendments modify these special rules so that:

- when a partner in a partnership becomes a subsidiary member of a consolidated group, the modification to the treatment of partnership liabilities under the tax cost setting rules applies to things that, in accordance with the accounting principles that the partnership would use if it were to prepare financial statements just before the joining time, are liabilities of the partnership at the joining time; and
- when a partner in a partnership leaves a consolidated group, the modification to the treatment of partnership liabilities under the tax cost setting rules applies to things that, in accordance with the accounting principles that the partnership would use if it were to prepare financial statements just before the leaving time, are liabilities of the partnership at the leaving time.

[Schedule 1, items 80, 81, 82 and 83, subsections 713-225(6) and 713-265(4)]

Part 9 — Inherited deductions

1.149 When an entity joins a consolidated group, the allocable cost amount of a joining entity is reduced by certain deductions that are inherited by the head company under step 7 of the allocable cost amount (section 705-115). The purpose of this adjustment is to ensure that inherited deductions do not give rise to both a higher allocable cost amount and a future income tax deduction — that is, the adjustment prevents the head company from getting a double benefit.

1.150 The amendments will clarify that inherited deductions are deductions of the joining entity that the head company becomes entitled to as a consequence of the operation of the single entity rule (subsection 701-1(1)) and the entry history rule (section 701-5). ***[Schedule 1, item 87, subsection 705-115(2)]***

1.151 Expenditure on certain assets acquired on or before 13 May 1997 (such as capital works expenditure on buildings) is specifically excluded from being an inherited deduction. This preserves the benefit of transitional provisions that grandfather the capital gains tax cost base treatment of these assets.

1.152 To ensure that this exclusion operates as intended, inherited deductions that are covered by step 7 will not include deductions under section 43-15 for undeducted construction expenditure in relation to an asset acquired by the joining entity before 7.30 pm, by legal time in the Australian Capital Territory, on 13 May 1997. ***[Schedule 1, item 88, subsection 705-115(3)]***

1.153 When an entity leaves a consolidated group, the old group's allocable cost amount is increased by the amount of deductions of the head company that are inherited by the leaving entity under step 2 (section 711-35).

1.154 A technical amendment will clarify that the step 2 amount is worked out by multiplying all the deductions of the head company that are inherited by the leaving entity by the company tax rate (currently 30 per cent). This will ensure that there is no duplication of the tax benefit associated with inherited deductions when an entity leaves a consolidated group. ***[Schedule 1, item 89, subsection 711-35(1)]***

1.155 In addition, inherited deductions that are covered by step 2 will not include deductions under section 43-15 for undeducted construction expenditure in relation to an asset that, because of the exit history rule (section 701-40), the leaving entity is taken to have acquired before 7.30 pm, by legal time in the Australian Capital Territory, on 13 May 1997. ***[Schedule 1, item 90, subsection 711-35(3)]***

Part 10 — General insurance companies

1.156 General insurance companies are taxed on movements in the value of the unearned premium reserve and movements in the value of the outstanding claims liabilities.

- The unearned premium reserve broadly represents the amount of premium income received by a general insurance company in an income year that relates to risk coverage in a subsequent income year.
- The outstanding claims liabilities broadly represent the present value of the amount that a general insurance company determines to be necessary to set aside to pay outstanding claims.

1.157 A general insurance company can deduct the amount of any increase in the value of these amounts over an income year. The amount of any decrease in the value of these amounts over an income year is included in assessable income.

1.158 The basis for working out the value of the unearned premium reserve and the value of the outstanding claims liabilities under the income tax law is different to the basis for working out those amounts under the accounting standards. In particular, there are differences between the income tax treatment and the accounting treatment of:

- deferred acquisition costs — that is, certain costs incurred by a general insurance company in an income year in connection with issuing insurance policies that relate to benefits that are received by the company in a later income year;
- deferred reinsurance expenses — that is, certain reinsurance expenses incurred by a general insurance company in an income year in connection with reinsurance policies that relate to benefits that are received by the company in a later income year; and
- recoveries receivable — that is, amounts expected to be received under reinsurance policies and from other sources in relation to claims that have been incurred.

1.159 The differences between the income tax treatment and the accounting treatment of deferred acquisition costs, deferred reinsurance expenses and recoveries receivable cause distortions to arise under the tax cost setting rules.

1.160 To remove these distortions, the tax cost setting rules will be modified where a general insurance company joins or leaves a consolidated group and brings or takes with it:

- deferred acquisition costs in relation to the company's unearned premium reserve;
- deferred reinsurance expenses in relation to the company's unearned premium reserve; and
- recoveries receivable in relation to the company's outstanding claims.

