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EXPOSURE DRAFT

TOFA AND CONSOLIDATION

EXPLANATORY MATERIAL

(Circulated by the authority of the
Deputy Prime Minister and Treasurer, the Hon Wayne Swan MP)

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Chapter 1 Consolidation

Outline of chapter

1.1 Schedule 1 to this exposure draft amends the *Income Tax Assessment Act 1997* (ITAA 1997) to modify the consolidation tax cost setting and rights to future income rules and to make the tax outcomes for consolidated groups more consistent with the tax outcomes that arise when assets are acquired outside the consolidation regime.

Context of amendments

1.2 The consolidation regime aims to reduce tax compliance costs and improve the integrity of the income tax system by allowing a group of corporate entities the choice to lodge a single income tax return if, broadly, they are all wholly owned by an Australian resident company. The head company lodges the income tax return for the group, while the subsidiaries lose their individual income tax identities.

1.3 When a company acquires an asset, the cost of the asset can be recognised in different ways under the income tax law. When and how the cost is used will depend on the nature of the asset and the circumstances in which it is acquired. For example:

- in the case of a depreciating asset, the tax cost is deducted over the life of the asset;
- in the case of a capital gains tax (CGT) asset, the tax cost is recognised when the asset is sold (or when another CGT event happens to the asset);
- in the case of some other assets, the tax cost may be recognised when the asset is acquired, as income is derived from the asset, or when the asset is sold (depending on circumstances).

1.4 When a consolidated group acquires a company, the shares in the acquired company cease to be recognised for taxation purposes and the company's assets effectively become assets of the head company.

1.5 The tax costs of those assets are reset at an amount that reflects their respective share of the group's cost of acquiring the joining company (based on the relative market values of those assets). However, some specified assets (such as cash) retain their original tax cost.

1.6 A specific provision in the income tax law (section 701-55 of the ITAA 1997) deals with how the reset tax cost for an asset is used when applying other provisions of the income tax law to that asset. If a provision in the income tax law that is not specifically mentioned in that provision applies to the asset, the residual tax cost setting rule (subsection 701-55(6)) applies to specify the use of the reset tax cost.

1.7 Amendments to the consolidation regime made by the *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (the 2010 amendments) broadened the scope of the residual tax cost setting rule and introduced the rights to future income rule (subsection 701-55(5C)). Those amendments sought to remove uncertainty in the law by clarifying that, for some assets, the reset tax cost of the asset (rather than its original tax cost) is used when a taxing point later arises for the asset. They also clarified the tax outcomes for assets that are rights to future income (such as an entitlement to unbilled income). The amendments applied from 1 July 2002 as they were thought to be merely returning the regime to its originally stated intent.

1.8 Shortly after passage of those amendments, it became clear that the new rules, combined with Taxation Ruling TR 2004/13 on the meaning of an asset for consolidation purposes and a change to Australian Accounting Standard AASB 138 on intangible assets, could result in the recognition of the tax costs of some assets being brought forward in an unanticipated way.

1.9 For example, issues arose about whether a joining entity's original goodwill asset (which is a CGT asset) could be broken into a range of intangible assets (which have no actual tax cost and are not usually recognised for tax purposes), and whether some depreciating assets and some CGT assets could be reclassified as rights to future income or revenue assets. To the extent that these assets could be successfully identified and reclassified, tax recognition for the reset tax costs would be brought forward. In this way unintended windfalls could arise for some taxpayers.

1.10 Consequently, on 30 March 2011 the then Assistant Treasurer asked the Board of Taxation to examine the operation of the residual tax cost setting and rights to future income rules (see Media Release No. 045).

1.11 The Board of Taxation concluded that the scope of the rules, as enacted, appeared to be broader than was originally intended at the time of

their announcement in 2005. These rules, combined with the effect of other long-standing elements of the consolidation regime, could allow consolidated groups to access deductions that are not available to taxpayers outside the consolidation regime. Consequently, the revenue impact of the rules was likely to be significantly larger than expected.

1.12 These amendments respond to the need to protect a significant amount of revenue that would otherwise be at risk, and to make the tax outcomes for consolidated groups more consistent with those for entities outside consolidation.

Summary of new law

1.13 Schedule 1 to this exposure draft amends the consolidation provisions in the income tax law to modify the consolidation tax cost setting and rights to future income rules and to make the tax outcomes for consolidated groups more consistent with the tax outcomes that arise when assets are acquired outside the consolidation regime.

1.14 The changes affecting a corporate acquisition will depend on the time when the acquisition took place. That is, different changes apply to acquisitions that took place before 12 May 2010 (when the law was passed by both Houses of Parliament), after 30 March 2011 (when the Board of Taxation was asked to review the rules) and the intervening period.

1.15 As the 2010 amendments operated with effect back to 2002, some of the further changes (the pre-rules) also need to operate with effect from that date. These changes prevent the retrospective operation of unintended effects of, and perceived weaknesses in, the law. In particular, the pre-rules, which apply broadly to the period before 12 May 2010, will restore the tax cost setting rules that operated prior to the 2010 amendments (the original tax cost setting rules), with modifications to:

- limit deductions for rights to future income to work in progress (WIP) amount assets — that is, broadly, unbilled income;
- ensure that a deduction is allowed for the reset tax costs for consumable stores; and
- treat certain assets as goodwill.

1.16 The changes for the intervening period (the interim rules) will protect taxpayers who acted on the basis of the current law before the

Board of Taxation review was announced. These rules, which apply broadly to the period between 12 May 2010 and 30 March 2011, will restore the current 2010 residual tax cost setting and rights to future income rules, with modifications to:

- treat certain assets as goodwill;
- ensure that no value is attributed to certain contractual rights to future income; and
- ensure that the reset tax costs for consumable stores are deductible.

1.17 The prospective changes (the prospective rules) primarily implement the recommendations made by the Board of Taxation to improve the operation of the consolidation tax cost setting rules. These changes will increase certainty for taxpayers and make the tax outcomes for consolidated groups more consistent with the tax outcomes that arise when assets are acquired by entities outside the consolidation regime. In particular, the prospective rules, which apply broadly to the period after 30 March 2011, will:

- restrict the operation of the tax cost setting rules to CGT assets;
- apply a business acquisition approach to the residual tax cost setting rule;
- ensure that the reset tax costs for rights to future income that are WIP amount assets and consumable stores are deductible; and
- treat rights to future income, other than WIP amount assets, as retained cost base assets.

Comparison of key features of new law and current law

New law	*Current law*
The changes affecting a corporate acquisition will depend on the time when the acquisition took place. That is, different changes apply to acquisitions that took place before 12 May 2010 (the pre-rules), after 30 March 2011 (the prospective rules) and the intervening period (the interim rules). The pre-rules, which apply broadly to the period before 12 May 2010, will restore the original tax cost setting rules that operated prior to the 2010 amendments, with modifications to: • limit deductions for rights to future income to WIP amount assets; • ensure that a deduction is allowed for the reset tax costs for consumable stores; and • treat certain assets as goodwill. The interim rules, which apply broadly to the period between 12 May 2010 and 30 March 2011, will restore the current 2010 residual tax cost setting and rights to future income rules, with modifications to: • treat certain assets as goodwill; • ensure that no value is attributed to certain contractual rights to future income; and • ensure that the reset tax costs for consumable stores are deductible. The prospective rules, which apply broadly to the period after 30 March 2011, will: • restrict the operation of the tax cost setting rules to CGT assets; • apply a business acquisition approach to the residual tax cost setting rule; • ensure that the reset tax costs for	When a company acquires an asset, the cost of the asset can be recognised in different ways under the income tax law. When and how the cost is recognised will depend on the nature of the asset and the circumstances in which it is acquired. When a consolidated group acquires a company, the shares in the acquired company cease to be recognised for taxation purposes and the company's assets effectively become assets of the head company. The tax costs of those assets are reset at an amount that reflects their respective share of the group's cost of acquiring the joining company. However, some specified assets (such as cash) retain their original tax cost. A specific provision in the income tax law (section 701-55 of the ITAA 1997) deals with how the reset tax cost for an asset is used when applying other provisions of the income tax law to that asset. If the asset is a right to future income, the reset tax cost is deductible over, broadly, the lesser of the period of the relevant contract or 10 years. If the residual tax cost setting rule applies to specify the use of the reset tax cost, other provisions of the income tax law apply to the asset as if the head company had incurred expenditure to acquire the asset at the joining time.

New law	*Current law*
rights to future income that are WIP amount assets and consumable stores are deductible; and • treat rights to future income, other than WIP amount assets, as retained cost base assets.	

Detailed explanation of new law

1.18 The changes affecting a corporate acquisition will depend on the time when the acquisition took place. That is, different changes apply, with certain exceptions, to:

- acquisitions that took place before 12 May 2010 — in this case the pre-rules apply;
- acquisitions that took place between 12 May 2010 and 30 March 2011 — in this case the interim rules apply; and
- acquisitions that took place on or after 31 March 2011 — in this case the prospective rules apply.

1.19 The pre-rules amend the operation of the current law.

1.20 The interim rules amend the operation of the current law as modified by the pre-rules.

1.21 The prospective rules amend the operation of the current law as modified by both the pre-rules and the interim rules.

The pre-rules

1.22 The pre-rules amend the operation of the current law for, broadly, the pre-12 May 2010 period. These amendments:

- restore the original residual tax cost setting rule;
- limit deductions for rights to future income to WIP amount assets;
- ensure that a deduction is allowed for the reset tax costs for consumable stores; and

- treat certain assets as goodwill.

1.23 The objective of the pre-rules is to prevent the retrospective operation of unintended effects of, and perceived weakness in, the 2010 amendments to the law. The pre-rules are necessary to protect a significant amount of revenue that would otherwise be at risk. However, consistent with the announcement for these changes, the pre-rules ensure that consumable stores and work in progress amounts are deductible.

Original residual tax cost setting rule restored

1.24 When an entity joins a consolidated group, the tax costs of its assets are reset under the tax cost setting rules.

1.25 Section 701-55 specifies how the reset tax cost for an asset is used when applying other provisions of the income tax law to that asset. If a provision in the income tax law that is not specifically mentioned in section 701-55 applies to the asset, the residual tax cost setting rule (subsection 701-55(6)) applies to specify the use of the reset tax cost.

1.26 The 2010 amendments to the consolidation regime broadened the scope of the residual tax cost setting rule. The amendments applied from 1 July 2002 as they were thought to be merely returning the regime to its originally stated intent.

1.27 The 2010 amendments have had a broader impact than expected. Therefore, to prevent taxpayers from obtaining a windfall gain from those amendments in the pre-12 May 2010 period, the pre-rules modify the current law to restore the original residual tax cost setting rule. ***[Schedule 1, item 3, subsection 701-55(6)]***

1.28 Consequential amendments modify the heading to section 701-56 and remove subsections 701-56(1) and (2). ***[Schedule 1, items 4 and 5, heading to section 701-56]***

Rights to future income deductions limited to WIP amount assets

1.29 The 2010 amendments to the consolidation regime introduced the rights to future income rules (subsection 701-55(5C) and sections 701-90, 716-405 and 716-410). Those rules allowed consolidated groups to deduct the reset tax cost for a right to future income asset over, broadly, the lesser of the period of the relevant contract or 10 years. The amendments applied from 1 July 2002.

1.30 The 2010 amendments have had a broader impact than expected and unintentionally gave consolidated groups an advantage over other taxpayers. Therefore, to prevent taxpayers from obtaining a windfall gain

from those amendments in the pre-12 May 2010 period, deductions for the reset tax cost for rights to future income will be limited to WIP amount assets. This is consistent with the announcement that led to the 2010 amendments.

1.31 Section 25-95 specifies the circumstances in which taxpayers can deduct work in progress amounts. Where an entity that joins a consolidated group holds a WIP amount asset, section 25-95 will apply as if the head company had paid a work in progress amount for the income year in which the joining time occurs equal to the reset tax cost for the asset. ***[Schedule 1, item 2, subsection 701-55(5C)]***

1.32 A ***WIP amount asset*** is an asset that is in respect of work (but not goods) that has been partially performed by a recipient mentioned in paragraph 25-95(3)(b) for a third party but not yet completed to a stage where a recoverable debt has arisen in respect of the completion of the work. ***[Schedule 1, items 7 and 16, subsection 701-63(5) and the definition of 'WIP amount asset' in subsection 995-1(1)]***

1.33 Consequently, the consolidated group will be able to deduct the reset tax cost for the WIP amount asset under section 25-95.

1.34 If a WIP amount asset is held by an entity that is already owed by the group (that is, in a formation case), the WIP amount asset will be a retained cost base asset, with a tax cost setting amount equal to the joining entity's terminating value for the asset. ***[Schedule 1, item 9, paragraph 705-25(5)(d)]***

1.35 Consequential amendments are made to remove sections 716-405 and 716-410. ***[Schedule 1, items 10 and 11]***

Consumable stores are deductible

1.36 A primary objective of broadening the scope of the residual tax cost setting rule was to ensure that deductions could be claimed under the general deduction provision (section 8-1) for the reset tax costs of consumable stores.

1.37 Therefore, consistent with the announcement that led to the 2010 amendments, the general deduction provision will apply to allow a deduction for the reset tax cost for consumable stores.

1.38 Consequently, when an entity joins a consolidated group holding an asset that is consumable stores, for the purposes of applying the general deduction provision, the head company will be taken to have incurred an outgoing at the joining time in acquiring the asset for an amount equal to the reset tax cost for the asset. ***[Schedule 1, item 2, subsection 701-55(5D)]***

Certain assets treated as goodwill

1.39 For the avoidance of doubt, the pre-rules will treat certain assets as forming part of the goodwill asset of an entity. A goodwill asset is a CGT asset. Taxation Ruling TR 1999/16 outlines how the CGT provisions apply to goodwill assets. Applying that ruling, the tax cost allocated to these assets will be recognised only when, broadly:

- a subsidiary member leaves the group taking the goodwill asset with it;
- the goodwill asset is sold; or
- the goodwill asset ceases to exist.

1.40 For the pre-12 May 2010 period, an asset is treated as forming part of the goodwill asset if the asset is:

- an intangible asset, the value of which is attributable to the expected future profits from life insurance policies or general insurance policies;
- a customer relationship asset, know-how or another accounting intangible asset that is not a CGT asset and is not goodwill; and
- a non-deductible right to future income.

[Schedule 1, items 7 and 12, subsections 701-63(1) and (2), definition of 'asset forming part of goodwill' in subsection 995-1(1)]

1.41 Examples of accounting intangible assets that are treated as forming part of the goodwill asset include:

- customer related intangible assets — such as customer lists, order or production backlogs, and customer relationships;
- marketing related intangible assets — such as unregistered trademarks and trade names; and
- technology based intangible assets — such as databases and trade secrets (such as secret formulas, processes or recipes).

1.42 Under the pre-rules, a ***non-deductible right to future income*** is a right to future income that is not a WIP amount asset. ***[Schedule 1, items 7 and 13, subsection 701-63(3), definition of 'non-deductible right to future income' in subsection 995-1(1)]***

1.43 A ***right to future income*** is a valuable right (including a contingent right) to receive an amount for the performance of work or services or the provision of goods if:

- the valuable right forms part of a contract or agreement;
- the market value of the valuable right (taking into account all the obligations and conditions relating to the right) is greater than nil; and
- the valuable right is not a Division 230 financial arrangement — that is, a financial arrangement taxed under the taxation of financial arrangement rules.

[Schedule 1, items 7 and 14, subsection 701-63(4), definition of 'right to future income' in subsection 995-1(1)]

1.44 The definition of right to future income is substantially the same as the current definition in subsection 701-90(1). Therefore, a consequential amendment is made to remove section 701-90. ***[Schedule 1, item 8]***

Part 2 — Interim rules

1.45 The interim rules amend the operation of the current law as modified by the pre-rules. These rules apply to, broadly, the period between 12 May 2010 and 30 March 2011. These amendments restore the current rights to future income and residual tax cost setting rules. However, modifications are made to:

- treat certain assets as goodwill;
- ensure that no value is attributed to certain contractual rights to future income; and
- ensure that the reset tax costs for consumable stores are deductible.

1.46 The objective of the interim rules is to protect taxpayers who acted on the basis of the 2010 law before the Board of Taxation Review was announced. The modifications address material uncertainties in the operation of the 2010 law, and ensure that the law operates as intended.

Current rights to future income and residual tax cost setting rules restored

1.47 The interim rules restore the current rights to future income and residual tax cost setting rules. That is, the rules restore the following provisions:

- subsections 701-55(5C) and (6);
- subsections 701-56(1) and (2);
- section 701-90 (noting that subsection 701-90(1) has been relocated to subsection 701-63(4));
- paragraph 705-25(5)(d);
- section 716-405;
- section 716-410; and
- the definition of 'unexpended tax cost setting amount' in subsection 995-1(1).

[Schedule 1, items 18 to 21, 24, 26, 27, 29 and 30, subsections 701-55(5C) and (6), subsections 701-56(1) and (2), subsection 701-63(4), section 701-90, paragraph 705-25(5)(d), section 716-405, section 716-410 and the definition of 'unexpended tax cost setting amount' in subsection 995-1(1)]

Certain assets treated as goodwill

1.48 For the avoidance of doubt, the interim rules will treat certain assets as forming part of the goodwill asset of an entity. A goodwill asset is a CGT asset. Taxation Ruling TR 1999/16 outlines how the CGT provisions apply to goodwill assets. Applying that ruling, the tax cost allocated to these assets will be recognised only when, broadly:

- a subsidiary member leaves the group taking the goodwill asset with it;
- the goodwill asset is sold; or
- the goodwill asset ceases to exist.

1.49 For the interim period, an asset is treated as forming part of the goodwill asset if the asset is:

- a customer relationship asset, know-how or another accounting intangible asset that is not a CGT asset and is not goodwill; and
- a non-deductible right to future income.