[Schedule 1, item 92, subsections 713-725(1) and (4)]

1.161 If a general insurance company joins a consolidated group:

- the step 2 amount of the allocable cost amount for the joining entity is reduced by the amount of the deferred acquisition costs, deferred reinsurance expenses and recoveries receivable; and
- the deferred acquisition costs, deferred reinsurance expenses and recoveries receivable are taken to have a market value of zero for the purposes of working out their tax cost setting amount under section 705-35 — as a result, they will have a tax cost setting amount of nil.

[Schedule 1, item 92, subsection 713-725(2)]

1.162 If a general insurance company leaves a consolidated group:

- the step 4 amount of the old group's allocable cost amount for the leaving entity is reduced by the amount of the deferred acquisition costs, deferred reinsurance expenses and recoveries receivable; and
- the deferred acquisition costs, deferred reinsurance expenses and recoveries receivable are taken to have a terminating value of zero for the purposes of working out step 1 of the old group's allocable cost amount under section 711-25.

[Schedule 1, item 92, subsection 713-725(3)]

Retained cost base assets

1.163 Under the tax cost setting rules, the cost of some assets is set at an amount that is equal to the joining entity's cost of those assets. These assets are known as retained cost base assets (as distinct from reset cost base assets) and include, among other things:

- Australian currency; and
- a right to receive a specified amount of Australian currency (such as a bank deposit).

1.164 The amendments will ensure that retained cost base assets include:

- units in cash management trusts; and
- certain rights to future income.

Part 11 — Cash management trusts

1.165 Currently units held by a joining entity in a cash management trust are reset cost base assets. This causes undue compliance costs to arise where the cash management trust is effectively used like a bank account to meet day to day business needs. For example, a capital gain or capital loss will arise whenever an amount is withdrawn from the cash management trust.

1.166 Therefore, to reduce compliance costs, a unit in a cash management trust will be a retained cost base asset if the redemption value of the unit is expressed in Australian dollars and that redemption value cannot increase. ***[Schedule 1, item 95, paragraph 705-25(5)(ba)]***

1.167 The tax cost setting amount for a unit in a cash management trust that is a retained cost base asset is generally equal to the amount of Australian currency concerned – that is, the face value of the unit. ***[Schedule 1, item 94, subsection 705-25(2)]***

1.168 A ***cash management trust*** is a trust of a kind that is commonly known as a cash management trust where all the units in the trust have the same rights and either:

- the assets of the trust are Australian currency or a right to receive an amount of Australian currency; or
- the assets of the trust are predominantly, by value, Australian currency or a right to receive an amount of Australian currency.

[Schedule 1, item 96, the definition of 'cash management trust' in subsection 995-1(1)]

Part 11 — Rights to future income

1.169 Rights to future income (such as work in progress) held by a joining entity are reset cost base assets. This is appropriate if the joining entity was acquired by the head company prior to the joining time and had the rights to future income at the time of acquisition. In these circumstances, the amount paid by the head company to acquire the joining entity would reflect the value of the rights to future income at that time.

1.170 However, distortions can arise under the tax cost setting rules if rights to future income are owned by the group before the joining time and accrue to the head company.

1.171 To overcome these distortions, rights to future income held by a joining entity that accrue to the head company will be treated as retained cost base assets.

1.172 That is, a right to receive a payment in respect of work (but not goods) will be a retained cost base asset where:

- the work has not been performed to a stage where a recoverable debt has arisen;
- it is reasonable to expect that a recoverable debt will arise in respect of the right; and
- at the time the right was created:
  - the head company was the head company of a consolidatable group; and
  - the joining entity was a subsidiary member of a consolidatable group.

[Schedule 1, items 98 and 99, paragraph 705-25(5)(d)]

1.173 In addition, a right to receive a payment under a contract for the sale of goods (other than trading stock) will be a retained cost base asset where:

- the contract has not been completed to a stage where a recoverable debt has arisen;
- it is reasonable to expect that a recoverable debt will arise in respect of the right; and
- at the time the right was created:
  - the head company was the head company of a consolidatable group; and
  - the joining entity was a subsidiary member of a consolidatable group.

[Schedule 1, item 99, paragraph 705-25(5)(e)]

1.174 If an asset is a retained cost base asset that is covered by paragraph 705-25(5)(d) or (e), the asset's tax cost setting amount will be equal to the joining entity's terminating value for the asset. ***[Schedule 1, item 97, subsection 705-25(4B)]***

1.175 The asset's terminating value will generally be the amount that would be the asset's cost base just before the joining time if the asset were a CGT asset (subsection 705-30(5). In most cases, the terminating value of rights to future income held by a joining entity that accrue to the head company will be nil.

Example 1.18 Long-term construction contract

Head Co acquired all the membership interests in Company J on 1 July 1999.

On 15 January 2002, Company J entered into a long term construction contract with a third party.

Head Co formed a consolidated group on the 1 July 2003. Company J became a subsidiary member of the group. At that time, Company J has partially performed work under the construction contract that has not yet been completed to a stage where a recoverable debt has arisen.

Company J estimates the amount of income partly earned under the contract to be $25,000.

The contract will be a retained cost base asset because:

- it is a right to receive a payment in respect or work;
- the work has not yet been performed or completed to a stage where a recoverable debt has arisen;
- it is reasonable to expect that a recoverable debt will arise in relation to the debt; and
- at the time the right was created, Company J was a wholly-owned subsidiary of Head Co.

The tax cost setting amount for the bundle of rights that make up the contract is equal to Company J's terminating value for the asset, being its cost base just before the joining time. As the asset has a nil cost base at this time, the tax cost setting amount of the contract is nil.

Example 1.19: Unbilled income for the supply of gas

Head Co formed a consolidated group on the 1 July 2002. Company J became a subsidiary member of the group. Company J has been wholly-owned by Head Co since it was incorporated on 1 July 1990.

Company J carries on the business of supplying gas to its customers (being both domestic and commercial gas consumers) in circumstances similar to those considered in *FC of T v Australasian Gas Light Co* 83 ATC 4800; (1983) 15 ATR 105.

In its profit and loss statement for the income year ended the 30 June 2002, Company J had recorded unbilled gas income of $20 million. Its balance sheet contains an unbilled gas asset of the same amount. The unbilled gas income is recognised as income for accounting purposes. However, it is not yet been recognised as assessable income for income tax purposes in accordance with Taxation Ruling No IT 2095.

The unbilled gas asset of $20 million will be a retained cost base asset because:

- it is a right to receive a payment under a contract for the sale of goods (other than trading stock)
- the contract has not been completed to a stage where a recoverable debt has arisen;
- it is reasonable to expect that a recoverable debt will arise in relation to the right; and
- at the time the right was created, Company J was a wholly-owned subsidiary of Head Co.

The tax cost setting amount for the unbilled gas asset is equal to Company J's termination value for the asset, being its cost base just before the joining time. As the asset has a nil cost base at this time, the tax cost setting amount of the asset is nil.

Part 12 — Application of losses with a nil available fraction

1.176 When an entity joins a consolidated group any tax losses and net capital losses of the joining entity are transferred to the head company of the group, provided certain transfer tests are satisfied (Subdivision 707-A).

1.177 Transferred losses are given an available fraction that represents the joining entity's market value in proportion to the market value of the group as a whole (section 707-320). The available fraction limits the rate at which transferred losses can be used by the group. The objective is to ensure that the group cannot use the losses at a substantially faster rate than the joining entity could if it had not joined the group.

1.178 If the value of an entity's liabilities exceeds the value of its assets at the time it joins a consolidated group (that is, it has a market value of nil), any losses of the entity that are transferred to the head company of the group will have an available fraction of nil. Consequently, assuming that no transitional concessions apply, the losses can never be used by the group.

1.179 Concerns have been raised that inequitable outcomes arise in respect of a transferred loss with a nil available fraction where the loss is wholly or partly attributable to:

- a debt that is forgiven after the joining time, resulting in the head company being subject to the commercial debt forgiveness rules (Division 245 in Schedule 2C to the ITAA 1936);
- a debt that is terminated after the joining time, resulting in the head company being subject to the limited recourse debt rules (Division 243); or
- a liability that is taken by an entity which leaves the group, resulting in the head company making a capital gain because CGT event L5 (section 104-520) happens.

1.180 To overcome these concerns, the operation of the commercial debt forgiveness rules, the limited recourse debt rules and CGT event L5 will be modified if:

- an entity becomes a subsidiary member of a consolidated group;
- a tax loss or net capital loss was transferred from the joining entity to the head company of the group at the joining time under Subdivision 707-A; and
- the loss is in a bundle of losses for which the available fraction is nil.

[Schedule 1, item 104, subsection 707-415(1)]

1.181 In these circumstances, subject to certain conditions, the head company can choose to apply the loss to, broadly:

- reduce the net forgiven amount under the commercial debt forgiveness rules;
- reduce the capital allowance adjustment under the limited recourse debt rules; or
- reduce the capital gain that arises under CGT event L5 when the joining entity subsequently leaves the group.