[Schedule 1, items 7, 12 and 22, subsections 701-63(1) and (2), definition of 'asset forming part of goodwill' in subsection 995-1(1)]

1.50 Under the interim rules, a ***non-deductible right to future income*** is a right to future income that is:

- a right of the entity under a contract or arrangement, to the extent that the value of the right is contingent on the renewal of the contract or arrangement; or
- a right of the entity under a contract or arrangement entered into by the entity with another entity, to the extent that the other entity can unilaterally cancel the contract or arrangement without paying compensation or a penalty.

[Schedule 1, items 13 and 23, subsection 701-63(3) and the definition of 'non-deductible right to future income' in subsection 995-1(1)]

1.51 A right to future income under a contract or arrangement entered into by a joining entity that is contingent on the renewal of the contract or arrangement is uncertain and therefore is a non-deductible right to future income that is treated as goodwill. In this regard, the right is not an existing right to future income but is a mere expectation.

1.52 A right to future income under a contract or arrangement entered into by a joining entity with another entity is uncertain to the extent that the other entity can unilaterally cancel the contract or arrangement without paying compensation or a penalty. To the extent that the right to future income is uncertain, it is a non-deductible right to future income that is treated as goodwill.

1.53 In this regard, a joining entity's right to future income that arises under a contract is certain only to the extent that the other party to the contract has an actual obligation to pay an amount to the joining entity. If, under the terms of the contract, the other party is able to unilaterally cancel the contract immediately without having to pay any compensation or penalty, the joining entity's right to future income that arises under a contract is uncertain.

1.54 The question as to whether an entity can unilaterally cancel a contract or arrangement without paying compensation or a penalty can only be determined as a question of fact having regard to the circumstances of a particular case. However, the following examples illustrate the outcomes that could arise in some typical situations.

Example 1.1

Company A joins Head Co's consolidated group. Company A has entered into a contract with Company B to transport minerals from a mine site to a port. Company B is able to cancel the contract if Company A is unable to fulfil its obligations to transport minerals under the contract for a period of 12 months due to circumstances beyond Company A's control, such as a natural disaster which damages the infrastructure used to transport the minerals.

Company A's right to future income will not be a non-deductible right to future income because Company B can cancel the contract only in extraordinary and unexpected circumstances.

Example 1.2

Company A joins Head Co's consolidated group. Company A has entered into an on-going funds management contract with Company B. Company B is unable to cancel the contract within the first two years. Once those two years have expired, Company B is able to cancel the contract at any time, but must give three months advance notice of its intention to cancel the contract.

Company A's right to future income is effectively guaranteed for the first two years and three months of the contract. Company A's right to future income will be a non-deductible right to future income to the extent that it is not guaranteed.

Example 1.3

Company A joins Head Co's consolidated group. Company A has entered into a contract to provide services to Company B. Company B is unable to cancel the contract within the first two years. Once those two years have expired, Company B is able to cancel the contract at any time, but must pay a fee on the termination of the contract.

Company A's right to future income is effectively guaranteed for the first two years and for the amount of the termination fee.
Company A's right to future income will be a non-deductible right to future income to the extent that it is not guaranteed.

Example 1.4

Company A joins Head Co's consolidated group. Company A has entered into a telecommunications contract with Company B. The contract expires after two years. Once those two years have expired, Company A continues to provide telecommunications services to Company B until Company B cancels the arrangement.

Company A's right to future income is effectively guaranteed for the two year contractual period. Company A's right to future income will be a non-deductible right to future income to the extent that it is not guaranteed.

Example 1.5

Company A joins Head Co's consolidated group. Company A has entered into an on-going funds management contract with Company B. Under the terms of the contract, Company B is able to cancel the contract at any time provided that the cancellation does not cause Company A to breach liquidity requirements imposed by law.

Company A's right to future income will not be a non-deductible right to future income because Company B is unable to unilaterally cancel the contract.

No value is attributed to certain contractual rights to future income

1.55 A second modification to the interim rules is to ensure that no value is attributed to certain rights to future income.

1.56 The modification applies where

- the joining entity holds an asset;
- under the terms of a contract, the joining entity holds a right to future income arising from the asset; and
- the right to future income is not a non-deductible right to future income in relation to the joining entity.

[Schedule 1, item 28, subsection 705-56A(1)]

1.57 In these circumstances, the amount of the reset tax cost for the right to future income will depend on whether or not the market value of the asset at the joining time (disregarding any encumbrances or other claims on the asset) exceeds the sum of:

- the market value of the asset at the joining time; and

- the market value of the right to future income at that time.

[Schedule 1, item 28, subsection 705-56A(2)]

1.58 If the sum of those amounts does exceed the market value of the asset at the joining time (disregarding any encumbrances on the asset), then the market value of the right to future income is taken to be the amount of the excess. ***[Schedule 1, item 28, subsection 705-56A(3)]***

1.59 If the sum of those amounts does not exceed the market value of the asset at the joining time (disregarding any encumbrances on the asset), then:

- the right to future income is not taken into account under the tax cost setting rules; and
- the right to future income's tax cost setting amount is taken to be nil.

[Schedule 1, item 28, subsection 705-56A(4)]

Consumable stores are deductible

1.60 The modification in the pre-rules to ensure that the head company can apply the general deduction provision to deduct the reset tax costs for consumable stores is retained under the interim rules. ***[Schedule 1, item 2, subsection 701-55(5D)]***

Repeal of certain pre-rules

1.61 The pre-rules that apply to WIP amount assets do not apply in the interim period. Therefore, the definition of 'WIP amount asset' is removed under the interim rules. ***[Schedule 1, items 25 and 31]***

Part 3 — Prospective rules

1.62 The prospective rules amend the operation of the current law as modified by both the pre-rules and the interim rules. These rules apply to, broadly, the period after 30 March 2011. These amendments:

- restrict the operation of the tax cost setting rules to CGT assets;
- apply a business acquisition approach to the residual tax cost setting rule;

- ensure that the reset tax costs for rights to future income that are WIP amount assets and consumable stores are deductible; and
- treat rights to future income, other than WIP amount assets, as retained cost base assets.

1.63 The objective of the prospective rules is to increase certainty for taxpayers by making the tax outcomes for consolidated groups more consistent with the tax outcomes that arise when assets are acquired by entities outside the consolidation regime. In this regard:

- by ensuring that tax costs are not allocated to assets that are not ordinarily recognised for taxation purposes, these assets will not be allocated tax costs — this will improve the integrity of the consolidation regime as consolidated groups will not seek to find ways to deduct the tax cost allocated to such assets;
- by applying a business acquisition approach to the residual tax cost setting rule, assets acquired by a consolidated group as a result of acquiring an entity will generally be taken to be on capital account — this will ensure that the tax costs allocated to assets will be recognised only when a CGT event happens to the asset rather than giving rise to immediate revenue deductions;
- by ensuring that the reset tax costs for rights to future income that are WIP amount assets and consumable stores are deductible, consolidated groups will have certainty that revenue deductions can be claimed for these assets; and
- by treating rights to future income (other than WIP amount assets) as retained cost base assets, the consolidation tax cost setting rules will not result in substantial uplifts in the amount of the tax costs for these assets.

Restrict the tax cost setting rules to CGT assets that are recognised for taxation purposes

1.64 Under the prospective rules, the consolidation tax cost setting rules will only apply to things that are CGT assets. ***[Schedule 1, item 42, section 701-67]***

1.65 A 'CGT asset' is defined in subsection 108-5(1) to mean:

- any kind of property; or

- a legal or equitable right that is not property.

1.66 In addition, subsection 108-5(1) clarifies that, for the avoidance of doubt, a CGT asset is specifically taken to include:

- part of, or an interest in, an asset that is property or a legal or equitable right that is not property;
- goodwill or an interest in it;
- an interest in an asset of a partnership; and
- any other interest a partnership.

1.67 Therefore, the definition of CGT asset effectively includes assets that are not taxed under the CGT provisions, including:

- revenue assets;
- depreciating assets;
- trading stock;
- Division 230 financial arrangements;
- assets covered by the foreign currency gains and losses provisions;
- traditional securities; and
- qualifying securities.

1.68 Examples of assets that are not CGT assets include:

- customer related intangible assets — such as customer lists, order or production backlogs, and customer relationships;
- marketing related intangible assets — such as unregistered trademarks and trade names; and
- technology based intangible assets — such as databases and trade secrets (such as secret formulas, processes or recipes).

1.69 As assets which give rise to deductions for business capital expenditure are not CGT assets, a consequential amendment is made to remove the reference to the business capital expenditure provisions in the

list of provisions excluded from the scope of the residual tax cost setting rule. ***[Schedule 1, item 37, paragraph 701-56(3)(d)]***

Apply a business acquisition approach to the residual tax cost setting rule

1.70 Under the prospective rules, for the purpose of applying the residual tax cost setting rule to the assets of an entity that joins a consolidated group, the head company will be taken to have acquired all of the assets of the joining entity as part of acquiring the business of the joining entity as a going concern. ***[Schedule 1, items 34 to 36, subsections 701-56(1), (1A), (1B) and (2)]***

WIP amount assets are deductible

1.71 The modification in the pre-rules to ensure that the head company can apply the general deduction provision to deduct the reset tax costs for WIP amount assets is restored under the prospective rules. ***[Schedule 1, items 33, 38, 40, 41 and 51, subsection 701-55(5C), 701-63(4), 701-63(5) and the definition of 'WIP amount asset' in subsection 995-1(1)]***

Consumable stores deductible

1.72 The modification in the pre-rules to ensure that the head company can apply the general deduction provision to deduct the reset tax costs for consumable stores is retained under the prospective rules. ***[Schedule 1, item 2, subsection 701-55(5D)]***

Rights to future income, other than WIP amount assets, are retained cost base assets

1.73 Under the prospective rules, a right to future income (other than a WIP amount asset) will be a retained cost base asset, with a tax cost setting amount equal to the joining entity's terminating value for the asset. ***[Schedule 1, item 44, paragraph 705-25(5)(d)]***

1.74 Attachment A of the then Assistant Treasurer's Media Release No. 159 of 25 November 2011 specified that the prospective rules will treat other contractual rights to future income (such as a right to income that arises under an insurance contract or a reinsurance contract) as retained cost base assets. The amendments to implement this change are still being considered and are not in the exposure draft legislation.