[Schedule 1, item 104, subsection 707-415(2)]

1.182 However, the loss can be applied to reduce the net forgiven amount, capital allowance adjustment or capital gain in relation to an income year only to the extent that the loss could be utilised by the head company for the income year on the assumption that the available fraction for the bundle of losses was one. ***[Schedule 1, item 104, subsection 707-415(3)]***

1.183 In addition, a loss can be applied to reduce the net forgiven amount, capital allowance adjustment or capital gain only to the extent that it has not already been applied. ***[Schedule 1, item 104, subsection 707-415(7)]***

Applying the loss under the commercial debt forgiveness rules

1.184 The head company can choose to apply the loss under the commercial debt forgiveness rules if:

- the joining entity owed a debt just before the joining time to an entity that was not a member of the group at that time;
- the loss is wholly or partly attributable to the debt; and
- Subdivision 245-E in Schedule 2C to the ITAA 1936 (which outlines how the total net forgiven amount is applied) applies in relation to the debt (or another debt that is reasonably connected to the debt) because the debt is forgiven after the joining time.

[Schedule 1, item 104, item 1 of the table in subsection 707-415(2)]

1.185 In these circumstances, the head company can choose to apply the loss to reduce the total net forgiven amount mentioned in subsection 245-105(1) for the purposes of applying that total net forgiven amount to:

- reduce deductible revenue losses in accordance with subsection 245-105(5);
- reduce deductible net capital losses in accordance with subsection 245-105(6);
- reduce deductible expenditures in accordance with subsection 245-105(7); and
- reduce relevant cost bases of certain assets in accordance with subsection 245-105(8).

[Schedule 1, item 104, item 1 of the table in subsection 707-415(2)]

1.186 However, the amount of the loss that can be applied to reduce the total net forgiven amount cannot exceed the gross forgiven amount (within the meaning of section 245-75) of the debt to which the loss was attributable. ***[Schedule 1, item 104, subsection 707-415(4)]***

Applying the loss under the limited recourse debt rules

1.187 The head company can choose to apply the loss under the limited recourse debt rules if:

- the joining entity owed a limited recourse debt just before the joining time to an entity that was not a member of the group at that time;
- the limited recourse debt rules apply in relation to the debt; and
- the loss is wholly or partly attributable to a deduction mentioned in paragraph 243-15(1)(c) for an income year ending before the joining time – that is, the loss is wholly or partly attributable to, broadly, a capital allowance deduction in respect of finance expenditure, refinance expenditure or financed property.

[Schedule 1, item 104, item 2 of the table in subsection 707-415(2)]

1.188 In these circumstances, the head company can choose to apply the loss to reduce the deduction mentioned in paragraph 243-15(1)(c) for the purposes of working out whether the capital allowance deductions are excessive under subsection 243-35(1). ***[Schedule 1, item 104, item 2 of the table in subsection 707-415(2)]***

1.189 However, the amount of the loss that can be applied to reduce the deduction mentioned in paragraph 243-15(1)(c) cannot exceed the amount of the loss that is attributable to the deduction. ***[Schedule 1, item 104, subsection 707-415(5)]***

Applying the loss to reduce the CGT event L5 capital gain

1.190 The head company can choose to apply the loss to reduce the capital gain arising under CGT event L5 if:

- the joining entity ceases to be a subsidiary member of the group after the joining time; and

- the entity's liabilities at the leaving time are the same as, or are reasonably connected to, the liabilities that it had at the joining time.

[Schedule 1, item 104, item 3 of the table in subsection 707-415(2)]

1.191 In these circumstances, the head company can choose to apply the loss to reduce the amount remaining after applying step 4 of the table in subsection 711-20(1) for the purposes of working out whether CGT event L5 happens at the leaving time and, if so, the amount of any capital gain arising under CGT event L5. ***[Schedule 1, item 104, item 3 of the table in subsection 707-415(2)]***

1.192 However, the amount of the loss that can be applied to reduce any capital gain arising under CGT event L5 cannot exceed the amount of the capital gain – that is, the loss cannot be applied so that a capital loss arises under CGT event L5. ***[Schedule 1, item 104, subsection 707-415(6)]***

Consequential amendments

1.193 Consequential amendments will insert notes into the commercial debt forgiveness rules, the limited recourse debt rules and CGT event L5 to refer to the adjustments made by section 707-415. ***[Schedule 1, items 101, 102 and 103, subsections 104-520(3) and 243-35(2) of the ITAA 1997 and subsection 245-105(1) in Schedule 2C to the ITAA 1936]***

CGT event L7

1.194 CGT event L7 (section 104-30) happens when:

- a liability that was taken into account in working out the allocable cost amount for a subsidiary member at the joining time is discharged for a different amount; and
- the allocable cost amount would have been different if the discharged amount was used at the joining time.

1.195 A capital gain arises under CGT event L7 if the amount of the liability ultimately discharged (the realised amount) is less than the amount taken into account at the joining time. A capital loss arises if the realised amount is greater than the amount taken into account at the joining time.

1.196 The amendments will:

- remove the potential for double taxation, or a double taxation benefit, to arise where CGT event L7 happens; and

- repeal CGT event L7 from 8 May 2007.

Part 13 — No double counting

1.197 Concerns have been raised that CGT event L7 results in double taxation because, in some circumstances, the difference between the realised amount and the amount taken into account at the joining time is included in assessable income or allowed as a deduction under other provisions of the income tax law.

1.198 To alleviate these concerns, a capital gain or capital loss that arises under CGT event L7 will be reduced to the extent that the difference between the realised amount and the amount taken into account in working out the allocable cost amount at the joining time has been or will be taken into account (directly or indirectly) in working out the amount included in taxable income, or the amount of a tax loss, in any income year. ***[Schedule 1, item 106, subsection 104-530(6)]***

Example 1.20: Reducing a CGT event L7 capital gain

Company J is a general insurance company. Head Co acquires all of Company J's membership interests. Consequently, Company J joins Head Co's consolidated group.

The value of Company J's outstanding claims liabilities at the joining time is $150 million. Under the tax cost setting rules, this amount included in step 2 of the allocable cost amount in respect of the outstanding claims liabilities.

The insurance claims in relation to Company J's liabilities that it held at the joining time were eventually settled in the 2005-06 income year for $136 million.

If $136 million (rather than $150 million) had been included in step 2 of the allocable cost amount in respect of the outstanding claims liabilities at the joining time, the allocable cost amount would have been $14 million smaller. Therefore, Head Co will make a capital gain under CGT event L7 in the 2005-06 income year equal to the $14 million difference.

However, Head Co includes the reduction in the outstanding claims of $150 million is assessable income (section 321-10 of Schedule 2J to the ITAA 1936) and deducts $136 million for claims paid (section 321-25 of Schedule 2J to the ITAA 1936). Therefore, the $14 million is already included in the Head Co's taxable income.

Consequently, the capital gain arising under CGT event L7 will be reduced by $14 million to nil.

Part 14 — Removal of CGT event L7 from 8 May 2007

1.199 The value of liabilities that is used for tax cost setting purposes is generally the accounting value of those liabilities at the joining time (section 705-70).

1.200 The circumstances in which liabilities are discharged for an amount that is different to the accounting value at the joining time are generally limited to long standing provisions for liabilities that are contingent on future events (such as general insurance policy liabilities, life insurance policy liabilities, warranties and provisions for long service and annual leave).

1.201 In an arm's length acquisition case, the accounting value of the liabilities at the joining time genuinely reflects the value of those liabilities at that time — that is, it is the best estimate of those liabilities at the joining time and is not open to manipulation.

1.202 The introduction of the no double counting rule will limit the circumstances in which a capital gain or capital loss will arise under CGT event L7.

1.203 In addition, the value of long standing liability provisions tends to be calculated on a pooled basis, rather than on an individual basis. Tracking individual liabilities to determine whether the amount included at step 2 of the allocable cost amount for an individual liability exceeded the amount for which the liability was discharged places a significant compliance cost burden on affected groups.

1.204 Therefore, to reduce compliance costs, CGT event L7 (section 104-530) will be repealed with effect from 8 May 2007. ***[Schedule 1, item 109]***

1.205 Consequential amendments will be made to:

- remove references to CGT event L7 in the table of CGT events in section 104-5;
- remove references to CGT event L7 in the table that sets out rules about the cost base and reduced cost base of a CGT asset I section 110-10; and
- repeal section 701-34 of the *Income Tax (Transitional Provisions) Act 1997* (which provides that CGT event L7 does not happen in respect of certain liabilities).

[Schedule 1, items 108, 110 and 111, sections 104-5, 110-10 and 701-34]

Part 15 — Doubtful debts and CGT event L3

1.206 A capital gain arises under CGT event L3 if the total tax cost setting amounts for all retained cost base assets exceed the joining entity's allocable cost amount (section 104-510). A capital loss cannot arise under CGT event L3.

1.207 Impaired debts qualify as retained cost base assets because they are a right to receive a specified amount of Australian currency. The tax cost setting amount of impaired debts is the face value of those debts at the joining time.

1.208 However, the face value of the debt is likely to be higher than the amount that could be recovered under the debt (that is, the market value of the debt). Therefore, the amount taken into account in working out the capital gain under CGT event L3 does not reflect the amount of the debt that is likely to be recovered. Consequently, the capital gain arising under CGT event L3 is overstated.

1.209 To overcome this concern, the tax cost setting amount of an asset of a joining entity will be reduced if:

- the asset is a retained cost base that is a right to receive a specified amount of Australian currency covered by paragraph 705-25(5)(b);
- the market value of the asset is less than the tax cost setting amount of the asset – the tax cost setting amount is the amount of Australian currency concerned;
- the head company makes a capital gain under CGT event L3 (ignoring this modification) as a result of the joining entity becoming a subsidiary member of the group; and
- if the asset is an intra-group asset of the consolidated group, the joining entity has not been entitled to a deduction for an income year ending on or before the joining time because the market value of the asset is less than the specified amount of Australian currency.