Removal of interim rules

1.75 Under the prospective rules, specific provisions that applied under the interim rules will be removed. These are:

- the rules to allow a deduction for rights to future income under the interim rules (other than WIP amount assets) — that is, subsections 701-56(1) to (3) and sections 701-90, 716-405 and 716-410; and
- the rules to ensure that no value is attributed to certain rights to future income — that is, section 705-56A.

[Schedule 1, items 39, 43, 45, 46 and 47]

Application and transitional provisions

Application of the pre-rules

1.76 The pre-rules apply to the head company of a consolidated group or multiple entry consolidated group for an income year in respect of an entity that becomes a member of the group if:

- the joining time was before 12 May 2010; or
- the arrangement under which the joining entity joined the group commenced before 10 February 2010.

[Schedule 1, item 52 and subitems 53(1) and (2)]

1.77 However, the pre-rules will not apply if:

- the interim rules apply;
- the arrangement or transaction is covered by a notice of assessment issued before 12 May 2010 that comes within the scope of subitem 53(5); or
- the special rule in item 54 for an arrangement or transaction covered by a private ruling or written advice given by the Commissioner under an Annual Compliance Arrangement applies.

[Schedule 1, item 52 and subitems 53(3) and (5) and 54(2)]

1.78 If an arrangement or transaction is covered by a notice of assessment which was served on the head company by the Commissioner before 12 May 2010, the original 2002 rules will apply to the arrangement or transaction unless:

- the head company requests an amendment and the amendment relates to the application of subsection 701-55(6) of the original 2002 rules in respect of the joining entity; or
- the amendment of the assessment relates to an asset that is a customer relationship asset, know-how or another accounting intangible asset and is inconsistent with the treatment of those assets under the pre-rules.

[Schedule 1, item 52 and subitems 53(5) and (6)]

1.79 Therefore, where an assessment issued before 12 May 2010 based on the law that applied at that time (that is, the original 2002 rules), the assessment will generally be unaffected by the changes made to those original 2002 rules by the pre-rules.

1.80 However, if the head company has claimed, or requests an amendment to claim, a deduction for a WIP amount asset or consumable stores, the pre-rules will apply and the deduction will be allowed.

1.81 In addition, if a deduction for an asset that is a customer relationship asset, know-how or another accounting intangible asset was allowed under an assessment issued to the head company, the Commissioner can amend the assessment and apply the pre-rules to treat the asset as goodwill.

Application of the interim rules

1.82 The interim rules apply to the head company of a consolidated group or multiple entry consolidated group for an income year in respect of an entity that becomes a member of the group if:

- the joining time was before 12 May 2010 and the head company's latest notice of assessment, for an income year, that relates to the application of subsection 701-55(5C) or (6) in respect of the original 2010 rules in respect of the joining entity, was served on the head company by the Commissioner between 12 May 2010 and 30 March 2011; or

- the joining time was on or after 12 May 2010 and the arrangement under which the joining entity joined the group commenced between 10 February 2010 and 30 March 2011.

[Schedule 1, item 52 and subitems 53(1) and (3), item 55]

Application of the prospective rules

1.83 The prospective rules apply to the head company of a consolidated group or multiple entry consolidated group for an income year in respect of an entity that becomes a member of the group if:

- the joining time is on or after 31 March 2011; and
- neither the pre-rules nor the interim rules apply to the arrangement.

[Schedule 1, item 52 and subitems 53(1) and (4)]

Special rule for private rulings

1.84 The amendments will not apply where a claim is covered by:

- a private binding ruling issued before 31 March 2011; or
- written advice given by the Commissioner before 31 March 2011 under an Annual Compliance Arrangement.

[Schedule 1, subitems 54(1) and (2)]

1.85 In these circumstances:

- if the ruling or written advice was issued under the original 2002 rules, those rules will apply to the transaction;
- if the ruling or written advice was issued under the original 2010 rules, those rules will apply to the transaction.

1.86 However, if the head company seeks an amendment in relation to a matter covered by a ruling or written advice, the amendment will be considered having regard to the pre-rules or the interim rules (whichever is relevant). ***[Schedule 1, subitems 54(3)]***

Commencement of an arrangement

1.87 The time that an arrangement is taken to commence is outlined in Table 1.1. ***[Schedule 1, item 55]***

Table 1.1: Commencement of an arrangement

Type of arrangement	***Time that the arrangement commences***
Off-market takeover bid	The day on which the bidder lodged with the Australian Securities and Investments Commission a notice stating that the bidder's statement and offer document have been sent to the target (that is, step 4 in the table in subsection 633(1) of the *Corporations Act 2001* is completed).
On-market takeover bid	The day on which the bidder announced the bid to the relevant financial market (that is, step 2 in the table in subsection 635(1) of the Corporations Act is completed).
Scheme of arrangement	The day on which a company applies for a court order, under subsection 411(1) of the Corporations Act, for a meeting of the company's members, or one or more classes of the company's members, about the arrangement.
Other arrangement	The day on which the decision to enter into the arrangement (including an initial public offering) was made.

No interest payable on income tax refunds or where additional tax becomes payable

1.88 Attachment A of the then Assistant Treasurer's Media Release No. 159 of 25 November 2011 specified that the amendments will ensure that no interest is payable on income tax refunds for the period prior to 12 May 2010 as a result of an amendment to allow a deduction because of the changes to the original 2002 rules. However, the amendments will not apply where the interest has already been paid to taxpayers.

1.89 In addition, no interest or penalties will be payable where additional tax becomes payable because the Commissioner amends an assessment that issued before 31 March 2011, or further amends an amended assessment that issued before that date, to disallow a deduction for a claim under the pre-rules or the interim rules.

1.90 The amendments to implement these changes are still being developed and are not in the exposure draft legislation.

Amendment of assessments

1.91 Generally, the Commissioner 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 *Income Tax Assessment Act 1936*).

1.92 As the pre-rules and the interim rules apply to periods in respect of which the four year amendment period has wholly or partly expired, 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 date of commencement of the amendments (that is the day on which the amendments receive Royal Assent);
- the amendment is made within two years after that date; and
- the amendment is made for the purpose of giving effect to the amendments in Schedule 1.

[Section 4]

Consequential amendments

1.93 Consequential amendments are made to:

- modify the list of provisions about deductions under each of the pre-rules, the interim rules and the prospective rules;
- correct cross references in section 701-58; and
- remove redundant definitions.

[Schedule 1, items 1, 6, 15, 17, 32, 48, 49 and 50, sections 12-5 and 701-58 and subsection 995-1(1)]

Chapter 2
Amendments to the TOFA consolidation interaction provisions

Outline of chapter

2.1 Schedule 2 to this exposure draft amends section 715-375 of the *Income Tax Assessment Act 1997* (ITAA 1997) to ensure that, for consolidated groups applying Division 230 of the ITAA 1997 in relation to their financial arrangements (that is, consolidated groups that are taxpayers who apply Division 230 in relation to their financial arrangements (TOFA taxpayers)), the head company is deemed to have received an amount for assuming an accounting liability that is, or is part, of a financial arrangement as part of a joining/consolidation event, and the amount is deemed to be the accounting liability's accounting value at the joining time.

2.2 Schedule 2 to this exposure draft also amends the transitional provisions in the *Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009* (TOFA Act) to ensure that:

- section 715-375 and subsection 701-55(5A) of the ITAA 1997 (TOFA consolidation interaction provisions) apply to a joining/consolidation event that occurred prior to the consolidated group starting to apply the TOFA provisions in relation to its financial arrangements (pre-TOFA joining) and the head company makes a transitional election to apply the TOFA provisions to its existing financial arrangements;
- the reliance on financial reports method cannot be used to transition existing financial arrangements, acquired/assumed as part of a pre-TOFA joining, into the TOFA regime; and
- for assets acquired as part of a pre-TOFA joining where the head company has made the transitional election, the difference between the tax cost setting amount and the starting value for TOFA purposes is spread over four years from the head company's first TOFA year.

2.3 All references to legislative provisions in this chapter are references to the ITAA 1997 unless otherwise stated.

2.4 In this chapter, an asset refers to an asset that is, or is part of, a financial arrangement, and a liability refers to a liability that is, or is part of, a financial arrangement.

Context of amendments

2.5 The TOFA Act received Royal Assent on 26 March 2009. The TOFA Act inserted Division 230 of the ITAA 1997 and related consequential (including the TOFA consolidation interaction provisions) and transitional amendments into the income tax laws (TOFA provisions). The TOFA provisions represent a major legislative reform to the tax arrangements applying to a complex area of commerce.

2.6 Shortly after their introduction, the Government announced that technical amendments and further integrity measures may be necessary to ensure the law operates as intended (see the then Assistant Treasurer's Media Release No. 43 of 4 September 2009). Several tranches of amendments to the TOFA provisions were announced and/or made following the Government's monitoring of the implementation of the reform, including the then Assistant Treasurer's Media Release No. 43 of 4 September 2009, No. 145 of 29 June 2010 and No. 19 of 29 November 2010. All have applied with retrospective effect from the start of the TOFA provisions.

2.7 The TOFA provisions define what a Division 230 financial arrangement is and provide various tax timing methods to account for the gains and losses from holding and ceasing to hold the financial arrangement for income tax purposes.

2.8 The TOFA consolidation interaction provisions were introduced as part of the TOFA provisions and are intended to ensure appropriate interaction between the TOFA regime and the tax consolidation regime. Specifically, the provisions set out, for the purposes of applying the TOFA provisions (including the balancing adjustment provisions in Subdivision 230-G of the ITAA 1997) to the financial arrangements that the head company acquired or assumed from a joining company, the head company's TOFA starting values for the financial arrangements, which are then used to calculate the TOFA gains or losses from the financial arrangements in the hands of the head company.

2.9 The TOFA provisions generally apply to financial arrangements a TOFA taxpayer starts to have during income years commencing on or after 1 July 2010, unless the taxpayer has elected to have the TOFA provisions apply for income years commencing on or after 1 July 2009.

2.10 However, subitem 104(2) allows a head company to elect to bring its existing financial arrangements (those that it acquired/assumed before it entered the TOFA regime) into the TOFA regime and apply the TOFA provisions to work out the gains and losses from the financial arrangements. This provision is designed to reduce the head company's compliance costs by ensuring that the head company does need to apply two different sets of tax provisions to their financial arrangements.

2.11 If such an election is made, the taxpayer is required to make a transitional balancing adjustment. There are two methods of working out the TOFA transitional balancing adjustments for existing financial arrangements. Subitem 104(13) of Schedule 1 to the TOFA Act provides the primary method (the primary method) which compares the amounts already subject to tax with amounts that would have been brought to account under Division 230 for an existing financial arrangement for the period starting from the time a TOFA taxpayer starts to have the financial arrangement until the time the taxpayer enters into the TOFA regime.

2.12 Subitems 104(14) and (15) of Schedule 1 to the TOFA Act provide an alternative method (the alternative method) for calculating the transitional balancing adjustments using the balances of the deferred tax asset (DTA) and deferred tax liability (DTL) accounts in the head company’s financial reports.

2.13 If the transitional balancing adjustment is positive, a quarter of this amount will be included in the taxpayer’s assessable income for the first income year that Division 230 applies and each of the next three income years. Conversely, if the transitional balancing adjustment is negative, a quarter of this amount may be allowed as a deduction for the first income year that Division 230 applies and each of the next three income years.

2.14 Post enactment consultation with industry and the Australian Taxation Office (ATO) on the TOFA provisions has revealed several technical deficiencies with the current wording of the TOFA consolidation interaction provisions and how they interact with the TOFA transitional balancing adjustment provisions and the balancing adjustment provisions in Subdivision 230-G of the ITAA 1997.

2.15 On 25 November 2011, the then Assistant Treasurer, announced in Attachment B to the Media Release No. 159 of 2011 changes to the TOFA consolidation interaction provisions and the TOFA transitional balancing adjustment provisions to address the deficiencies identified.

Summary of new law

2.16 For liabilities that are subject to the fair value, reliance on financial reports or retranslation tax timing methods, the amendments clarify that the head company of the consolidated group is deemed to have received an amount for assuming the liability that is equal to the liability's accounting value at the joining time.

2.17 For liabilities that are subject to a tax timing method other than the fair value, financial reports or retranslation method, the amendments deem the head company of the consolidated group to have received an amount for assuming the liability at the joining time, and the deemed amount is the liability's accounting value at the joining time applying the joining entity's accounting principles.

2.18 The amendments also ensure that the TOFA transitional balancing adjustment provisions and Subdivision 230-G balancing adjustment provisions operate as intended for existing financial arrangements assumed by the consolidated group as part of a pre-TOFA joining and where the head company has made the transitional election.

2.19 Specifically, the amendments:

- clarify that the TOFA transitional balancing adjustment primary method and Subdivision 230-G balancing adjustment provisions take into account the operation of the TOFA consolidation interaction provisions; and
- ensure that a head company with existing financial arrangements, assumed as part of a pre-TOFA joining, and which the head company elects to bring into TOFA can only use the TOFA transitional balancing adjustment primary method to work out its TOFA transitional balancing adjustments for those existing financial arrangements.

2.20 Finally, the amendments ensure for assets acquired as part of a pre-TOFA joining where the head company has made the transitional election and applies the fair value, reliance on financial reports or retranslation tax timing method, the difference between the tax cost setting amount and the head company's starting value for TOFA purposes is spread over four years from the head company's first TOFA year.

Comparison of key features of new law and current law

New law	*Current law*
The head company is deemed to have received an amount for the assumption of the joining entity's liabilities at the joining time.	The head company is deemed to have assumed the joining entity's liabilities at the joining time.
For liabilities that are subject to a tax timing method other than the fair value, reliance on financial reports or retranslation method, the head company is deemed to have received an amount equal to the amount of the liability as determined in accordance with the joining entity's accounting principles for tax cost setting or comparable standards for accounting made under a foreign law at the joining time.	For liabilities that are subject to a tax timing method other than the fair value, reliance on financial reports or retranslation method, the entry history rule applies to determine the value of liabilities that the head company is in effect deemed to have assumed at the joining time. This means the liability is in effect assumed for its original value, taking into account any repayment of the principal that may have been made in relation to the liability prior to the joining time.
The TOFA transitional balancing adjustment and Subdivision 230-G balancing adjustment are worked out as if the TOFA consolidation interaction provisions had applied to the existing financial arrangements from the time that the head company of the consolidated group starts to have them.	It is unclear whether the TOFA consolidation interaction provisions apply to existing financial arrangements that the head company assumes as part of a pre-TOFA joining and makes a TOFA transitional election to bring into the TOFA regime.
A head company with existing financial arrangements assumed as part of a pre-TOFA joining and in respect of which the head company has made a transitional election into the TOFA regime can only use the TOFA transitional balancing adjustment primary method when working out their TOFA transitional balancing adjustments for those existing financial arrangements.	The head company of consolidated group with existing financial arrangements, assumed as part of a pre-TOFA joining and in respect of which the head company has made a transitional election into the TOFA regime, may use the alternative method to work out its TOFA transitional balancing adjustments for those existing financial arrangements.

New law	*Current law*
For assets acquired as part of a pre-TOFA joining where the head company has made the transitional election and applies the fair value, reliance on financial reports or retranslation tax timing method, the difference between the tax cost setting amount and the head company's starting value for TOFA purposes is spread over four years from the head company's first TOFA year.	It is unclear whether section 701-61 applies to assets acquired as part of a pre-TOFA joining where the head company has made the transitional election.

Detailed explanation of new law

TOFA consolidation interaction provision for liabilities

Clarification that it is the head company who must apply the TOFA provisions to the liabilities

2.21 The exposure draft amends paragraph 715-375(1)(c) so that, in order for subsection 715-375(2) to apply, the liability assumed by the head company at the joining time must be a, or part of, a Division 230 financial arrangement of the head company at the joining time — the joining entity's TOFA status being irrelevant. ***[Schedule 2, item 2]***

2.22 By disregarding the single entity rule under subsection 701-1(1) of the ITAA 1997, item 1 of Schedule 2 to this exposure draft clarifies that the determination of whether there is a liability must be done from the joining entity's perspective at the joining time. ***[Schedule 2, item 1]***

2.23 Subsection 715-375(1) sets out the pre-conditions for subsection 715-175(2) to apply. Paragraphs 715-375(1)(a) and (b) make clear that the subject of section 715-375 is the accounting liability of the joining entity at the joining time (which in this context means immediately before the joining time).

2.24 Paragraph 715-375(1)(c) requires a joining entity's accounting liability to be a 'Division 230 financial arrangement' (or be a part of one). Subsection 995-1(1) defines a 'Division 230 financial arrangement' to be a financial arrangement to which Division 230 applies in relation to the taxpayer's gains and losses from the arrangement.

2.25 Where the joining entity is not a TOFA entity (that is, not applying Division 230 to its financial arrangement liabilities) immediately before the joining time, paragraph 715-375(1)(c) is not satisfied if applied from the joining entity's perspective and subsection 715-375(2) would not apply to deem the head company as having assumed the liabilities at the joining time. This is unintended.

2.26 The intention is to clarify that, while paragraphs 715-375(1)(a) and (b) apply from the joining entity's perspective, paragraph 715-375(1)(c) operates from the head company's perspective.