[Schedule 1, item 113, subsection 705-27(1)]

1.210 Where an asset satisfies these conditions, the tax cost setting amount of the asset will be reduced by the amount of the capital gain arising under CGT event L3, but not below zero. As the tax cost setting amount of the asset is reduced, the capital gain arising under CGT event L3 will also be reduced by an equivalent amount (paragraph 104-510(1)(b)). ***[Schedule 1, item 113, subsection 705-27(1)]***

1.211 An ***intra-group asset*** of a consolidated group means an asset in respect of which the requirements in subsection 701-58(1) are satisfied. Those requirements are, broadly:

- the tax cost of the asset was set at the joining time because an entity became a subsidiary member of the group;
- ignoring the operation of the single entity rule (subsection 701-1(1)), the entity held the asset at the joining time; and
- taking into account the operation of the single entity rule, the head company of the group did not hold the asset at the joining time.

[Schedule 1, item 115, the definition of 'intra-group asset' in subsection 995-1(1)]

1.212 If the tax cost setting amount of two or more of the joining entity's assets could be reduced under subsection 705-27(1), a reduction is made sequentially to the tax cost setting amounts of each of those assets. ***[Schedule 1, item 113, paragraph 705-27(2)(a)]***

1.213 The head company can choose the sequence of assets to which the reduction applies. However, if the head company does not make such a choice, the reduction applies sequentially to each of the assets according to the time at which they were created, from the earliest to the latest. ***[Schedule 1, item 113, paragraphs 705-27(2)(b) and (c)]***

1.214 The head company's choice must be made by the day on which the head company lodges its income tax return for the income year in which the CGT event happened or within a further time allowed by the Commissioner. The way that the head company prepares its income tax return is sufficient evidence of the making of the choice. ***[Schedule 1, item 113, subsections 705-27(3) and (4)]***

1.215 However, once the amount of the capital gain arising under CGT event L3 is reduced to nil, no further reductions of the tax cost setting amount can be made.

1.216 As a result of these changes, paragraph 705-35(1)(b) is modified to remove a reference to section 705-25. ***[Schedule 1, item 114, paragraph 705-35(1)(b)]***

Part 16 — Blackhole expenditure for MEC groups

1.217 In this Part, references to a consolidated group do not include a MEC group.

1.218 A capital gain arises if, broadly, the capital proceeds received by a taxpayer when a CGT event happens to a CGT asset exceed the cost base of that asset.

1.219 The cost base of a CGT asset consists of five elements. One of those elements is incidental costs incurred by the taxpayer (section 110-35). The ninth category of incidental costs is expenditure that:

- is incurred by the head company of a consolidated group to an entity that is not a member of the group;
- reasonably relates to a CGT asset held by the head company; and
- is incurred because of a transaction between members of the group.

1.220 The ninth category of incidental costs was inserted into the income tax law with effect from 1 July 2005 as part of the blackhole expenditure amendments to ensure the head company of a consolidated group gets appropriate tax recognition for costs paid to third parties in respect of intra-group transactions affecting CGT assets held by the group.

1.221 A technical amendment will ensure that consistent treatment applies to the head company of a MEC group that pays costs to third parties in respect of intra-group transactions affecting CGT assets held by the group. ***[Schedule 1, item 117, paragraph 110-35(10)(a)]***

Part 17 — Transitional rules for groups with substituted accounting periods

1.222 As a transitional concession, the allocable cost amount of a joining entity could be increased by the undistributed, untaxed profits accrued to the group before 1 July 2003 (former section 701-30 of the *Income Tax (Transitional Provisions) Act 1997*). This concession provided groups with an outcome that could be achieved through the payment of an unfranked dividend to the head company prior to the removal of the inter-corporate dividend rebate.

1.223 This transitional concession applied to:

- a consolidated group that came into existence before 1 July 2003; or
- a consolidated group that came into existence between 1 July 2003 and 30 June 2004, but only if it came into existence on the first day of the income year of the head company starting after 30 June 2003.

1.224 The transitional concession will be modified so that, where a consolidated group came into existence between 1 July 2003 and 30 June 2004, the concession applies only if the group came into existence on or before the first day of the income year of the head company starting after 30 June 2003. ***[Schedule 1, items 119 and 120, subsection 701-30(1) of the Income Tax (Transitional Provisions) Act 1997]***

1.225 Therefore, if the head company of a consolidated group had a substituted accounting period that ended, for example, on 31 March 2004, a joining entity can access the transitional concession provided the group came into existence on or before 31 March 2004.