For liabilities subject to any of the TOFA tax timing methods — deem the head company to have received a payment for starting to have the liability at the joining time

2.27 Item 3 of Schedule 2 of this exposure draft removes subsections 715-375(2), (3) and (4), replacing them with the new subsection 715-375(2) which not only continues to deem the head company as starting to have the joining entity's liabilities at the joining time, but also deems the head company to have received a payment for assuming those liabilities. ***[Schedule 2, item 3]***

2.28 For liabilities subject the fair value, reliance on financial reports or retranslation tax timing methods, that deemed payment equals the amount of the liability assumed by the head company as determined under the current subsections 715-375(3) and (4), that is, the 'Division 230 starting value' as defined in subsection 995-1(1). It is the amount of the liability according to the relevant accounting standard referred to under each of the tax timing methods respectively, that apply in relation to the arrangement.

2.29 For liabilities subject the fair value, reliance on financial reports or retranslation tax timing method, the amendments ensure that the law operate to achieve the original policy intent as outlined in paragraph 12.44 of the explanatory memorandum to the Bill that became the TOFA Act:

> 'for liabilities that are or form part of financial arrangements that are subject to the fair value, foreign exchange retranslation, or reliance on financial reports method, the head company applies Division 230 as if the liability were assumed at the time of joining for an amount equal to the liability's Division 230 starting value.'

2.30 For liabilities subject to the accruals/realisation tax timing method or tax hedging method, the current subsection 715-375(2) does not specify the amount of the liability in the hands of the head company at the joining time. The amendments set the amount of the deemed payment and the amount of the liability in the hands of the head company to be the

accounting value of the liability applying the joining entity's accounting principles (see explanation below).

2.31 Currently, the head company is not deemed to have received a payment equal to the value of the liability they assumed from the joining entity at the joining time for any of the TOFA tax timing methods. As a result, a head company applying any of the TOFA tax timing methods is able to obtain tax outcomes for the gains or losses that accrue during the period that the joining entity held the accounting liability prior to the joining time.

2.32 Such an approach is inconsistent with the TOFA overarching objective to allocate the gains and losses from a financial arrangement to 'the period to which the gains or losses relate' so as to more closely align with commercial norms. In a merger or takeover, the head company should not be able to claim deductions for losses from financial arrangements that relate to the pre-joining/consolidation period.

2.33 It is also inconsistent with the principle of the consolidation regime to avoid duplication of losses.

Example 2.6: Derivative liability assumed by the head company as part of a consolidation event and to which the fair value, reliance on financial reports or retranslation tax timing methods applies

On 1 July 2011, a joining entity entered into a cash-settlable forward transaction for $0. The term of the forward is three years.

On 1 July 2012, the joining entity becomes a subsidiary member of a consolidated group, which is a TOFA taxpayer (having entered the TOFA regime on 1 July 2010) and made a fair value tax timing election.

At the time of joining, the forward has a fair value of –$120. Because the forward is fair valued through profit/loss for accounting purposes, –$120 is also the amount for tax purposes under the fair value tax timing method.

On 1 July 2014, the forward matures with a fair value of –$100, and is settled with a payment of $100.

As subsection 715-375(1) is satisfied, the amended paragraph 715-75(2)(b) applies to treat the head company of the consolidated group as starting to have the forward at the joining time for receiving a payment equal to $120, the forward's Division 230 starting value at the joining time.

On disposal the head company brings to account no gain or loss for tax purposes, as the $20 gain (being the difference between the deemed

receipt of $120 and actual payment of $100 to settle the forward) had been brought to account under the fair value tax timing method (being the change in fair value of the forward from the time the head company assumes the forward from the joining entity until the swap matures).

Without the amendments to subsection 715-375(2), the head company would be treated as starting to have an accounting liability at joining time, valued at –$120 (its Division 230 starting value at the joining time) for the purposes of Division 230 and the transitional balancing adjustment.

At disposal, without the amendments, the head company would be able to deduct $120 loss, as the head company paid $100 to settle the forward (which would not be offset by the deemed receipt) and brought to account $20 gain under the fair value tax timing method.

For liabilities that are subject to the accruals/realisation tax timing method or the tax hedging method — the head company's TOFA starting value is the amount of the liability, as determined in accordance with the joining entity's accounting principles for tax cost setting

2.34 The amended subsection 715-375(2) sets, where the head company is to apply the accruals/realisation tax timing method or the tax hedging method, the amount of the liability in the hands of the head company at the joining time. This is also the amount the head company is deemed to have received as a payment for assuming the liability at the joining time. ***[Schedule 2, item 3]***

2.35 For liabilities to which the head company applies the accruals/realisation tax timing method or the tax hedging method, the current subsection 715-375(2) does not specify the head company's TOFA starting value for assuming the liability from the joining entity at the joining time.

2.36 Furthermore, paragraph 12.43 of the TOFA explanatory memorandum states that the consolidation entry history rule applies to these liabilities, which in practice means the head company assumes the liability for its original value (taking into account any repayments of the principal prior to the joining time).

2.37 By assuming the liability for its original value (applying the entry history rule), the head company includes gains and losses on the financial arrangement that relate to a period before the head company assumed the liability at the joining time. As noted above, this is contrary to the overarching policy design of the TOFA regime.

2.38 The new paragraph 715-375(2)(a) of Schedule 2 to this exposure draft provides that, for the liabilities to which the head company is to

apply the accruals/realisation tax timing method or the tax hedging method, the amount of the liability in the hands of the head company at the joining time is the liability's accounting value applying the joining entity's accounting principles. ***[Schedule 2, paragraph3(2)(a)]***

2.39 This effectively switches off the entry history rule in respect of the arrangement, ensuring that the head company is only able to account for gains and losses on the financial arrangement that accrue after it assumed the liability from the joining entity at the joining time.

2.40 It is also consistent with the treatment of assets and ensures symmetrical treatment of assets and liabilities as a financial arrangement can change from an asset to a liability and vice versa.

2.41 However, unlike the fair value, reliance on financial reports or retranslation tax timing methods, there are no specific accounting standards that apply to a head company that applies the accruals/realisation tax timing method to its financial arrangements.

2.42 Moreover, there is a possibility that the accounting principles applied to the liability by the joining entity immediately before the joining time are not the same accounting principles that the head company applies to its liabilities. This could result in there being two different accounting values for the liability at the joining time. Using the head company's accounting principles may result in the difference not being subject to taxation.

2.43 To address these issues, the new paragraph 715-375(2)(a) sets the amount of the liability subject to the accruals/realisation tax timing method or the tax hedging method in the hands of the head company at the joining time to be the amount of the liability, as determined in accordance with the joining entity's accounting principles for tax cost setting or comparable standards for accounting made under a foreign law. ***[Schedule 2, paragraph 3(2)(a)]***

Example 2.7: Foreign currency denominated loan assumed by the head company as part of a consolidation event and to which the accrual/realisation tax timing method applies

On 1 July 2011, a joining entity entered into a foreign currency denominated liability under which:

- it receives US$100 on 1 July 2011,
- must pay AU$10 interest on 1 July 2012, 1 July 2013 and 1 July 2014; and
- must repay US$100 on 1 July 2014.

As at 1 July 2011, AU$1 buys US$1. As a result, the AUD value of the US$100 received is $100.

On 1 July 2012, and just after the interest payable on 1 July 2012 is paid, the joining entity becomes a subsidiary member of a consolidated group, which is a TOFA taxpayer (having entered the TOFA regime on 1 July 2010). The head company makes no TOFA tax timing method election, and as a result applies the accruals/realisation tax timing method to its financial arrangements (including the liability).

At the time of joining, the joining entity's accounting principles for tax cost setting determine the amount of the liability as –$120. This is because, at the time of joining, AU$1 buys US$0.8333.

On 1 July 2014, the US$100 is repaid. The AUD value of this payment, at the time of payment, is $120.

As subsection 715-375(1) is satisfied, the new paragraph 715 375(2)(a) applies to treat the head company of the consolidated group as starting to have the accounting liability at the joining time for receiving a payment equal to $120. This is the amount of the liability determined in accordance with the joining entity's accounting principles for tax cost setting at the joining time.

On 1 July 2014, the liability comes to an end. For the purposes of working out the Subdivision 230-G balancing adjustment for the liability, the head company is deemed to have received $120 for assuming the liability under step 1(a) of the method statement. And the amount of the liability in the hands of the head company at the joining time (that is –$120) is used to work out the gain or loss and the spreading of that gain or loss on an on-going basis.

TOFA transitional balancing adjustment — pre-TOFA joining/consolidation events

Pre-condition to the application of the new subitems 104B(2) to (4)

2.44 The new subitem 104B(1) provides the conditions for the application of the new subitems 104B(2), (3) and (4). ***[Schedule 2, subitems 104B(1)]***

2.45 The new subitems only apply to assets and liabilities acquired/assumed by the head company from the joining entity at the joining time as a result of the single entity rule ***[Schedule 2, paragraphs 104B(1)(a) and (b)].*** The single entity rule states that following consolidation, members of a consolidated group are treated as a single entity for income tax purposes. Subsidiary entities lose their individual income tax identities and upon entry into a consolidated group are treated as part of the head company.