Part 18 — Loss multiplication rules for widely held companies

1.226 If one or more entities are interposed between individual shareholders and a company with realised or unrealised losses (a loss company), the company's losses could be reflected in the value of shares and loans held between such entities (inter-entity interests) when they are sold or otherwise realised.

1.227 The inter-entity loss multiplication rules in Subdivision 165-CD ensure that the economic losses of companies do not get inappropriate multiple tax recognition when inter-entity interests are sold or otherwise realised. Section 165-115K provides that the inter-entity loss multiplication rules apply where, broadly:

- an alteration time happens in respect of a loss company; and
- an entity has relevant equity interests or relevant debt interests in the loss company immediately before the alteration time.

1.228 Section 165-115X provides that an entity (other than an individual) has a relevant equity interest in a loss company at a particular time if, broadly:

- the entity has a controlling stake in the loss company; and
- the entity directly or indirectly has interests in the loss company that give it control of, or the ability to control, (either directly or indirectly through interposed entities) 10 per cent or more of the voting power, dividend rights, or capital distribution rights of the loss company.

1.229 However, a company will not have a relevant equity interest if it satisfies the exception in subsection 165-115X(3).

1.230 Similarly, section 165-115Y provides that an entity (other than an individual) has a relevant debt interest in a loss company at a particular time if, broadly, the entity has a controlling stake in the loss company and:

- the entity is owed a debt by the loss company of not less than $10,000; or
- the entity is owed a debt by an entity (the debtor entity) other than the loss company of not less than $10,000 where the debtor entity has a relevant equity interest or relevant debt interest in the loss company.

1.231 However, a company will not have a relevant debt interest if it satisfies the exception in subsection 165-115Y(4).

1.232 Widely held companies have difficulty in satisfying the exceptions in subsections 165-115X(3) and 165-115Y(4). As a result, in some circumstances the losses of a loss company receive no tax recognition at all.

1.233 To address these concerns, the inter-entity loss multiplication rules will be modified to make it easier for widely held companies to claim capital losses or deductions on the disposal of direct and indirect interests in loss companies. These modifications will significantly reduce compliance costs for widely held companies.

1.234 A ‘widely held company’ is defined in subsection 995-1(1) to mean, broadly:

- a company whose shares are listed for quotation in the official list of an approved stock exchange; or
- a company that has more than 50 members, unless no more than 20 persons had rights to at least 75 per cent of the value of the shares in the company or at least 75 per cent of the voting power or dividend rights of the company.

Circumstances in which a widely held company will have a relevant equity interest

1.235 For the purpose of applying the inter-entity loss multiplication rules, a widely held company will not have a relevant equity interest in a loss company at a particular time unless an entity has a controlling stake in the loss company and that entity has a direct or indirect interest in, or is owed a debt by, the widely held company in respect of which:

- the entity could, if a CGT event happened in respect of the interest or debt, make a capital loss (other than a capital loss that would be disregarded) that reflects any part of the loss company’s overall loss; or
- the entity has deducted or can deduct, or could deduct at a later time, an amount in respect of the cost of the acquisition, or a net loss on the disposal, of the interest or debt, where the deduction reflected or would have reflected, or would reflect, any part of the loss company’s overall loss.

[Schedule 1, item 121, subsections 165-115X(2A) and (2B)]

1.236 However, subsection 165-115X(2A) will not apply to a widely held company in respect of a particular time if an entity that had a direct or indirect interest in, or was owed a debt by, the widely held company at an earlier time, and had a controlling stake in the loss company at that earlier time:

- made a capital loss (other than a capital loss that was disregarded) because a CGT event happened in respect of the interest or debt, where the capital loss reflected any part of the loss company’s overall loss; or

- has deducted or could have deducted at an earlier time, or could deduct at a later time, an amount in respect of the cost of the acquisition, or a net loss on the disposal, of the interest or debt, where the deduction reflected or would have reflected, or would reflect, any part of the loss company's overall loss.

[Schedule 1, item 121, subsection 165-115X(2C)]

Circumstances in which a widely held company will have a relevant debt interest

1.237 For the purpose of applying the inter-entity loss multiplication rules, a widely held company will not have a relevant debt interest in a loss company at a particular time unless an entity has a controlling stake in the loss company and that entity has a direct or indirect interest in, or is owed a debt by, the widely held company in respect of which:

- the entity could, if a CGT event happened in respect of the interest or debt, make a capital loss (other than a capital loss that would be disregarded) that reflects any part of the loss company's overall loss; or

- the entity has deducted or can deduct, or could deduct at a later time, an amount in respect of the cost of the acquisition, or a net loss on the disposal, of the interest or debt, where the deduction reflected or would have reflected, or would reflect, any part of the loss company's overall loss.

[Schedule 1, item 124, subsections 165-115Y(3A) and (3B)]

1.238 However, subsection 165-115Y(3A) will not apply to a widely held company in respect of a particular time if an entity that had a direct or indirect interest in, or was owed a debt by, the widely held company at an earlier time, and had a controlling stake in the loss company at that earlier time:

- made a capital loss (other than a capital loss that was disregarded) because a CGT event happened in respect of the interest or debt, where the capital loss reflected any part of the loss company's overall loss; or

- has deducted or could have deducted at an earlier time, or could deduct at a later time, an amount in respect of the cost of the acquisition, or a net loss on the disposal, of the interest or debt, where the deduction reflected or would have reflected, or would reflect, any part of the loss company's overall loss.

[Schedule 1, item 124, subsection 165-115Y(3C)]

Consequential amendments

1.239 Consequential amendments will clarify that:

- subsections 165-115X(3) and (4), which exclude certain interests from being relevant equity interests, do not apply to widely held companies;
- subsections 165-115Y(4) and (5), which exclude certain interests from being relevant debt interests, do not apply to widely held companies;
- the consequences which arise under section 715-255 when a loss company leaves a consolidated group apply only if the head company has a relevant equity interest under section 165-115X in the leaving entity at the leaving time; and
- the consequences which arise under section 715-270 when a trust that is taken to be a loss company leaves a consolidated group apply only if the head company has a relevant equity interest under section 165-115X in the leaving entity at the leaving time.

[Schedule 1, items 122, 123, 125, 126, 127 and 128, subsections 165-115X(3A) and (4), subsections 165-115Y(4A) and (5), paragraph 715-255(1)(ba) and subsection 715-270(5)]

Application and transitional provisions

1.240 Many of the announced measures are proposed to apply from 1 July 2002 (the commencement of the consolidation regime). Others are proposed to apply from the date of the relevant announcement.

1.241 Several submissions have been received seeking variations to the proposed application dates for a number of the measures. The proposed application dates will be reviewed in the light of those submissions as part of the completion of these amendments.

Measures announced to apply from 1 July 2002

1.242 The measures which apply from 1 July 2002 (that is, from the commencement of the consolidation regime) are the measures to:

- ensure the tax cost setting amount allocated to a joining entity's assets is used for the purposes of applying other provisions of the income tax law;
- modify the circumstances in which a company is eligible to be appointed as the provisional head company of a MEC group;
- improve the treatment of pre-CGT membership interests of a joining entity;
- clarify and improve the operation of various aspects of the tax cost setting rules that apply when an entity joins or leaves a consolidated group (other than the measure to phase out the over-depreciation adjustment to the allocable cost amount);
- treat units held in cash management trusts and certain rights to future income as retained cost base assets;
- ensure losses transferred to the head company by a joining entity that is insolvent at the joining time can be used by the head company in certain circumstances;
- remove the potential for double taxation, or a double taxation benefit, to arise where CGT event L7 happens;
- modify the operation of the loss multiplication rules for widely held companies; and
- ensure certain consolidation transitional rules apply to the head company of a group which has a substituted accounting period where the group consolidated after 30 June 2003 on a day prior to the first day of its income year.

[Schedule 1, items 4, 31, 33, 50, 62, 86, 91, 93, 100, 105, 107 and 129]

Measures announced to apply from 1 July 2005

1.243 The measure to ensure that the blackhole expenditure provisions that apply to consolidated groups also apply to MEC groups applies from 1 July 2005 (that is, from the commencement of the blackhole expenditure provisions). ***[Schedule 1, item 118]***

Measures announced to apply from 27 October 2006

1.244 The measure to allow consolidated groups to convert to MEC groups, and vice versa, with minimal tax consequences (other than the modification to the circumstances in which a company is eligible to be appointed as the provisional head company of a MEC group) applies to conversion events which happen on or after 27 October 2006 (that is, from the date of announcement). ***[Schedule 1, item 13]***

Measures announced to apply from 8 May 2007

1.245 The measures which apply from 8 May 2007 (that is, from the date of announcement) are the measures to:

- phase out the over-depreciation adjustment to the allocable cost amount;
- repeal CGT event L7; and
- reduce the capital gain that arises under CGT event L3 where a joining entity has impaired debts at the joining time.

[Schedule 1, items 52, 112 and 116]

Amendment of assessments

1.246 Generally, the Commissioner of Taxation can amend an assessment of a company, other than a small business entity, within four years from the date of the notice of assessment (section 170 of the ITAA 1936.

1.247 As a number of these amendments apply from 1 July 2002, the period for amending assessments will be extended. That is, the operation of section 170 will be modified so that it does not prevent the amendment of an assessment if:

- the assessment was made before the commencement of Schedule 1;

- the amendment is made within four years after that date; and
- the amendment is made for the purpose of giving effect to the amendments in Schedule 1.

[Section 4]