2.46 These assets and liabilities must be, or must be part of, a financial arrangement at the start of the head company's first applicable income year. ***[Schedule 2, paragraph 104B(1)(c)]***

2.47 Item 102 of Schedule 1 to the TOFA Act defines first applicable income year (first TOFA year) as the first income year for which the TOFA provisions apply to the taxpayer.

2.48 Subsection 995-1(1) defines a 'financial arrangement' as having the meaning given by sections 230-45 to 230-50. That is, the asset or liability is, or is part, of a financial arrangement that satisfies either section 230-45 or 230-50.

2.49 The head company's first TOFA year must start after the joining time and the head company must have the asset or liability for the whole period from the joining time to the start of the head company's first TOFA year, whether or not because of the single entity rule. ***[Schedule 2, paragraphs 104B(1)(d) and (e)]***

2.50 'Joining time' is defined in the new paragraph 104B(1)(a) as the time the joining entity becomes a subsidiary member of the consolidated group or MEC group. This definition is consistent with the meaning of joining time under the consolidation provisions.

2.51 The intention of the inclusion of the words 'Whether or not because of the single entity rule…' is to ensure that item 104B applies where the head company acquires/assumes financial arrangements from the joining entity at the joining time and then later the joining entity legally transfer those financial arrangements to the head company.

2.52 Finally, the head company must elect to have subitem 104(2) apply to itself. ***[Schedule 2, paragraph 104B(1)(f)]***

2.53 Subitem 104(2) of Schedule 1 to the TOFA Act sets out that the TOFA provisions apply to all financial arrangements that the head company starts to have before the start of its first TOFA year and continues to have at the start of its first TOFA year, provided that the head company elects to have subitem 104(2) apply to them. Thus, new subitems 104B(2) to (4) only apply to assets or liabilities that the head company acquires/assumes from the joining entity at the joining time as part of a pre-TOFA joining and the head company has elected to apply the TOFA provisions to its existing financial arrangements (including these assets and liabilities).

Existing assets acquired from the joining entity as part of the pre-TOFA joining

2.54 Subsection 701-55(5A) determines, for TOFA purposes, the time that the head company starts to have the asset and the amount that the head company is deemed to have paid for the asset.

2.55 It provides that the head company is deemed to have acquired the asset for its Division 230 starting value (where the asset is subject to a fair value, reliance on financial reports or retranslation tax timing election), or its tax cost setting amount (where the asset is subject to the accruals/realisation tax timing method or tax hedging method) at the joining time.

2.56 However, the subsection 701-55(5A) only applies once the pre-condition 'if Division 230 is to apply in relation to the asset' is satisfied.

2.57 In the context of a pre-TOFA joining, if the pre-condition is tested at the joining time, it is unclear whether the pre-condition can be satisfied because at the joining time, the head company is not in the TOFA regime. As such, it is unclear whether Division 230 can apply in relation to the asset at the joining time and therefore whether subsection 701-55(5A) can apply to set the time the head company starts to have the asset; the amount of the asset in the hands of the head company at the joining time for the purposes of working out the transitional balancing adjustment; and the amount deemed to have been paid by the head company for the asset for the purpose of working out the Subdivision 230-G balancing adjustment. This is unintended.

2.58 Consequently, the new paragraph 104B(2)(a) is designed to ensure that, for the purposes of transitioning the asset into the TOFA regime and working out the Subdivision 230-G balancing adjustment, subsection 701-55(5A) applies to the assets acquired by the head company from the joining entity at the joining time as part of a pre-TOFA joining and which the head company has elected to transition into the TOFA regime. ***[Schedule 2, paragraph 104B(2)(a)]***

2.59 The assumed application of subsection 701-55(5A) to a pre-TOFA joining has the following implications:

- for the purposes of working out the TOFA transitional balancing adjustment for the asset:
  - the head company is deemed to start to have the asset at the joining time, which is prior to the head company

entering into the TOFA regime (that is, steps 1 to 4 of subitem 104(13) of the TOFA Act); and

– the amount the head company is deemed by subsection 701-55(5A) to have provided for acquiring the asset sets the amount of the asset in the hands of the head company at the joining time which is then taken into account in working out what would be the tax outcome if the TOFA provisions had applied to the asset from the time the head company starts to have the asset (that is, steps 1 and 2 of subitem 104(13) of the TOFA Act, but steps 3 and 4 of subitem 104(13) of the TOFA Act are not intended to be affected); and

- the head company's deemed payment for the asset at the joining time is taken into account in working out the Subdivision 230-G balancing adjustment that is made when the asset ceases to be held by the head company (for example, upon maturity or disposal).

Example 2.8: Derivative asset acquired by the head company as part of a pre-TOFA joining and transitioning into the TOFA regime

On 1 July 2008, a joining entity entered into a cash-settlable forward transaction for $0. The term of the forward is four years.

On 1 July 2009, the joining entity becomes a subsidiary member of a consolidated group. At the time of joining, the forward has a fair value of $120. Because the forward is fair valued through profit/loss for accounting purposes, $120 is also the amount of the asset for tax purposes applying the fair value tax timing method.

The head company continues to hold the forward until it enters into the TOFA regime on 1 July 2010, which is the start of the head company's first TOFA year. At that time, the fair value of the asset is $100.

On 1 July 2010, the head company makes an irrevocable election under item 104(2) of the TOFA Act to apply the TOFA provisions in relation to all of the financial arrangements it had on 1 July 2010. It also makes a valid fair value tax timing election under Subdivision 230-C.

As such, the asset satisfies the conditions under the new subitem 104B(1). Paragraph 104B(2)(a) applies in relation to the asset. The assumed application of subsection 701-55(5A) to the asset has the following consequences:

- for the purposes of applying subitem 104(13) of the TOFA Act in working out the transitional balancing adjustment for the asset, the head company is treated as if it acquired the asset at the joining

time for a payment equal to the asset's Division 230 starting value at the joining time; and

- for the purposes of applying section 230-445 in working out the Subdivision 230-G balancing adjustment for the forward when it matures on 1 July 2012, the head company is deemed to have paid an amount equal to the forward's Division 230 starting value at the joining time.

Transitional balancing adjustment

Applying this assumption, the result of the transitional balancing adjustment would be as follows:

Step 1: $0 (This is because the subitem 104(13) method statement is to be calculated on the assumption that subsection 701-55(5A) applied in relation to the asset at the joining time which resulted in the head company starting to have the asset. As such, the increase in fair value of the forward that occurred between 1 July 2008 and 1 July 2009 is ignored for the purposes of step 1).

Step 2: $20 (The decrease in the fair value from the joining time would have been a loss that would have been made from the forward had Subdivision 230-C applied in relation to the forward after the joining time).

Step 3: $0 (No amounts have been assessed since the joining time.)

Step 4: $0 (No amounts have been deducted since the joining time.)

Step 5: $0

Step 6: $20

Step 7: $20 loss allowed as a deduction, and spread in accordance with subitem 104(17) — Subdivision 230-G balancing adjustment

Applying the method statement in section 230-445 when the forward matures on 1 July 2012:

Step 1(a): $0 (on the assumption the forward matures on 1 July 2012 with fair value of $0).

Step 1(b): $110 (This includes the transitional balancing adjustment amount included so far allowed as a deduction and the decline in fair value from 1 July 2010 to 1 July 2012 which has already been deducted over those two years under the fair value method).

Step 1(c): $0

Step 1(d): $10 (the transitional balancing adjustment amount yet to be allowed as a deduction).

Step 1 result: $120

Step 2(a): $120 (the deemed acquisition in accordance with the assumed application of paragraph 701-55(5A)(b) by paragraph 104B(2)(a)).

Step 2(b): $0

Steps (c) to (e): $0

Step 2 result: $120

Step 3: Subdivision 230-G balancing adjustment of $0 upon maturity.

As such, from the head company's perspective, the forward has an overall loss of $120 over its term, of which $20 loss was brought to account as the TOFA transitional adjustment; and $100 loss was brought to account under the fair value tax timing method.

Existing liabilities assumed by the head company as part of a pre-TOFA joining and transitioning into the TOFA regime

2.60 As explained above, the new subsection 715-375(2) determines, for TOFA purposes, the time that the head company starts to have the liability and the amount that the head company is deemed to have received for assuming the liability. This deemed receipt gives the amount of the liability in the hands of the head company at the joining time.

2.61 However, the new subsection 715-375(2) only applies, if the pre-conditions in subsection 715-375(1) are first satisfied. One of these preconditions is that the liability is, or is part of, a Division 230 financial arrangement of the head company at the joining time (because of the single entity rule).

2.62 In the case of a pre-TOFA joining, it is unclear whether the liability is, or is not part of a, Division 230 financial arrangement of the head company at the joining time as the head company has yet to enter the TOFA regime. Thus, it is unclear whether subsection 715-375(2) applies to transition a liability assumed by the head company as part of a pre-TOFA joining into the TOFA regime. This is unintended.

2.63 The new paragraph 104B(2)(b) has the effect that section 715-375 is assumed to apply to the liability at the joining time for particular purposes including transitioning the liability into the TOFA regime. ***[Schedule 2, paragraph 104B(2)(b)]***

2.64 The assumed application of section 715-375 to a pre-TOFA joining has the following implications:

- for the purposes of working out the transitional balancing adjustment for the liability:
  - the head company is deemed to start to have the liability at the joining time, which is prior to the head company entering into the TOFA regime (that is, steps 1 to 4 of subitem 104(13) of the TOFA Act); and
  - the amount the head company is deemed by section 715-375 to have received for assuming the liability sets the amount of the liability in the hands of the head company at the joining time which is then taken into account in working out what would be the tax outcome if the TOFA provisions had applied to the liability from the time the head company starts to have the liability (that is, steps 1 and 2 of subitem 104(13) of the TOFA Act, but steps 3 and 4 of subitem 104(13) of the TOFA Act are not intended to be affected); and
- the head company's deemed receipt of a payment for the liability at the joining time is taken into account in working out the Subdivision 230-G balancing adjustment when the liability ceases to be held by the head company (for example, upon maturity or disposal).

Example 2.9: Derivative liability assumed by the head company as part of a pre-TOFA joining and transitioning into the TOFA regime

On 1 July 2008, a joining entity entered into a cash-settlable forward transaction for $0. The term of the forward is four years.

On 1 July 2009, the joining entity becomes a subsidiary member of a consolidated group. At the time of joining, the forward has a fair value of –$120. Because the forward is fair valued through profit/loss for accounting purposes, –$120 is also the amount of the liability for tax purposes, applying the fair value tax timing method.

The head company continues to hold the forward until it enters into the TOFA regime on 1 July 2010, which is the start of the head company's first TOFA year. At that time, the fair value of the liability is –$100.

On 1 July 2010, the head company makes an irrevocable election under subitem 104(2) of the TOFA Act to apply the TOFA provisions in relation to all of the financial arrangements it had on 1 July 2010. It also makes a valid fair value election under Subdivision 230-C.

As such, the liability satisfies the preconditions under the new subitem 104B(1). Paragraph 104B(2)(b) applies in relation to the liability. The assumed application of section 715-375 to the liability has the following consequences:

- for the purposes of applying subitem 104(13) of the TOFA Act to work out the transitional balancing adjustment for the liability, the head company is treated as starting to have the liability at the joining time for receiving a payment equal to the liability's Division 230 starting value at joining time (which, in this case, is -$120); and
- for the purposes of applying section 230-445 to work out the Subdivision 230-G balancing adjustment for the liability when it matures on 1 July 2012, the head company is deemed to have received a payment equal to the forward's Division 230 starting value at the joining time.

Transitional balancing adjustment

Applying this assumption, the result of the transitional balancing adjustment would be as follows:

Step 1: $20 (the increase in fair value from the joining time would have been a gain that would have been made from the forward).

Step 2: $0 (Because the subitem 104(13) method statement is to be calculated on the assumption that section 715-375 applied to deem the head company starting to have the liability at the joining time, the increase in fair value of the forward that occurred between 1 July 2008 and 1 July 2009 is ignored for the purposes of step 2).

Step 3: $0 (No amounts have been assessed since the joining time.)

Step 4: $0 (No amounts have been deducted since the joining time.)

Step 5: $20

Step 6: $0

Step 7: $20 gain included in assessable income, and spread in accordance with subitem 104(17).

Subdivision 230-G balancing adjustment

Applying the method statement in section 230-445 on 1 July 2012, when the forward matures:

Step 1(a): $120 (the deemed assumption in accordance with the assumed application of section 715-375 by paragraph 104B(2)(b)).

Step 1(b): $0

Step 1(c): $0

Step 1(d): $0

Step 1 result: $120

Step 2: $0 (on the assumption that the forward matures on 1 July 2012 with a fair value of $0).

Step 2(b): $110 (The increase in fair value from 1 July 2010 to 1 July 2012 which has already been included as assessable income over those two years under the fair value method and the transitional balancing adjustment amount included so far in assessable income.)

Step 2(c): $0

Step 2(d): $10 (the transitional balancing adjustment amount yet to be included in assessable income).

Step 2 result: $120

Step 3: 230-G balancing adjustment of $0 upon maturity.

As such, from the head company's perspective, the forward has an overall gain of $120 over its term, of which $20 gain was and is to be brought to account as the TOFA transitional adjustment; and $100 gain was brought to account under the fair value tax timing method.

Applying the alternative method to work out the transitional balancing adjustments for existing assets and liabilities acquired/assumed by the head company as part of a pre-TOFA joining

2.65 The new subitem 104B(3) ensures that the subitems 104(14) and (15) cannot be used in calculating the transitional balancing adjustments for existing liabilities and assets that the head company acquired/assumed as part of a pre-TOFA joining and elected to transition into the TOFA regime.

2.66 Under the alternative method, the transitional balancing adjustment for a financial arrangement is worked out by grossing up an amount related to the financial arrangement in the taxpayer's Deferred Tax Asset (DTA) or Deferred Tax Liability (DTL) accounts. The DTA/DTL amounts essentially represent the deductible temporary difference or the taxable temporary difference as defined in the accounting standards: the difference represents a comparison of the tax carrying value with the accounting carrying value. Normally, the grossed up

DTA/DTL amounts are a good approximation of the transitional balancing adjustments that would have been worked out under the primary method.

2.67 However because DTA/DTL calculations do not take into account 'notional tax events', in some cases the alternative method does not provide a reasonable approximation of the amount that would be calculated under the primary method.

2.68 In the case of an asset or liability acquired/assumed by the head company as part of a pre-TOFA joining, the alternative method does not provide a reasonable approximation of the transitional balancing adjustments worked out under the primary method because the DTA/DTL amounts are accumulated from the time the joining entity starts to have the asset or liability. The DTA/DTL amounts reflect the deferred tax effect for the entire period from when the joining entity started to have the financial arrangement until the head company enters into the TOFA regime (unlike the primary method which calculates the difference between actual tax outcomes under the pre-TOFA tax laws and the notional tax outcomes under the TOFA regime from the date the head company started to have the liability until the time the head company started to apply the TOFA provisions).

2.69 For this reason, existing assets and liabilities acquired/assumed by the head company as part of a pre-TOFA joining need to be ‘backed out’ of the alternative method. This is achieved by the new subitem 104B(3) which states that subitems 104(14) and (15) do not apply in relation to these assets and liabilities. ***[Schedule 2, subitem 104B(3)]***

2.70 As such, the head company must use the primary method to calculate the transitional balancing adjustments for these financial arrangements.

Existing assets acquired by the head company as part of a pre-TOFA joining and subject to the fair value, reliance on financial reports or retranslation tax timing methods

2.71 The new subitems 104B(4) to (7) replicates the section 701-61 adjustment for existing assets that the head company acquired as part of a pre-TOFA joining and to which it has elected to apply the fair value, financial reports or retranslation tax timing method. ***[Schedule 2, subitems 104B(4) to 104B(7)]***

2.72 Apart from the transitional balancing adjustment, for assets that are subject to the fair value, reliance on financial reports or retranslation tax timing methods, section 701-61 requires a taxpayer to work out the difference between the tax cost setting amount and the Division 230 starting value of an asset that the head company acquired as part of a

joining/consolidation event, and to spread the difference over four years starting from the income year in which the single entity rule commenced to apply.

2.73 However, section 701-61 may not apply to assets that the head company acquired as part of a pre-TOFA joining and which it has elected to bring into the TOFA regime and to apply the fair value, financial reports or retranslation tax timing methods. This is because, as explained in paragraph 2.60, it is unclear whether subsection 701-55(5A) can apply at a joining time prior to the head company entering the TOFA regime.

2.74 New subitems104B(4) to (7) are designed to achieve the same outcome as provided under section 701-61 for assets that are acquired by the head company as a result of a pre-TOFA joining, except the difference between the asset's tax cost setting amount and the Division 230 starting value is to be spread over four years, starting from the head company's first TOFA year, as opposed to the income year in which the joining occurred.

Example 2.10: Derivative asset acquired by the head company as part of a pre-TOFA joining, transitioning into the TOFA regime and to which the head company applies the fair value, reliance on financial reports or retranslation tax timing methods

This is a continuation of Example 2.3.

On 1 July 2009 the head company acquires all of the joining entity's membership interests for $1050. Consequently, the joining entity joins head company's consolidated group.

The joining entity has two assets, the forward which has a fair value of $120 and cash at bank of $1000.

In setting the tax costs of the assets of the joining entity, assuming the joining entity has no liabilities, the allocable cost amount (ACA) for the joining entity is $1050.

Cash at bank is a retained cost base asset and has its tax cost set at $1000.

The remaining ACA of $50 is allocated to the forward which is a reset cost base asset. The tax cost of the forward is set at $50, despite the fact that its fair value at the joining time is $120.

Applying subitem 104B(5), the Division 230 starting value at the joining time is $120. The tax cost setting amount at the joining time was $50. This means that the Division 230 starting value at the joining time exceeds the tax cost setting amount. Because of this, $17.50 (that

is, 25 per cent of this excess) is to be included in the head company's assessable income for:

- the income year that started on 1 July 2010; and
- each of the three subsequent income years.